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**PROGRAM DESCRIPTIONS AND GENERAL
BUDGET INFORMATION FOR
FISCAL YEAR 1998**

Prepared by the Staff of the
**COMMITTEE ON FINANCE
UNITED STATES SENATE**
WILLIAM V. ROTH, JR., *Chairman*



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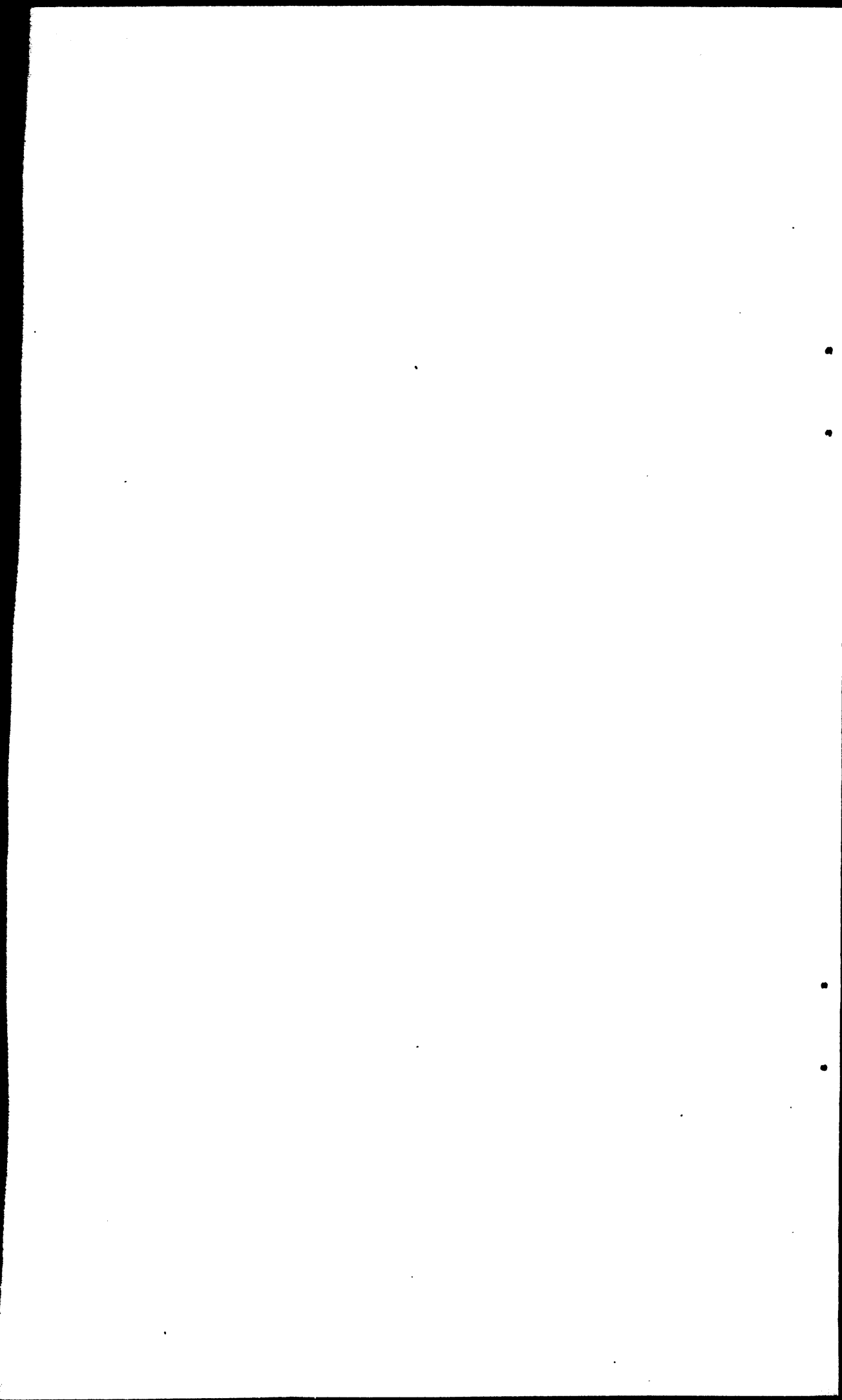
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PREFACE

This document contains data and information that will be needed by the Committee on Finance for meeting its FY1998 budget reconciliation instructions. Included are descriptions of the budget process and constraints, followed by descriptions of each of President Clinton's FY1998 budget proposals that falls within the jurisdiction of the Committee on Finance. A description of present law precedes the description of each proposal. At the end of each section are tables showing the estimated budgetary effects of the proposals prepared both by the Joint Committee on Taxation (revenues) or the Congressional Budget Office (spending), and estimates prepared by the Office of Management and Budget are also included.

The Committee would like to thank the staffs of the Joint Committee on Taxation, the Congressional Research Service, and the Congressional Budget Office for their assistance in preparing this document.



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BUDGET PROCESS AND CONSTRAINTS

A. Budget Enforcement Procedures

The Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as Gramm-Rudman-Hollings) set annual deficit targets that were intended to lead to a balanced budget in 1991. It also established a procedure—known as sequestration—to make those goals binding. Under sequestration, an across-the-board reduction in spending (excepting numerous entitlement programs) would automatically occur if the projected deficit exceeded its goal. The deficit targets were revised in 1987, and lawmakers designated 1993 as the year in which the deficit would be eliminated. Although the deficit declined in the fiscal year following enactment of Gramm-Rudman-Hollings (and remained virtually at the same level for the next 2 years) the fixed deficit target approach failed to achieve the desired reductions. (For 1990, the last year for which the procedures were fully in effect, the actual deficit exceeded the revised target deficit by \$121 billion and the original target by \$185 billion.) Moreover, that approach led to rosy economic projections, the use of questionable budgetary saving such as timing shifts, and a perception that the process put an unfair burden on discretionary appropriations. Consequently, the law was amended by the Budget Enforcement Act of 1990 (BEA).

In place of fixed deficit targets, the BEA established annual caps on discretionary budget authority and outlays provided in appropriation acts. It also instituted a pay-as-you-go requirement for mandatory spending and revenue legislation. Under the BEA, discretionary appropriations in excess of the caps trigger a sequestration of only discretionary spending. Furthermore, a sequestration of mandatory spending is imposed if the net effect of all legislation affecting mandatory spending or revenues is to increase the deficit. The BEA kept those rules in place through fiscal year 1995. The Omnibus Budget Reconciliation Act of 1993 extended them through fiscal year 1998, with essentially no change.

In general, the BEA procedures have been successful in preventing new legislation from increasing the deficit. One indication that the pay-as-you-go procedure has been effective is that since 1990 proponents of legislation that would increase mandatory spending or cut taxes have almost always been greeted with, "How are you going to pay for it?" That may seem an obvious question, but it was one that proponents of legislation did not generally have to answer before 1990. In addition, there have been no pay-as-you-go sequestrations. Since the enactment of the BEA, only two small discretionary sequestrations have been ordered. In one case, the sequestration offset an overage that the Office of Management and Budget estimated at \$2.4 million (the Congressional Budget Office estimated that appropriations did not exceed the cap), which resulted

in a sequester reducing each discretionary spending account by .0013 percent. In the other instance, enacted appropriations exceeded the cap by \$395 million because of a drafting mistake in an appropriation bill enacted just before the Congress adjourned for the year. When the Congress reconvened, it enacted legislation that corrected the mistake and canceled the sequestration.

Although the BEA procedures have been successful in constraining new budgetary legislation, many Members of Congress have expressed concern that those constraints do not limit increases in mandatory spending that can occur without changes in law and do not require the elimination of deficits. With the expiration of the BEA procedures looming, the Congress must decide whether to extend those constraints (either in essentially the same form or with modifications).

B. The Line-Item Veto

The Line Item Veto Act was enacted last year and went into effect on January 1, 1997. The act, which as indicated below was subsequently declared unconstitutional by a Federal District Court, represents a different kind of constraint on the budgetary decisions of the Congress by granting the President the authority to cancel certain new spending or tax benefits signed into law after that date. The act was to have remained in effect for 8 years. Since a final adjudication of the act's constitutionality may not be rendered until later in 1997 or in 1998, a description of the act's provisions follow.

The Line Item Veto Act is intended to allow the President—as part of a broader effort to reduce the deficit—to eliminate new spending and tax breaks that he deems wasteful or unnecessary. Although there is disagreement over whether the new law will reduce the deficit, most observers agree that it is a significant change in the Federal budget process that is likely to shift budgetary power from the Congress to the President.

Under the act, the President may cancel “any dollar amount of discretionary budget authority, any item of new direct spending, or any limited tax benefit” that he signs into law. The President must notify the Congress of any cancellations by special message and he must do so within 5 days of signing the law from which cancellations have been made. Cancellations go into effect only when the Congress receives the special message.

A cancellation may only be overturned by the enactment of a subsequent law. For each special message, the Congress may consider a “disapproval bill” under fast-track legislative procedures during a 30-day review period (that could extend well beyond 30 calendar days because of recesses and adjournments). The President may not use his cancellation authority on a disapproval bill. Of course, the Congress may include provisions overturning cancellations as part of a measure that is not a disapproval bill, but such a measure would not come under fast-track procedures or be protected from the President's cancellation authority.

Before the Line Item Veto Act, the President could propose to cancel amounts of budget authority provided by law, but any such rescission that he proposed had to be enacted into law to go into effect permanently. Under the act, the President may unilaterally

cancel certain spending and tax benefits that he has signed into law, and any cancellations can only be reversed by the enactment of a subsequent law. Because the President seems likely to veto any disapproval bill, such a measure will probably require the support of two-thirds of the Congress—the margin needed to override a veto—to ensure its enactment.

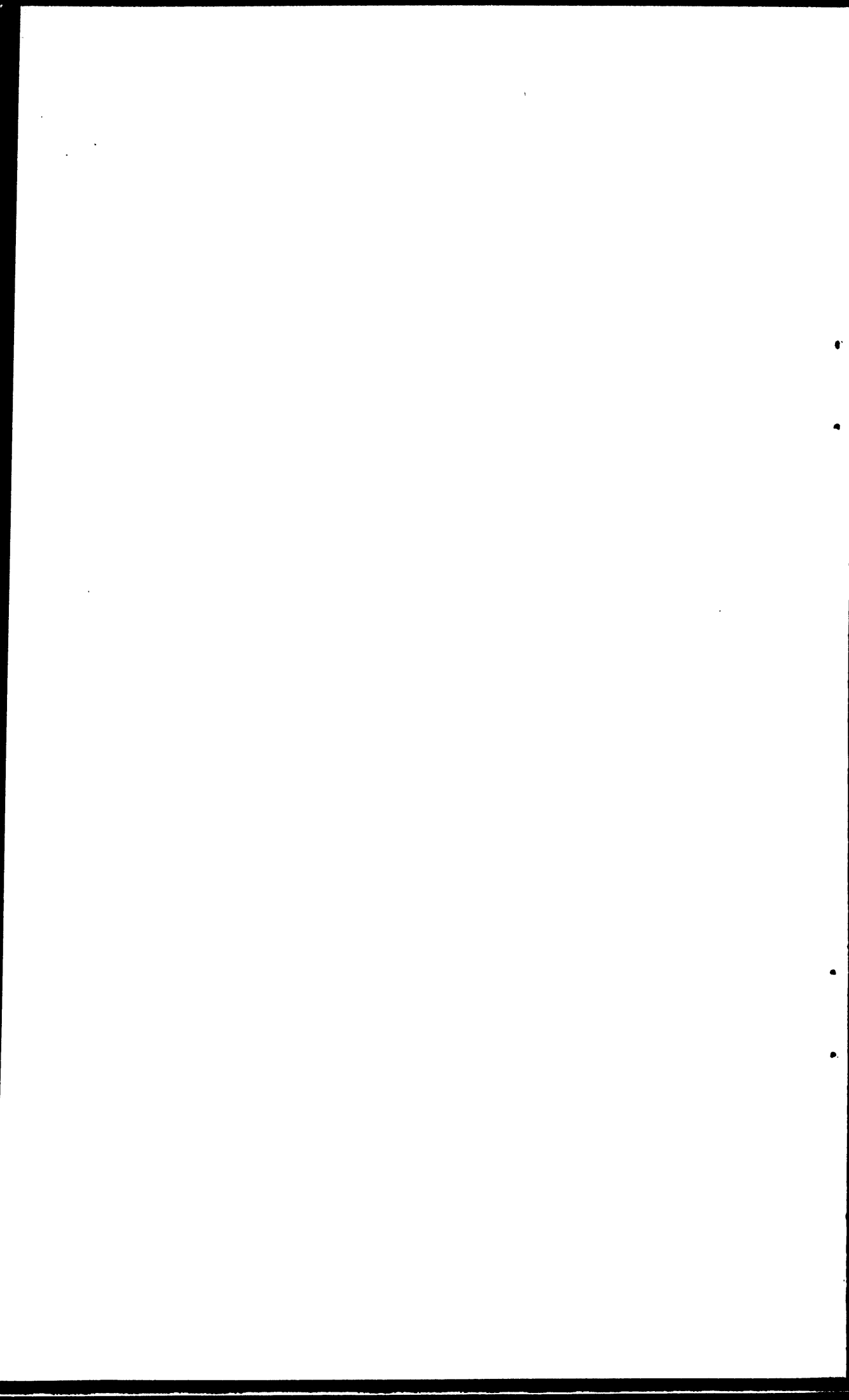
In certain respects the act is broader, and in others more restrictive, than some earlier proposals to expand the President's impoundment authority. For example, earlier proposals generally would have applied only to discretionary appropriations provided in annual appropriations acts. The act permits the President to cancel such amounts as well as certain new, direct (mandatory) spending and tax benefits. In the case of discretionary appropriations, however, the President may only cancel entire dollar amounts specified in appropriations acts, governing committee reports, or related statutes. He may not cancel a portion of such amounts, which would have been allowed under some earlier proposals.

Budget enforcement procedures in effect since 1990 have worked to prevent new spending and revenue laws from increasing the deficit. It is unclear whether, if sustained by the Supreme Court, the President's new authority will lead to further reductions in the deficit or will simply empower him to substitute his own budgetary priorities for those of the Congress. In any event, the act does not address the leading cause of recent and projected deficits; namely, mandatory spending increases under existing law. To control such spending, whether as part of a plan to balance the budget or for other purposes, the Congress must enact legislation modifying existing laws.

On January 2, 1997, a lawsuit was filed in the U.S. District Court for the District of Columbia challenging the constitutionality of the act. The plaintiffs, six Members of Congress, including Senators Byrd, Hatfield, Levin, and Moynihan, contended that the act violated Art. I, Sec. 7 of the Constitution, which requires that any bill making or changing Federal law must be passed by both houses of Congress and then presented to the President *in toto*, in which form he must sign it (or allow it to become law by the passage of 10 days, Sundays excepted) or veto it. The defendants in the case, which was captioned *Sen. Robert C. Byrd, et al. v. Franklin Raines, et al.*, were the Director of the Office of Management and Budget and the Secretary of the Treasury.

The District Court heard oral argument in *Byrd v. Raines* on March 21, 1997, and on April 10, 1997, the court ordered that the Line Item Veto Act was adjudged and declared unconstitutional. In an opinion by Judge Thomas Penfield Jackson, the court held that the act was unconstitutional because it effectively permitted the President to repeal duly enacted provisions of Federal law, which is a function reserved to the Congress under the Constitution.

At the time of this writing, it is expected that the defendants will appeal the District Court's decision directly to the U.S. Supreme Court pursuant to Section 3 of the Line Item Veto Act, which provides for expedited judicial review.



REVENUE PROVISIONS

This section,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the revenue provisions contained in the President's fiscal year 1998 budget proposal, as submitted to the Congress on February 6 1997.²

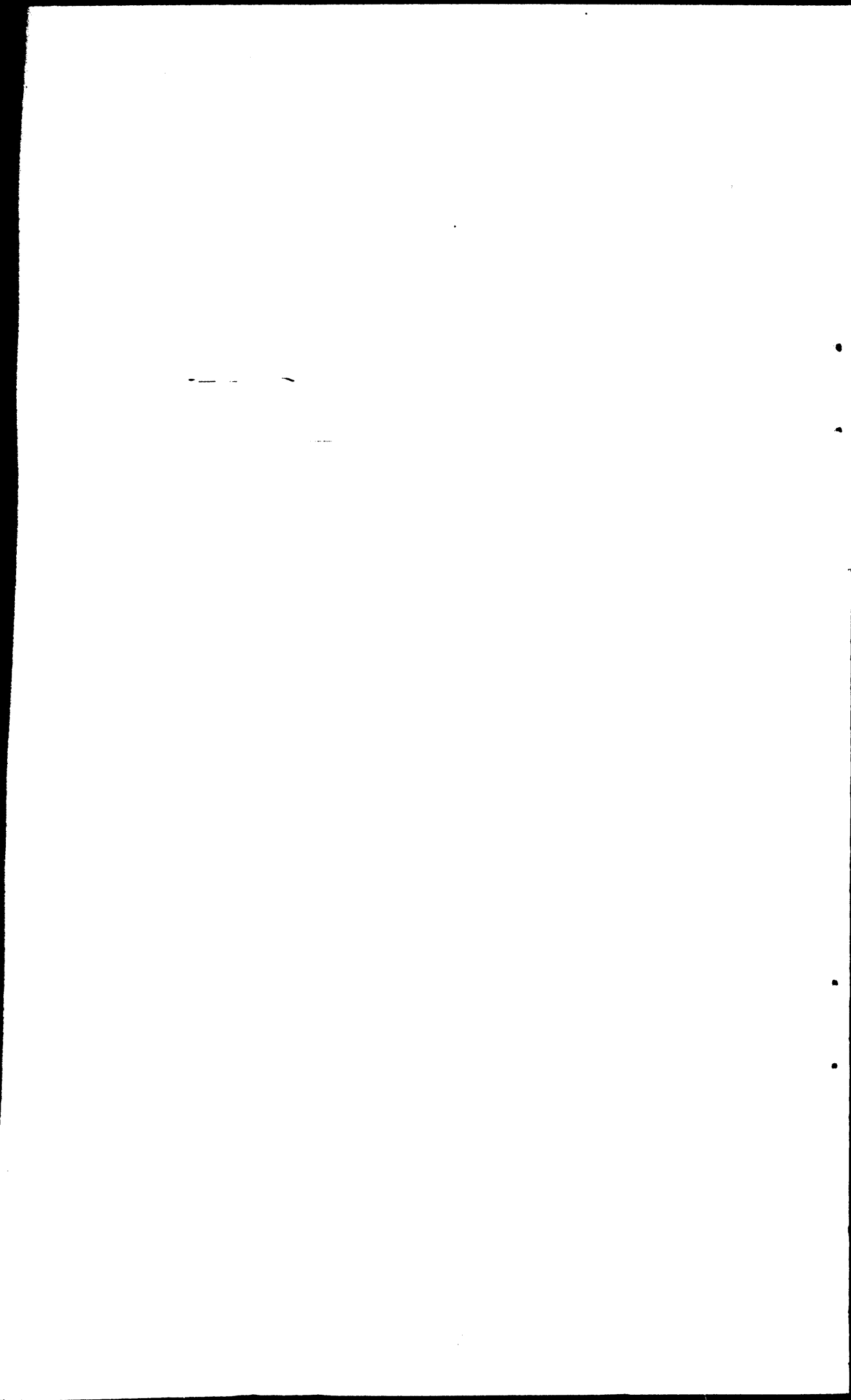
This section does not include a description of certain user fees and other proposals contained in the President's fiscal year 1998 budget proposal that may or may not be considered to be in the jurisdiction of the House Committee on Ways and Means or the Senate Committee on Finance.³

This section contains only a description of present law and each of the tax revenue proposals contained in the President's budget. The document does not provide any analysis of the policy issues raised by the proposals. The Joint Committee staff anticipates providing such policy analysis at a later date (e.g., in connection with Senate Finance or Ways and Means Committee hearings on the proposals).

¹ This section may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCX-6-97R), February 10, 1996.

² See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals, February 1997*. Also, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, pp. 45-60.

³ See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, pp. 61-69.



I. TAX CUT SUNSET

The President's budget proposal states that a mechanism will apply to ensure that the budget is balanced in 2002 under both Office of Management and Budget ("OMB") and Congressional Budget Office ("CBO") economic assumptions. Specifically, the President's budget states the following:

"The Administration is confident that its own assumptions will continue to prove the more accurate.

"Nevertheless, the budget includes a mechanism to ensure that the President's plan reaches balance in 2002 under OMB or CBO assumptions. If OMB's assumptions prove correct, as we expect, then the mechanism would not take effect. If, however, CBO proves correct—and the President and Congress cannot agree on how to close the gap through expedited procedures—then most of the President's tax cuts would sunset, and discretionary budget authority and identified entitlement programs would face an across-the-board limit."⁴

The budget proposal documents published by the Administration contain no additional detail with respect to the sunset mechanism as relates to the President's tax proposals. A draft document provided by OMB to the staff of the Joint Committee on Taxation specifies in detail the application of the mechanism to spending provisions. However, with respect to the tax reduction provisions in the President's budget, the OMB document merely states that specified tax cuts sunset at the end of calendar year 2000.

The Treasury Department has indicated in a draft document provided to the staff of the Joint Committee on Taxation that the sunset mechanism would apply to the following provisions: (1) the tax credit for families with young children, (2) the HOPE scholarship tuition tax credit, (3) the education and job training deduction, (4) the expanded Individual Retirement Arrangement ("IRA") provisions, (5) the expanded empowerment zone and enterprise communities provision, and (6) the deduction for environmental remediation expenses ("Brownfields"). The Treasury Department provided specific detail with respect to how the IRA provisions would be sunset under the mechanism, but did not provide details with respect to the application of the sunset to the other specified tax cut provisions.

Until additional information is known regarding the application of the sunset mechanism, the staff of the Joint Committee on Taxation is not able to provide an analysis of the sunset mechanism nor can the budget effects of the Administration's tax proposals be finally estimated. In order to provide such analysis and revenue estimates, the following information is required: (1) a description of

⁴Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998*.

how the sunset date identified by the OMB would apply to the specified tax cut provisions, other than IRAs, (2) statutory language detailing the application of the sunset mechanism, and (3) a CBO analysis of the budget proposal and the sunset mechanism. The President's budget documents and the OMB description of the sunset mechanism appear to assume that CBO economic assumptions will trigger the application of the tax cut sunset mechanism. However, the estimated budget receipts shown in the President's budget proposal do not incorporate the effects of the sunset mechanism.

II. MIDDLE CLASS TAX RELIEF

A. Tax Credit for Families with Children Under Age 13

Present Law

In general

Present law does not provide any tax credit specific based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount for personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is \$2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of \$121,200 for single taxpayers, \$151,500 for heads of household, and \$181,800 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

In addition, under present law, taxpayers with children may be entitled to (1) a tax credit for child care expenses and (2) an exclusion from income for employer-provided dependent care assistance. Further, the amount of earned income credit (EIC) to which a taxpayer is entitled may be increased depending upon the taxpayer's family size.

Description of Proposal

The proposal would provide taxpayers with a nonrefundable tax credit of \$300 for each qualifying child under the age of 13 (as of the close of the calendar year in which the taxpayer's taxable year begins) for taxable years 1997, 1998 and 1999. The credit would be calculated before the application of the earned income credit (in a manner similar to the provision contained in the Balanced Budget Act of 1995 as passed by the Congress). The amount of the credit would be increased to \$500 for each qualifying child for taxable years beginning after December 31, 1999.

The credit would be phased out ratably for taxpayers with AGI over \$60,000 and would be fully phased out at AGI of \$75,000. In the case of a taxable year beginning after calendar year 2000, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1996. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset the child credit for calendar years after 2000. See the description of this sunset mechanism in Part I., above.

B. Tax Incentives for Education and Training

1. HOPE scholarship tuition tax credit

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to \$5,250 paid by his or her employer for educational assistance, regardless of whether the education maintains or improves a skill required by the employee's current position (sec. 127). This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997⁵ (and does not apply to graduate level courses beginning after June 30, 1996).

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁶ "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds

⁵The legislative history of the Small Business Job Protection Act of 1996 indicated Congressional intent to extend the exclusion for employer-provided educational assistance through May 31, 1997. The statute, however, extended the exclusion through June 30, 1997.

⁶If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses

do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceeds contributions made by that person.

Description of Proposal

Individual taxpayers would be allowed to claim a non-refundable credit against Federal income taxes up to \$1,500 per student per year for tuition and required fees (but not room and board expenses) for the first two years of the student's post-secondary education in a degree or certificate program. The education expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The credit would be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. With respect to each student, a taxpayer may claim either the credit or the proposed above-the-line deduction (described below). If, for any taxable year, a taxpayer chooses to claim a credit with respect to a particular student, then the proposed above-the-line deduction will not be available with respect to that particular student for that year (although the proposed deduction may be available with respect to that student for other taxable years, such as after the student completes two years of college and no longer is eligible for the credit). For one taxable year, a taxpayer may claim the proposed above-the-line deduction for education expenses with respect to one student and also claim the credit with respect to other students. An eligible student would not be entitled to claim a credit under the proposal if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student would be treated as paid by the parent for purposes of the proposal.

With respect to each individual student, a taxpayer is limited to a tuition tax credit of the lesser of the qualified education expenses incurred during the taxable year with respect to that student or the maximum credit amount. The maximum credit amount for a taxable year would be \$1,500, reduced by any Federal educational grants, such as Pell Grants, awarded to the student for that year (or for education beginning in the first three months of the next year, if credits are claimed based on payments for that education). Beginning in 1998, the maximum credit amount would be indexed for inflation, rounded down to the closest multiple of \$50.

The maximum credit amount would be phased out ratably for taxpayers with modified AGI between \$50,000 and \$70,000 (\$80,000 and \$100,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise ex-

cluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Modified AGI for purposes of the credit would be determined without regard to the proposed above-the-line deduction for higher education expenses (described below) in cases where the credit is claimed with respect to one student and the deduction is claimed with respect to another student in the same taxable year. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of \$5,000.

The credit would be available for "qualified higher education expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, books, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified higher education expenses unless this education is part of a degree program.

An eligible student would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible institution of higher education. The student must pursue a course of study on at least a half-time basis. In addition, for a student's qualified higher education expenses to be eligible for the credit, the student must not have been convicted of a Federal or State felony consisting of the possession or distribution of certain drugs, and generally cannot be a nonresident alien. Furthermore, a taxpayer would be entitled to the credit for a student in a second taxable year only if the student obtained a qualifying grade point average for all previous post-secondary education. Generally, this would be an average of at least 2.75 on a 4-point scale, or a substantially similar measure of achievement.⁷

Eligible institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified education expenses generally would include only out-of-pocket tuition and fees. Qualified education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and required fees would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any tax-free veteran's educational benefits. In addition, qualified education expenses would be reduced by the interest from U.S. savings bonds

⁷ Institutions that do not use a 4-point grading scale would be allowed to retain their own system while still allowing their students to qualify for the credit; these institutions will determine what measure under the system they use reasonably approximates a B-GPA.

that is excludable from gross income under section 135 for the taxable year. However, no reduction of qualified education expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under any section of the Code (including the proposed above-the-line deduction for education expenses), then no credit would be available for such expenses.

The credit would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified higher education expenses paid with the proceeds of a loan generally would be eligible for the credit (rather than repayment of the loan itself). The credit would be recaptured in cases where the student or taxpayer receives a refund (or reimbursement through insurance) of tuition and fees for which a credit has been claimed in a prior year.

The Secretary of the Treasury (in consultation with the Secretary of Education) would have authority to issue regulations to implement the proposal, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations would address the information reports that educational institutions would file to assist students and the IRS in determining whether a student meets the eligibility requirements for the credit and calculating the amount of the credit potentially available. Where certain terms are defined by reference to the Higher Education Act of 1965, the Secretary of Education would have authority to issue regulations, as well as authority to define other education terms as necessary.

Effective Date

The proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset the HOPE scholarship tuition tax credit for calendar years after 2000. See the description of this sunset mechanism in Part I., above.

2. Education and job training tax deduction

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellane-

ous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to \$5,250 paid by his or her employer for educational assistance, regardless of whether the education maintains or improves a skill required by the employee's current position (sec. 127). This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997⁸ (and does not apply to graduate level courses beginning after June 30, 1996).

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁹ "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount

⁸The legislative history of the Small Business Job Protection Act of 1996 indicated Congressional intent to extend the exclusion for employer-provided educational assistance through May 31, 1997. The statute, however, extended the exclusion through June 30, 1997.

⁹If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceeds contributions made by that person.

Description of Proposal

Individual taxpayers would be allowed an above-the-line deduction for qualified higher education expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of

higher education. The deduction would be allowed in computing a taxpayer's AGI and could be claimed regardless of whether the taxpayer itemizes deductions. In 1997 and 1998, the maximum deduction allowed per taxpayer return would be \$5,000. After 1998, the maximum deduction would increase to \$10,000. The maximum deduction would not vary with the number of students in a taxpayer's family. A taxpayer may claim the deduction for a taxable year with respect to one or more students, even though the taxpayer also claims a proposed Hope Scholarship tuition tax credit (discussed previously) for that same year with respect to other students. With respect to each student, a taxpayer must choose between claiming the proposed credit or the deduction. If, for any taxable year, a taxpayer chooses to claim the proposed credit with respect to a particular student, then the deduction will not be available with respect to that particular student for that year (although the deduction may be available with respect to that student for other taxable years, such as after the student completes two years of college and no longer is eligible for the credit). A student would not be eligible to claim a deduction under the proposal if that student is claimed as a dependent for tax purposes by another taxpayer. If a parent claims a student as a dependent, any education expenses paid by the student would be treated as paid by the parent for purposes of the proposal. In contrast to the proposed Hope Scholarship tuition tax credit, there would be no limit on the number of taxable years for which the proposed deduction for qualified higher education expenses could be claimed with respect to a particular student.

The maximum deduction would be phased out ratably for taxpayers with modified AGI between \$50,000 and \$70,000 (\$80,000 and \$100,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions) and would be determined without regard to the deduction allowed by the proposal. Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of \$5,000.

The deduction would be available for "qualified higher education expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, books, and similar personal, living or family expenses would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified higher education expenses unless this education is part of a degree program (or lead to improvement or acquisition of job skills).

An "eligible student" generally would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis. However, a student taking a course to improve or acquire job skills also would be an eligible student for purposes of the deduction. In

contrast to the proposed Hope Scholarship tuition tax credit (described previously), there are no requirements for purposes of the deduction that the student maintain any grade point average or be free of felony drug convictions. An eligible student generally could not be a nonresident alien.

Eligible institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified education expenses generally would include only out-of-pocket tuition and fees. Qualified education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, total tuition and required fees would be reduced (prior to the application of the \$5,000 or \$10,000 deduction limitation) by scholarship or fellowship grants excludable from gross income under present-law section 117 and any tax-free veteran's educational benefits.¹⁰ In addition, qualified education expenses would be reduced by the interest from U.S. savings bonds that is excludable from gross income under section 135 for the taxable year. However, no reduction of qualified education expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under any other section of the Code, then such expenses would not be deductible under the proposal.

The deduction would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified higher education expenses paid with the proceeds of a loan generally would be eligible for the deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursement through insurance) of previously deducted tuition and fees, making such refunds includable in income in the year received.

The Secretary of the Treasury would be granted authority to issue regulations to implement the proposal, including rules requiring record keeping and information reporting.

Effective Date

The proposal would be effective for payments made on or after January 1, 1997, for education commencing on or after July 1, 1997. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset the education and job training tax deduction for calendar years after 2000. See the description of this sunset mechanism in Part I., above.

¹⁰ For example, if during a taxable year, a taxpayer pays \$8,500 for college tuition, but receives a \$4,000 tax-free scholarship to cover some of those same tuition expenses, then the taxpayer would be deemed to have paid \$4,500 of qualified higher education expenses under the proposal.

3. Tax incentives for expansion of student loan forgiveness

Present Law

In the case of an individual, gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (sec. 108(f)).

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion.

Description of Proposal

The proposal would expand section 108(f) so that an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. As under present law, the section 108(f) exclusion would apply only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

The exclusion would also be expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program where loan repayment and forgiveness are contingent on the borrower's income level.

Effective Date

The proposal would be effective with respect to amounts otherwise includible in income after the date of enactment.

4. Extension of exclusion for employer-provided educational assistance

Present Law

Under present law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that meets certain requirements. The exclusion is limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applies whether or not the education is job related. Under present law, in the absence of this exclusion, educational assistance is excludable from income only if it is related to an employee's current job.

The exclusion for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997.¹¹ The exclusion is not available for graduate level courses beginning after June 30, 1996. Graduate courses are defined as any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, marketing or other advanced academic or professional degree.

Description of Proposal

Under the proposal, the exclusion for employer-provided educational assistance would be extended through December 31, 2000, and the provision limiting the exclusion to undergraduate courses would be retroactively repealed.

Effective Date

The extension of the exclusion would be effective for taxable years beginning after December 31, 1996. The repeal of the limitation on the exclusion to undergraduate education would be effective for graduate level courses beginning after June 30, 1996.

5. Small business tax credit for employer-provided educational assistance

Present Law

Under present law, an employer may deduct certain job-related training and education expenses, as well as amounts paid or incurred for educational assistance provided to employees pursuant to an educational assistance program that meets certain requirements. Employer payments for job-related training and amounts paid under a qualified educational assistance program up to \$5,250 annually are excluded from the gross income and wages of the employee. The exclusion for employer-provided educational assistance expires after June 30, 1997.¹² Under present law, not more than 5

¹¹ The legislative history of the Small Business Job Protection Act of 1996 indicated Congressional intent to extend the exclusion for employer-provided educational assistance through May 31, 1997. The statute, however, extended the exclusion through June 30, 1997.

¹² The legislative history of the Small Business Job Protection Act of 1996 indicated Congressional intent to extend the exclusion for employer-provided educational assistance through May 31, 1997. The statute, however, extended the exclusion through June 30, 1997.

percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners.

Description of Proposal

The proposal would provide a temporary 10-percent income tax credit for small businesses with respect to expenses incurred for education of employees by third parties under a qualified employer-provided educational assistance program. The credit would be available to employers (including self-employed individuals) where the business has average annual gross receipts of \$10 million or less for the prior three years.

Effective Date

The proposal would be effective for payments made in taxable years beginning after December 31, 1997 and before January 1, 2001 with respect to expenses incurred during those years.

C. Provisions Relating to Individual Retirement Plans

Present Law

In general

Under certain circumstances, an individual is allowed a deduction for contributions to an individual retirement account or an individual retirement annuity (an "IRA"). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70½.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of \$2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution of up to \$2,000 for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income ("AGI") of less than \$25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than \$40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between \$25,000 and \$35,000 of AGI. For married tax-

payers, the maximum deduction is phased out between \$40,000 and \$50,000 of AGI.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of \$2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn.

In addition, a 10-percent additional tax applies to withdrawals from IRAs made before age 59½, unless the withdrawal is made (1) on account of a death or disability, (2) in the form of annuity payments, (3) for medical expenses that exceed 7.5 percent of adjusted gross income ("AGI") or (4) for medical insurance (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then, to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed. The exception to the additional tax ceases to apply if the individual has been reemployed for at least 60 days.

Elective deferrals

Under a qualified cash or deferred arrangement, an individual can elect to have compensation paid in cash or contributed to a tax-qualified retirement plan. Amounts contributed at the election of the employee are referred to as elective deferrals. Elective deferrals are not includible in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the same rules applicable to qualified plans generally, and are also subject to additional requirements. One of these additional requirements is that the maximum amount of elective deferrals that can be made in a year by an individual is limited to \$9,500 in 1997. This dollar limit is indexed for inflation in \$500 increments. A similar limit applies to elective deferrals under similar arrangements (e.g., tax-sheltered annuities).

Description of Proposal

In general

In general, the proposal would (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to \$20,000 (so that, for married taxpayers in 1997, 1998, and 1999, the income phase-out range would be \$70,000 to \$90,000 of AGI, and \$80,000 to \$100,000 thereafter; and for single taxpayers in 1997, 1998, and 1999, the income phase-out range would be \$45,000 to \$65,000 of AGI, and \$50,000 to \$70,000 thereafter); (2) index the \$2,000 IRA contribution limit and the income limits; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time home buyer expenses, medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State tuition program instruments.

Deductible IRA contributions

The proposal would increase the income limits at which the maximum IRA deduction is phased out for active participants in employer-sponsored retirement plans in two steps. For married taxpayers in 1997, 1998, and 1999, the income phase-out range would be \$70,000 to \$90,000 of AGI, and \$80,000 to \$100,000 thereafter. For single taxpayers in 1997, 1998, and 1999, the income phase-out range would be \$45,000 to \$65,000 of AGI, and \$50,000 to \$70,000 thereafter. The income thresholds would be indexed for inflation, beginning after 2000.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts that have been held in an IRA for less than 5 years.

Inflation adjustment for IRA contribution limit

The \$2,000 IRA deduction limit would be indexed for inflation for taxable years beginning after 1997.

Nondeductible tax-free IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions also would be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Dis-

tributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs during the 5-year period after contribution would be subject to income tax, and also would be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or unless a present-law exception to the tax, other than the exception for distributions after age 59½, applies).

An individual whose AGI for a year does not exceed \$100,000 for married taxpayers and \$70,000 for single taxpayers could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer.¹³ However, if a transfer is made before 1999, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.¹⁴

Special purpose withdrawals

The proposal would provide exceptions to the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild (whether or not a dependent), (2) for acquisition of a principal residence for a first-time home buyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild, (3) for medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, whether or not that person otherwise qualifies as the individual's dependent, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

Investment in qualified State prepaid tuition program instruments

The proposal would provide that any IRA assets can be invested in qualified State tuition program instruments. To the extent the instrument is converted into tuition and fees, the account holder would be treated as receiving a distribution equal to the cost of such tuition and fees as of the time of the conversion. Further, such a deemed distribution would be treated as a special purpose withdrawal for qualified higher education expenses, and thus would not be subject to the 10-percent additional tax on early withdrawals. The tax treatment of the deemed distribution would depend on whether the instrument is held by an IRA or a Special IRA.

¹³The amount transferred would not be included in the taxpayer's AGI for purposes of applying the income limits on IRA contributions to the taxpayer for the year of transfer.

¹⁴In the case of such a transfer before 1999, the amount of such transfer would also be taken into account for purposes of the 15-percent excise tax on excess distributions ratably over a four-year period.

Effective Date

The proposal would generally be effective on January 1, 1997. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset some of the expanded IRA provisions for calendar years after 2000. See the description of this sunset mechanism in Part I., above. A document provided by the Treasury Department indicates that the sunset would apply to (1) the increased income limits, (2) the increased IRA deduction limit, (3) contributions to Special IRAs, and (4) rollovers from deductible IRAs to Special IRAs.

D. Exclusion of Capital Gains on Sale of Principal Residence

Present Law

Rollover of gain

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion

In general, an individual, on a one-time basis, may exclude from gross income up to \$125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

Description of Proposal

A taxpayer generally would be able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence. The exclusion would be allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The proposal provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after December 31, 1996.

To be eligible for the exclusion, a taxpayer must have owned a residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange of the residence. A taxpayer who is forced to sell without meeting these requirements (e.g., because of a change of place of employment or medical reasons) would be able to exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of \$250,000 would be available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the proposal would allow the newly married taxpayer a maximum exclusion of \$250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.

Effective Date

The proposal would be available for all sales or exchanges of a principal residence occurring on or after January 1, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences. In the case of sales or exchanges occurring between January 1, 1997 and the date of enactment, taxpayers could elect whether to apply the new exclusion or prior law. For a taxpayer who acquired his or her current principal residence in a rollover transaction within the five years prior to the date of enactment, the residency requirement of the proposal would be applied by taking into account the period of the taxpayer's residence in the previous principal residence.

III. DISTRESSED AREAS INITIATIVES

A. Expand Empowerment Zones and Enterprise Communities

Present Law

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.¹⁵ Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392).

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first \$15,000 of wages paid to a zone resident who works in the zone; (2) an additional \$20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to \$38,000 of expensing for 1997); and (3) special tax-exempt financing for certain zone facilities (described in more detail below).

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone

¹⁵The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or \$5,000 (whichever is greater).

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the business's tangible property is used within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than 5 percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.¹⁶ In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to \$50 per resident of each State, or (if greater) \$150 million per State.

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above) the principal user of which is an "enterprise zone business" (also defined above¹⁷), or (2) functionally related and subordinate land located in the empowerment zone or

¹⁶Also, a qualified business does not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

¹⁷For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

enterprise community. These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all qualified enterprise zone bonds for each qualified enterprise zone business may not exceed \$3 million per zone or community. In addition, total qualified enterprise zone bond financing for each principal user of these bonds may not exceed \$20 million for all zones and communities.

Description of Proposal

To amend the Internal Revenue Code of 1986 Two additional empowerment zones with same tax incentives as previously designated empowerment zones

The Secretary of HUD would be authorized to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas) with respect to which would apply the same tax incentives (i.e., the wage credit, additional expensing, and special tax-exempt financing) as are available within the empowerment zones authorized by OBRA 1993. The two additional empowerment zones would be subject to the same eligibility criteria under present-law section 1392 that applied to the original six urban empowerment zones. In order to permit designation of these two additional empowerment zones, the proposal would increase the present-law 750,000 aggregate population cap applicable to empowerment zones located in urban areas to a cap of one million aggregate population for the eight urban empowerment zones. No additional Federal grants would be authorized.

The two empowerment zones would be required to be designated within 180 days after enactment, and the designations generally would remain in effect for 10 years.

Designation of additional empowerment zones and enterprise communities

In addition, the proposal would authorize the Secretaries of HUD and Agriculture to designate an additional 20 empowerment zones (no more than 15 in urban areas and no more than five in rural areas) and an additional 80 enterprise communities (no more than 50 in urban areas and no more than 30 in rural areas).¹⁸ With respect to these additional empowerment zones and enterprise communities, the present-law eligibility criteria would be expanded slightly. First, the square mileage limitations of present law (i.e., 20 square miles for urban areas and 1,000 for rural areas) would be expanded to allow the empowerment zones to include an additional 2,000 acres and enterprise communities to include an additional 1,000 acres. This additional acreage, which could be developed for commercial or industrial purposes, would not be subject to the poverty rate criteria and could be divided among up to three noncontiguous parcels. In addition, the present-law requirement that at least half of the nominated area consist of census tracts with poverty rates of 35 percent or more would not be applicable.

¹⁸ Under the proposal, areas located within Indian reservations would be eligible for designation as empowerment zones or enterprise communities.

Thus, under present-law section 1392(a)(4), at least 90 percent of the census tracts within a nominated area must have a poverty rate of 25 percent or more, and the remaining census tracts must have a poverty rate of 20 percent or more.¹⁹ For this purpose, census tracts with populations under 2,000 would be treated as satisfying the 25-percent poverty rate criteria if (1) at least 75 percent of the tract was zoned for commercial or industrial use and (2) the tract was contiguous to one or more other tracts that actually have a poverty rate of 25 percent or more.

Within the 20 additional empowerment zones, qualified "enterprise zone businesses" would be eligible to receive up to \$20,000 of additional section 179 expensing²⁰ and to utilize special tax-exempt financing benefits. The Administration's proposed "brownfields" tax incentive (described elsewhere) also would be available within all designated empowerment zones. Businesses within the 20 additional empowerment zones would not, however, be eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit would be available only in the nine present-law zones and two urban zones designated under the first part of the proposal).

Within the 80 additional enterprise communities, qualified "enterprise zone businesses" would (as within the present-law enterprise communities) be eligible to utilize special tax-exempt financing benefits, as well as the "brownfields" tax incentives that applies to all designated zones and communities.

The 20 additional empowerment zones and 80 additional enterprise communities would be required to be designated before 1999, and the designations generally would remain in effect for 10 years.

Modification of definition of enterprise zone business

The proposal would modify the present-law requirement of section 1397B that an entity may qualify as an "enterprise zone business" only if (in addition to the other present-law criteria) at least 80 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community. The proposal would liberalize this present-law requirement by reducing the percentage threshold so that an entity could qualify as an enterprise zone business if at least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community (assuming that the other criteria of section 1397B are satisfied).

In addition, section 1397B would be modified so that rather than requiring that "substantially all" tangible and intangible property (and employee services) of an enterprise zone business be used (and performed) within a designated zone or community, a "substantial portion" of tangible and intangible property (and employee services) of an enterprise zone business would be required to be used (and performed) within a designated zone or community. Moreover, the proposal would further amend the section 1397B rule governing in-

¹⁹ In lieu of the poverty criteria, outmigration may be taken into account in designating one rural empowerment zone and up to five rural enterprise communities.

²⁰ However, the additional section 179 expensing would not be available within the additional 2,000 acres allowed to be included under the proposal within an empowerment zone.

tangible assets so that a substantial portion of an entity's intangible property must be used in the active conduct of a qualified business within a zone or community, but there will be no need (as under present law) to determine whether the use of such assets is "exclusively related to" such business. However, the present-law rule of section 1397B(d)(4) would continue to apply, such that a "qualified business" would not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license. The proposal also would clarify that an enterprise zone business that leases to others commercial property within a zone or community may rely on a lessee's certification that the lessee is an enterprise zone business. Finally, the proposal would provide that the rental to others of tangible personal property shall be treated as a qualified business if and only if at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a zone or community (rather than the present-law requirement that "substantially all" tangible personal property rentals of an enterprise zone business satisfy this test).

This modified "enterprise zone business" definition would apply to all previously designated and newly designated empowerment zones and enterprise communities.

Tax-exempt financing rules

Exceptions to volume cap

The proposal would allow "new empowerment zone facility bonds" to be issued for qualified enterprise zone businesses in the 20 additional empowerment zones authorized to be designated under the proposal. These bonds would not be subject to the State private activity bond volume caps or the special limits on issue size applicable to qualified enterprise zone facility bonds under present law. The maximum amount of these bonds that could be issued would be limited to \$60 million per rural zone, \$130 million per urban zone with a population of less than 100,000, and \$230 million per urban zone with a population of 100,000 or more.

Changes to certain rules applicable to both empowerment zone facility bonds and qualified enterprise community facility bonds

Qualified enterprise zone businesses located in newly designated empowerment zones and enterprise communities, as well as those located in previously designated empowerment zones and enterprise communities, would be eligible for special tax-exempt bond financing under present-law rules, subject to the modifications described below (and the exception to the volume cap described above for newly designated empowerment zones).

The proposal would waive until the end of a "startup period" the requirement that 95 percent or more of the proceeds of bond issue be used by a qualified enterprise zone business. With respect to each property the startup period would end at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). This waiver would only be available if at the beginning of the startup period there is

a reasonable expectation that the use by a qualified enterprise zone business would be satisfied at the end of the startup period and the business makes bona fide efforts to satisfy the enterprise zone business definition.

The proposal also would waive the requirements of an enterprise zone business (other than the requirement that at least 35 percent of the business' employees be residents of the zone or community) for all years after a prescribed testing period equal to first three taxable years after the startup period.

Finally, the proposal would relax the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds. In the case of property which is substantially renovated by the taxpayer, the property would not need to be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceeded 15 percent of the taxpayer's basis at the beginning of the period, or \$5,000 (whichever is greater).

Effective Date

The proposed two additional urban empowerment zones (within which would be available the same tax incentives as are available in the empowerment zones designated pursuant to OBRA 1993) would be designated within 180 days after enactment. The proposed 20 additional empowerment zones (within which the wage credit would not be available) and the 80 additional enterprise communities would be designated after enactment but prior to January 1, 1999. For purposes of the additional section 179 expensing available within empowerment zones, the modifications to the definition of "enterprise zone business" would be effective for taxable years beginning on or after the date of enactment.

The proposed changes to the tax-exempt financing rules would be effective for qualified enterprise zone facility bonds and the new empowerment zone facility bonds issued after the date of enactment. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset the expanded empowerment zones and enterprise communities for calendar years after 2000. See the description of this sunset mechanism in Part I., above.

B. Expensing of Environmental Remediation Costs ("Brownfields")

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred

to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. *Woolrich Woolen Mills v. United States*, 289 F.2d 444 (3d Cir. 1961).

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the State it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the *Plainfield Union* valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94-38, 1994-1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the *Plainfield Union valuation analysis*.²¹ However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for \$1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (PLR 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

Description of Proposal

The proposal would provide that taxpayers could elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction would apply for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site would not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property which would otherwise be allocated to the site under the principles set forth in *Comm'r v. Idaho Power Co.*²² and section 263A would be treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally would be any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas generally would include (1) empowerment zones and enterprise communities (as designated

²¹ Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

²² *Comm'r v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

under present law and to be designated under the proposal); (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above.

Both urban and rural sites would qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) could not be targeted areas. Appropriate State environmental agencies would be designated by the EPA; if no State agency is designated, the EPA would be responsible for providing the certification. Hazardous substances generally would be defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The proposal further would provide that, in the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the proposal would be treated as a depreciation deduction and the property would be treated as subject to section 1245. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

Effective Date

The proposal would apply to eligible expenditures incurred after the date of enactment. The President's budget proposal contains a tax cut sunset provision that, if triggered, would sunset the expensing of environmental remediation costs for calendar years after 2000. See the description of this sunset mechanism in Part I., above.

C. Tax Credit for Equity Investments in Community Development Financial Institutions

Present Law

The Community Development Financial Institutions Fund (the "CDFI Fund") was created by the Community Development Banking and Financial Institutions Act of 1994. Administered by the Department of the Treasury, the CDFI Fund provides equity investments, grants, loans, and technical assistance to qualifying community development financial institutions ("CDFIs"). Qualifying CDFIs are organizations that have community development as their primary mission and that develop a range of programs and methods to accomplish that mission. CDFIs and their investors are not eligible for any special tax incentives under present law.

Description of Proposal

The proposal would provide \$100 million in nonrefundable general business tax credits for qualifying equity investments in

CDFIs between 1997 and 2006. The credits would be allocated among equity investors by the CDFI Fund through a competitive bidding process. The maximum credit allocable to a particular investment would be 25 percent of the amount invested, although the CDFI Fund could negotiate a lower percentage.

The credit would be available in the taxable year in which the qualifying investment is made. Unused credits could be carried forward for 15 years and back three years, but no credit could be carried back to taxable years beginning prior to the date of enactment. The credit could be used to offset up to 25 percent of a taxpayer's alternative minimum tax liability. An investor's basis in its equity interest would be reduced by the amount of credit claimed. The credit would be subject to recapture in the event of a sale or other disposition of the equity interest within five years after the date of acquisition.

Effective Date

The credit would be available for qualifying investments made in taxable years beginning after December 31, 1996.

IV. WELFARE-TO-WORK TAX CREDIT

Present Law

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

For purposes of the work opportunity tax credit, the targeted groups for which the credit is available include (1) families receiving Aid to Families with Dependent Children (AFDC), (2) qualified ex-felons, (3) high-risk youth, (4) vocational rehabilitation referrals, (5) qualified summer youth employees, (6) qualified veterans, and (7) families receiving food stamps.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,050.

The deduction for wages is reduced by the amount of the credit.

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.²³

Description of Proposal

The proposal provides to employers a 50-percent credit on the first \$10,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients for both the first and second years of employment. The maximum credit each year would be \$5,000 per qualified employee.

Qualified long-term family assistance recipients would include: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages would include amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of section 127); (2) health plan coverage for the employee, but not

²³ See the proposal described below to extend and expand the work opportunity tax credit.

more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after the date of enactment and before October 1, 2000.

V. EXPANSION OF ESTATE TAX EXTENSION PROVISIONS FOR CLOSELY HELD BUSINESSES

Present Law

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1,000,000 in value of the closely-held business. All interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. If the deduction is taken against the estate tax, supplemental returns must be filed each year to recompute the value of the taxable estate.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate. In general, the installment payment election is available only if the estate directly owns an interest in a closely held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely held active trade or business, but if the election is made, neither the five-year deferral (i.e., the provision that requires no principal payments until the fifth year) nor the special 4-percent rate applies.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

Description of Proposal

The proposal would increase the amount of value in a closely held business that would be eligible for the special low interest rate, from \$1,000,000 to \$2,500,000. Interest paid on the deferred estate tax would not be deductible for estate or income tax purposes, but the 4-percent rate would be reduced to 2 percent, and the deferred estate tax on any value of a closely held business in excess of \$2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments.

The proposal also would expand the availability and benefits of the holding company exception to include partnerships that function as holding companies, and would clarify and expand the non-readily tradeable stock requirement to include non-publicly traded partnerships. In addition, an estate using the holding company exception (as modified by the proposal) would be able to take advantage of the five-year deferral and special 2-percent rate, thus providing the same relief to closely held businesses whether owned directly or through holding companies.

Finally, the proposal would authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien.

Effective Date

The proposal would apply to the estates of decedents dying after December 31, 1997. Estates that are deferring estate tax under current law could make a one-time election to use the lower interest rates and forgo the interest deduction.

VI. OTHER TAX INCENTIVES

A. Equitable Tolling of the Statute of Limitations Period for Claiming Tax Refunds for Incapacitated Taxpayers

Present Law

In general, a taxpayer must file a refund claim within three years of the filing of the return or within two years of the payment of the tax, whichever period expires later (if no return is filed, the two-year limit applies) (sec. 6511(a)). A refund claim that is not filed within these time periods is rejected as untimely.

There is no explicit statutory rule providing for equitable tolling of the statute of limitations. Several courts have considered whether equitable tolling implicitly exists. The First, Third, Fourth, and Eleventh Circuits have rejected equitable tolling with respect to tax refund claims. The Ninth Circuit, however, has permitted equitable tolling.

Description of Proposal

The proposal would permit equitable tolling of the statute of limitations for refund claims for the period of time during which an individual taxpayer is under a sufficient medically determined physical or mental disability as to be unable to manage his or her financial affairs. Tolling would not apply during periods in which the taxpayer's spouse or another person is authorized to act on the taxpayer's behalf in financial matters.

Effective Date

The proposal would apply with respect to tax years ending after the date of enactment.

B. Extend and Modify Puerto Rico Tax Credit

Present Law

The Small Business Job Protection Act of 1996 generally repealed the Puerto Rico and possession tax credit. However, certain domestic corporations that had active business operations in Puerto Rico or another U.S. possession on October 13, 1995 may continue to claim credits under section 936 or section 30A for a ten-year transition period. Such credits apply to possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is granted whether or not the corporation pays income tax to the possession.

One of two alternative limitations is applicable to the amount of the credit attributable to possession business income. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes); beginning in 2002, the income eligible for the credit computed under this limit gen-

erally is subject to a cap based on the corporation's pre-1996 possession business income. Under the alternative limit, the amount of the credit is limited to the applicable percentage (45 percent for 1997 and 40 percent for 1998 and thereafter) of the credit that would otherwise be allowable with respect to possession business income; beginning in 1998, the income eligible for the credit computed under this limit generally is subject to a cap based on the corporations's pre-1996 possession business income. Special rules apply in computing the credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The credit is eliminated for taxable years beginning after December 31, 2005.

Description of Proposal

The proposal would modify the credit computed under the economic activity limit with respect to operations in Puerto Rico only. First, the proposal would eliminate the December 31, 2005 termination date with respect to such credit. Second, the proposal would eliminate the income cap with respect to such credit. Third, the proposal would eliminate the limitation applying the credit only to certain corporations with pre-existing operations in Puerto Rico with respect to such credit. The proposal would not modify the credit computed under the economic activity limit with respect to operations in possessions other than Puerto Rico. The proposal also would not modify the credit computed under the alternative limit.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

C. Extend Foreign Sales Corporation Benefits to Licenses of Computer Software for Reproduction Abroad

Present Law

Under special tax provisions that provide an export incentive, a portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights other than films, tapes, records, or similar reproductions for commercial or home

use. The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Treas. Reg. sec. 1.927(a)-1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does not constitute export property, and that standardized, mass marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Treas. Reg. sec. 1.927(a)-1T(f)(3)).

Description of Proposal

The proposal would provide that computer software licensed for reproduction abroad would not be excluded from the definition of export property for purposes of the FSC provisions.

Effective Date

The proposal would apply to software licenses granted after the date of enactment.

D. District of Columbia Tax Incentives

Present Law

Under present law, residents of and businesses, employees, and owners of property located in the District of Columbia are not eligible for any special Federal tax treatment by virtue of their District of Columbia nexus.

Description of Proposal

The proposal would provide tax incentives intended, according to the Department of Treasury, "to encourage employment of disadvantaged residents and to revitalize those areas of the District of Columbia where development has been inadequate."²⁴ The proposal does not identify any specific measures in this regard.

²⁴ Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, February 1997, p. 31.

VII. EXTENSIONS OF EXPIRING TAX PROVISIONS

A. Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after May 31, 1997.²⁵

A 20-percent research tax credit also applied to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.²⁶

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

²⁵When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995. The credit later was extended for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

²⁶The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury. If a taxpayer elects the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during the first 11 months of such taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of

amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").²⁷

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for one year—i.e., for the period June 1, 1997, through May 31, 1998.

²⁷Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Effective Date

Extension of the research tax credit would be effective for expenditures paid or incurred during the period June 1, 1997, through May 31, 1998.

B. Contributions of Stock to Private Foundations

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.²⁸ However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.²⁹

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to May 31, 1997.³⁰ Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Description of Proposal

The proposal would extend the special rule contained in section 170(e)(5) for one year—for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through May 31, 1998.

²⁸ The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

²⁹ As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

³⁰ The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

Effective Date

The provision would be effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through May 31, 1998.

C. Work Opportunity Tax Credit

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,050.

The deduction for wages is reduced by the amount of the credit.

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk-youth

A high-risk youth is an individual certified as being at least 18 but not 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). Quali-

fied wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral

Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee

Qualified summer youth employees are individuals: (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been an employee of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified Veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individ-

ual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families receiving Food Stamps

An eligible recipient is an individual aged 18 but not 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Description of Proposals

The first proposal would extend for one year the work opportunity tax credit.

The second proposal would add a new targeted group to the work opportunity tax credit. The new group is composed of individuals aged 18-50 who lost eligibility for food stamps under the Administration's proposal to impose time limits on food stamp eligibility. However, individuals who have become ineligible either by refusing to work or, failing to comply with the food stamp program work requirements would not qualify as members of this new targeted group. Members of this new targeted group would remain in the targeted group for the 12-month period after losing eligibility for food stamps under the Administration's proposal.

Effective Date

The proposal to extend the work opportunity tax credit would be effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before October 1, 1998. The proposal to add a new food stamp targeted group would be effective for wages paid or incurred to qualified members of that group who begin work for the employer on or after the date of enactment and before October 1, 2000.

D. Orphan Drug Tax Credit

Present Law

A 50-percent nonrefundable tax credit is allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

As with other general business credits (sec. 38), taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit is scheduled to expire and will not apply to expenses paid or incurred after May 31, 1997.³¹

Description of Proposal

The orphan drug tax credit would be extended for one year—i.e., for the period June 1, 1997, through May 31, 1998.

Effective Date

The proposal would be effective for qualified clinical testing expenses paid or incurred during the period June 1, 1997, through May 31, 1998.

³¹ The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

VIII. CORPORATE REFORMS AND OTHER TAX PROVISIONS

A. Provisions Relating to Financial Products

1. Deny interest deduction on certain debt instruments

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid. If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Section 385(c) provides rules for when an issuer's characterization of an interest in a corporation shall be binding on the issuer and the holders.

Description of Proposal

Under the proposal, no deduction would be allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (1) has a maximum weighted average maturity of more than 40 years, or (2) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party. In addition, an instrument would be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument would also be treated as payable in stock if it is part of an arrangement designed to result in the payment of the instrument with such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

For purposes of determining the weighted average maturity of an instrument or the term of an instrument, any right to extend, renew, or relend will be treated as exercised and any right to accelerate payment will be ignored.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (1) has a maximum term of more than 15 years, and (2) is not shown as indebtedness on the sepa-

rate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 15 years issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and the holder, the issuer will be treated as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements (or are included in financial statements filed) with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. In addition, this proposal would not apply to leveraged leases.

The proposal generally would not apply to demand loans, redeemable ground rents or any other indebtedness specified by regulation.

The proposal is not intended to affect the characterization of instruments as debt or equity under current law.

Effective Date

The proposal would be effective generally for instruments issued on or after the date of first committee action.

2. Defer interest deduction on certain convertible debt

Present Law

Certain debt instruments contain a feature that allows the holder or the issuer, at certain future dates, to convert the instrument into shares of stock of the issuer or a related party. Some of these instruments may be issued at a discount and are convertible into a fixed number of shares of the issuer, regardless of the amount of original issue discount ("OID") accrued as of the date of conversion. Treasury regulations governing the accrual and deductibility of OID ignore options to convert a debt instrument into stock or debt of the issuer or a related party or into cash or other property having a value equal to the approximate value of such stock or debt (Treas. reg. sec. 1.1272-1(c)). Thus, OID on a convertible debt instrument generally is deductible as interest as such OID accrues, regardless of whether or not the debt is ultimately converted. The treatment of a holder of a discount instrument is similar to that of the issuer, i.e., a holder includes OID in income on an accrual basis.

Other convertible instruments may be issued with coupon interest, rather than OID, and may provide that if the debt is converted into stock, the holder does not receive any interest that accrued but was unpaid between the latest coupon date and the conversion date. Under present law, the issuer of such instrument generally cannot deduct such accrued but unpaid interest.³²

³²See, Rev. Rul. 74-127, 1974-1 C.B. 47 and *Scott Paper v. Comm.*, 74 T.C. 137 (1980).

Description of Proposal

The proposal would defer interest deductions on convertible debt until such time as the interest is paid. For this purpose, payment would not include: (1) the conversion of the debt into equity of the issuer or a related person (as determined under secs. 267(b) and 707(b)) or (2) the payment of cash or other property in an amount that is determined by reference to the amount of such equity. Convertible debt would include debt: (1) exchangeable into the stock of a party related to the issuer, (2) with cash-settlement conversion features, or (3) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Convertible debt would not include debt that is "convertible" because a fixed payment of principal or interest could be converted by the holder into equity of the issuer or a related party having a value equal to the amount of such principal or interest. Holders of convertible debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

The proposal would be effective for convertible debt issued on or after the date of first committee action.

3. Limit dividends-received deduction

a. Reduce dividends-received deduction to 50 percent

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

Description of Proposal

Under the proposal, the dividends-received deduction available to corporations owning less than 20 percent (by vote and value) of the stock of a U.S. corporation would be reduced to 50 percent of the dividends received.

Effective Date

The proposal would be effective for dividends paid or accrued after the 30th day after the date of enactment of the provision.

b. Modify holding period for dividends-received deduction

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Description of Proposal

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The proposal would be effective for dividends paid or accrued after the 30th day after the date of the enactment of the provision.

c. Deny dividends-received deduction for preferred stock with certain non-stock characteristics

Present Law

A corporate taxpayer is entitled to a deduction of 70 percent of the dividends it receives from a domestic corporation. The percentage deduction is generally increased to 80 percent if the taxpayer owns at least 20 percent (by vote and value) of the stock of the dividend-paying corporation, and to 100 percent for "qualifying dividends," which generally are from members of the same affiliated group as the taxpayer.

The dividends-received deduction is disallowed unless the taxpayer satisfies a 46-day holding period for the stock (or a 91-day period for certain preferred stock). The holding period generally does not include any period during which the taxpayer has a right or obligation to sell the stock, or is otherwise protected from the risk of loss otherwise inherent in the ownership of an equity interest. If an instrument were treated as stock for tax purposes, but provided for payment of a fixed amount on a specified maturity date and afforded holders the rights of creditors to enforce such payment, the Internal Revenue Service has ruled that no divi-

dends-received deduction would be allowed for distributions on the instrument.³³

Description of Proposal

Except in the case of "qualifying dividends," the dividends-received deduction would be eliminated for dividends on limited term preferred stock. For this purpose, preferred stock includes only stock that is limited and preferred as to dividends and that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent. Stock is only treated as having a limited term if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock; (2) the holder or a related person is required to redeem or purchase the stock; (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised; or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction rate stock). For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes the likelihood of the redemption or purchase remote.

No inference regarding the present-law tax treatment of the above-described stock is intended by this proposal.

Effective Date

The proposal would apply to dividends on stock issued after the 30th day after the date of enactment of the provision.

4. Disallowance of interest on indebtedness allocable to tax-exempt obligations

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (sec. 265). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.³⁴

³³ See Rev. Rul. 94-28, 1994-1 C.B. 86.

³⁴ Section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of Pub. L. No. 98-369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

Application to non-financial corporations

In Rev. Proc. 72-18, 1972-1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. Under Rev. Proc. 72-18, a deduction is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations.

This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception.—In the case of an individual, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.—If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.³⁵

Application to financial corporations and dealers in tax-exempt obligations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which is not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer (sec. 265). In the case of an obligation of an issuer which reasonably anticipates to issue not more than \$10 million of tax-exempt obligations (other than certain private activity bonds) within a calendar year (the "small issuer exception"), only 20 percent of the interest allocable to such tax-exempt obligations is disallowed (sec. 291(a)(3)). A similar pro rata rule applies to dealers in tax-exempt

³⁵ *R.B. George Machinery Co.*, 26 B.T.A. 594 (1932) acq. C.B. XI-2, 4; Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

obligations, but there is no small issuer exception and the 20-percent disallowance rule does not apply.³⁶

Description of Proposal

The proposal would extend to all corporations (other than insurance companies) the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets. The proposal would not extend the small-issuer exception to taxpayers which are not financial institutions. Nonetheless, the proposal would not apply to nonsaleable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Under the proposal, insurance companies would not be subject to the pro rata rule and would be subject to present law. Finally, the proposal would apply the interest disallowance provision to all related persons (within the meaning of section 267(f)). Accordingly, in the case of related parties that are members of the same consolidated group, the pro rata disallowance rule would apply as if all the members of the group were a single taxpayer. The consolidated group rule would be applied without regard to any member that is an insurance company. In the case of related persons that are not members of the same consolidated group, the tracing rules would be applied by treating all of the related persons as a single entity. The proposal is not intended to affect the application of section 265 to related parties under current law.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired after the date of first committee action.

5. Basis of substantially identical securities determined on an average basis

Present Law

A taxpayer generally recognizes gain or loss on the sale of property measured by the difference between the amount realized on the disposition and the taxpayer's adjusted basis in the property. The gain or loss may be treated as long-term capital gain or loss depending upon the character and holding period of the property. Under Treasury regulations, if a taxpayer sells a portion of his or her holdings in stocks or bonds, the taxpayer is allowed to identify the securities disposed of for purposes of determining gain or loss on the disposition. If the taxpayer does not make an adequate identification, he or she generally is deemed to have disposed of the securities first acquired. Mutual fund investors are allowed to determine the adjusted bases of their shares based on the average cost of all such shares.

³⁶ Rev. Proc. 72-18.

Description of Proposal

In the case of substantially identical securities, the basis of the securities would be determined on an average basis. If a taxpayer disposes of less than all of such securities, the taxpayer would be treated as having disposed of the securities first acquired. The Secretary of the Treasury may provide, by regulation, that the average basis rule would not apply to certain substantially identical securities if such securities have a special status under a Code provision. For example, regulations could provide that the basis of shares of stock contributed to a partnership (and subject to Code section 704(c)) would not be averaged with the basis of substantially identical shares of stock purchased by the partnership.

For purposes of the proposal, a "security" generally would mean any of the securities described in section 475(c)(2), other than subparagraph (F) thereof, including (1) stock in a corporation; (2) a partnership or beneficial interest in widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; (4) certain interest rate, currency, or equity notational principal contracts; or (5) evidence in an interest in, or a derivative financial instrument in, any security described above. The proposal generally would not apply to contractual financial products, such as over-the-counter options, notional principal contracts, or forward contracts because a taxpayer generally would not have multiple contracts that are substantially identical.

Effective Date

The proposal would be effective for determinations made 30 days after the date of enactment.

6. Require recognition of gain on certain appreciated positions in personal property

Present Law

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss is usually realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices is generally determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender) no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for

income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss.

Taxpayers also can lock in gain on certain property by entering into straddles without recognizing gain for tax purposes. A straddle consists of offsetting positions with respect to personal property. A taxpayer can take losses on positions in straddles into account only to the extent the losses exceed the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on straddles.

Taxpayers may engage in other arrangements, such as "equity swaps" and other "notional principal contracts," where the risk of loss and opportunity for gain with respect to property are shifted to another party (the "counterparty"). These arrangements do not result in the recognition of gain by the taxpayer.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term and 60 percent long-term. Securities dealers also are required to mark their securities to market.

Description of Proposal

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain limited circumstances, a person related to the taxpayer) substantially eliminates risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property. For example, a taxpayer that holds appreciated stock and enters into a short position with respect to that stock would recognize any gain on the stock. An equity swap with regard to the stock that substantially eliminates risk of loss and opportunity for gain would also be subject to provision. Similarly, a taxpayer that holds appreciated stock and grants a call option or enters into a put option on the stock would generally recognize gain on the stock if there is a substantial certainty that the option will be exercised. In addition, a taxpayer would recognize gain on an appreciated position in stock, debt or partnership interests if the taxpayer enters into a transaction that is marketed or sold as substantially eliminating the risk of loss and opportunity for gain, regardless of

whether the transaction involves the same or substantially identical property.

The taxpayer would recognize gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. An appropriate adjustment (such as an increase in the basis of the position) would be made in the amount of any additional gain or loss subsequently realized with respect to the position; and a new holding period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest, if there would be gain were the position sold. Certain actively traded trust instruments are treated as stock for this purpose. A position is defined as any interest, including a futures or forward contract, short sale, or option.

Constructive sales would not include a transaction if the appreciated financial position that is part of such transaction is marked to market under present law sections 475 (mark to market for securities dealers) or 1256 (mark to market for futures contracts, options and currency contracts).

A constructive sale also would not include any contract for the sale of any stock, debt instrument, or partnership interest that is not a marketable security (as defined in the section 453(f)(2) rules that apply to installment sales) if the sale is reasonably expected to occur within one year after the date such contract is entered into.

A person would be considered related to another for purposes of the proposal if the relationship was one described in sections 267 or 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

If there is a constructive sale of less than all of the appreciated financial positions held by the taxpayer, the proposal would apply to such positions in the order in which acquired or entered into. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The application of this proposal would be affected by the separate proposal described above that would require a computation of average cost basis and a FIFO ordering rule for substantially identical securities. For example, the average cost/FIFO proposal effectively would eliminate the ability for a taxpayer to defer gain under a typical short-against-the-box transaction (i.e., where a taxpayer with appreciated securities borrows identical securities, currently sells the borrowed securities, and later delivers the appreciated securities to close out the borrowing). Under the average cost/FIFO proposal, the taxpayer would be deemed to have sold his appreciated securities, thus recognizing gain.

Effective Date

The proposal would be effective for constructive sales entered into after the date of enactment. It also would apply to constructive

sales entered into after January 12, 1996 and before the date of enactment that remain open 30 days after the date of enactment. The proposal would apply to these pre-enactment transactions as if the constructive sale occurred on the date which is 30 days after the date of enactment.

In the case of a decedent dying after the date of enactment, if a constructive sale of an appreciated financial position (as defined in the proposal) had occurred before the date of enactment and remains open on the day before the decedent's death, and no gain had been recognized under the constructive sale rules on the position, such position (and any property related to it, under principles of the provision) would be treated as property constituting rights to receive income in respect of a decedent under section 691.

7. Gains and losses from certain terminations with respect to property

Present Law

Extinguishment treated as sale or exchange.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.³⁷ Under a special provision, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). The personal property subject to this rule is (1) personal property (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer and (2) a "section 1256 contract"³⁸ which is capital asset in the hands of the taxpayer. Section 1234A does not apply to the retirement of a debt instrument.

Character of gain on retirement of debt obligations.—Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID³⁹ generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity (sec. 1271(a)(2)). These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer.

³⁷ See *Fairbanks v. U.S.*, 306 U.S. 436 (1039); *Comm'r v. Pittston Co.*, 252 F. 2d 344 (2nd Cir.), cert. denied, 357 U.S. 919 (1958).

³⁸ A "section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

³⁹ The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income as it accrues as interest on an accrual basis. The mandatory inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons before March 2, 1984, and loans of less than \$10,000 between natural persons if such loan is not made in the ordinary course of business of the lender (secs. 1272(a)(2)(D) and (E)).

Description of Proposal

Extension of relinquishment rule to all types of property.—The proposal would extend the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property.

Character of gain on retirement of debt obligations issued by natural persons.—The proposal would repeal the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as exchanges. Thus, under the proposal, gain or loss on the retirement of such debt will be capital gain or loss. The proposal would retain the present-law exceptions for debt issued before July 2, 1982, by non-corporations or nongovernments.

Effective Date

The proposal would be effective 30 days after the date of enactment.

8. Determination of original issue discount where pooled debt obligations subject to acceleration

Present Law

A taxpayer generally may deduct the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. The issuer of a debt instrument with original issue discount ("OID") generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the interest may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the time of maturity must be known.

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. Specifically, in the case of (1) any regular interest in a REMIC, (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

If the principal amount of an indebtedness may be paid without interest by a specified date (as is the case with certain credit card balances), present law does not require the lender to accrue interest until after the specified date has passed. In addition, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt.

Description of Proposal

The proposal would apply the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the payments on which may be accelerated by reason of prepayments. Thus, under the proposal, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool.

The proposal is not intended to apply to pools of receivables for which interest charges are incidental. Thus, for example, it is intended that the proposal would not apply to a merchant that (1) permits customers to pay their bills within a reasonable time and (2) does not routinely receive interest from a substantial portion of its customers. In addition, the Secretary of the Treasury would be authorized to provide appropriate exemptions from the proposal, including exemptions for taxpayers that hold a limited amount of debt instruments.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. If a taxpayer is required to change its method of accounting under the proposal, such change would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment would be included in income ratably over a four-year period.

B. Corporate Tax Provisions

1. Require gain recognition for certain extraordinary dividends

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraor-

dinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)). The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock (sec. 1059(d)(1)(A)). The Treasury Department has general regulatory authority to carry out the purposes of the section.

Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns, where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented.⁴⁰ Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.⁴¹

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference (sec. 356(a)(2)).

Description of Proposal

Under the proposal, except as provided in regulations, a corporate shareholder would recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.⁴²

In addition, the proposal would require immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

⁴⁰See H.R. Rep. 99-841, II-166, 99th Cong. 2d Sess. (Sept. 18, 1986).

⁴¹See Treas. Reg. sec. 1.701-2(f), Example (2).

⁴²Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a dividend.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under continuing section 1059(g) of present law, the Treasury Department would be authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the bill.

Effective Date

The proposal would generally be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995 and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995.⁴³ However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under present law of any transaction within the scope of the provision, including transactions utilizing options.

In addition, no inference is intended regarding the rules under present law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

2. Repeal percentage depletion for nonfuel minerals mined on certain Federal lands

Present Law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

⁴³Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The statutory percentage for gold, silver, copper, and iron ore is 15 percent; the statutory percentage for uranium, lead, tin, nickel, tungsten, zinc, and most other hard rock minerals is 22 percent. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The Mining Law of 1872 permits U.S. citizens and businesses to freely prospect for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of \$100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least \$500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for \$2.50 or \$5.00 per acre.

Description of Proposal

The proposal would repeal the present-law percentage depletion provisions for nonfuel minerals extracted from any land where title to the land or the right to extract minerals from such land was originally obtained pursuant to the provisions of the Mining Law of 1872.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

3. Modify net operating loss carryback and carryforward rules

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward fifteen years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to REITs (no carrybacks), specified liability losses (10-year carryback), excess interest losses (no carrybacks), and net capital losses of corporations (carryforward limited to five years).

Description of Proposal

The proposal would limit the NOL carryback period to one year and extend the NOL carryforward period to 20 years. The proposal

would not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses.

Effective Date

The proposal would be effective for NOLs arising in taxable years beginning after the date of enactment.

4. Treat certain preferred stock as "boot"

Present Law

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" (often called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of "other property," gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Description of Proposal

The proposal would amend the relevant provisions (sections 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or section 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, a right or obligation would be disregarded if it may be exercised only upon the death, disability, or mental incompetency of the

holder or, in the case of stock transferred in connection with the performance of services, upon the holder's retirement.

The following exchanges would be excluded from this gain recognition: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary would have regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

Effective Date

The proposal would be effective for transactions on or after the date of first committee action.

5. Conversion of large corporations into S corporations treated as complete liquidations

Present Law

The income of a corporation described in subchapter C of the Internal Revenue Code (a "C corporation") is subject to corporate-level tax when the income is earned and individual-level tax when the income is distributed. The income of a corporation described in

subchapter S of the Internal Revenue Code (an "S corporation") generally is subject to individual-level, but not corporate-level, tax when the income is earned. The income of an S corporation generally is not subject to tax when it is distributed to the shareholders. The tax treatment of an S corporation is similar to the treatment of a partnership or sole proprietorship.

The liquidation of a subchapter C corporation generally is a taxable event to both the corporation and its shareholders. Corporate gain is measured by the difference between the fair market values and the adjusted bases of the corporation's assets. The shareholder gain is measured by the difference between the value of the assets distributed and the shareholder's adjusted basis in his or her stock. The conversion of a C corporation into a partnership or sole proprietorship is treated as the liquidation of the corporation.

The conversion from C to S corporation status (or the merger of a C corporation into an S corporation) generally is not a taxable event to either the corporation or its shareholders.

Certain rules attempt to limit the potential for C corporations to avoid corporate-level tax by shifting appreciated assets to S corporation status prior to the recognition of such gains. Specifically, an S corporation is subject to a tax computed by applying the highest marginal corporate tax rate to the lesser of (1) the S corporation's recognized built-in gains or (2) the amount that would be taxable income if such corporation was not an S corporation (sec. 1374). For this purpose, a recognized built-in gain generally is any gain the S corporation recognizes from the disposition of any asset within a 10-year recognition period after the conversion from C corporation status or any income that is properly taken into account during the recognition period that is attributable to prior periods. However, a gain is not a recognized built-in gain if the taxpayer can establish that the asset was not held by the corporation on the date of conversion or to the extent the gain exceeds the amount of gain that would have been recognized on such date. In addition, the cumulative amount of recognized built-in gains that an S corporation must take into account may not exceed the amount by which the fair market value of the corporation's assets exceeds the aggregated adjusted basis of such assets on the date of conversion from C corporation status. Finally, net operating loss or tax credit carryovers from years in which the corporation was a C corporation may reduce or eliminate the tax on recognized built-in gains.

The amount of built-in gain that is subject to corporate-level tax also flows-through to the shareholders of the S corporation as an item of income subject to individual-level tax. The amount of tax paid by the S corporation on built-in gains flows-through to the shareholders as an item of loss that is deductible against such built-in gain income on the individual level.

Description of Proposal

The proposal would repeal section 1374 for large S corporations. A C-to-S corporation conversion (whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation) would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Thus, the proposal would require immediate

gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

For this purpose, a large S corporation is one with a value of more than \$5 million at the time of conversion. The value of the corporation would be the fair market value of all the stock of the corporation on the date of conversion.

Effective Date

The proposal generally would be effective for subchapter S elections that become effective for taxable years beginning after January 1, 1998. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an existing S corporation) after December 31, 1997. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1997 or on January 1, 1998.

In addition, the Internal Revenue Service would revise Notice 88-19⁴⁴ to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal. As a result, the conversion of a large C corporation to a regulated investment company ("RIC") or a real estate investment trust ("REIT") after the revisions would result in immediate recognition by the C corporation of the net built-in gain in its assets.

6. Require gain recognition on certain distributions of controlled corporation stock

Present Law

A corporation is generally required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain distributions of stock in a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution.

Description of Proposal

The proposal would adopt additional restrictions under section 355 on acquisitions and dispositions of the stock of distributing and controlled. Under the proposal, the distributing corporation (but not the shareholders) would be required to recognize gain on the distribution of the stock of controlled unless the direct and indirect shareholders of distributing, as a group, control both distributing and controlled at all times during the four year period commencing two years prior to the distribution. Control for this purpose means ownership of stock possessing at least 50 percent of the total com-

⁴⁴ Notice 88-19, 1988-1 C.B. 486, allows C corporations that become RICs or REITs to be subject to rules similar to those of section 1374, rather than being subject to the rules applicable to complete liquidations.

bined voting power and at least 50 percent of the total value of all classes of stock.

In determining whether shareholders retain control in both corporations throughout the four-year time period, any acquisitions or dispositions of stock that are unrelated to the distribution will be disregarded. A transaction is unrelated to the distribution if it is not pursuant to a common plan or arrangement that includes the distribution. For example, public trading of the stock of either distributing or controlled is disregarded, even if that trading occurs in contemplation of the distribution. Similarly, an acquisition of distributing or controlled in a merger or otherwise that is not pursuant to a common plan or arrangement existing at the time of the distribution is not related to the distribution. For example, a hostile acquisition of distributing or controlled commencing after the distribution will be disregarded. On the other hand, a friendly acquisition will generally be considered related to the distribution if it is pursuant to an arrangement negotiated (in whole or in part) prior to the distribution, even if at the time of distribution it is subject to various conditions, such as the approval of shareholders or a regulatory body.

Effective Date

The proposal would be effective for distributions after the date of first committee action.

7. Reform tax treatment of certain corporate stock transfers

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902. Section 304 does not apply to transfers of stock between members of a consolidated group.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the dividends received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the nontaxed portion of such dividend.

Description of Proposal

Under the proposal, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation would be treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation

in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation would be treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the proposal would amend section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend would be treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

Under the proposal, a special rule would apply to section 304 transactions involving acquisitions by foreign corporations. The proposal would limit the earnings and profits of the acquiring foreign corporation that would be taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account would not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of section 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) would apply. The Secretary of the Treasury would prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

No inference is intended as to the treatment of any transaction under present law.

Effective Date

The proposal would be effective for transactions after the date of first committee action.

8. Modify the extension of section 29 credit for biomass and coal facilities

Present Law

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to \$3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include: (1) oil produced from shale and tar sands; (2) gas produced from geopressed brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from

biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

Description of Proposal

The proposal would shorten by one year the "placed in service" period for facilities producing gas from biomass and synthetic fuel, such that only facilities placed in service before July 1, 1997, pursuant to a binding contract entered into before January 1, 1997, would be eligible for the credit.

Effective Date

The proposal would be effective on the date of enactment.

C. Foreign Provisions

1. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions

Present Law

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to this current inclusion rule includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (a) property that gives rise to the foregoing types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon is treated as foreign personal holding company income. In addition, income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

A variety of exceptions from foreign personal holding company income are provided for income earned by a CFC that is a regular dealer in the property sold or exchanged. However, no exception is available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of

the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

Description of Proposal

The proposal would add net income from notional principal contracts as a new category of foreign personal holding company income. In addition, the proposal would treat income derived from equity securities lending transactions pursuant to section 1058 as foreign personal holding company income.

Under the proposal, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income would be included in that category.

The proposal would provide an exception from foreign personal holding company income for income from transactions entered into in the ordinary course of a CFC's business as a regular dealer in forward contracts, options, notional principal contracts, and similar financial instruments (including instruments referenced to commodities).

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

2. Taxation of certain captive insurance companies and their shareholders

Present Law

A deduction generally is allowed for insurance premiums incurred in connection with a taxpayer's trade or business. In contrast, no deduction is allowed for amounts set aside by the taxpayer to fund future losses.

An insurance company is defined under Treasury regulations as a company whose primary and predominant business activity is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The term "insurance" is not defined in the Code. In general, courts have held that an insurance transaction involves risk shifting and risk distribution. See *Helvering v. LeGierse*, 312 U.S. 531 (1941).

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently their shares of certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC. In addition, special provisions under the subpart F rules apply to the related person insurance income of a CFC. Further, present law applies a look-through rule in characterizing certain subpart F

insurance income for purposes of determining unrelated business income of a tax-exempt organization.

Premiums paid by a U.S. person to a foreign insurer or reinsurer with respect to the insurance of U.S. risks are subject to an excise tax, absent an applicable tax treaty that includes a waiver of this tax.

Description of Proposal

In general

Under the proposal, "disqualified shareholder insurance" would be treated as derived from a business other than insurance for purposes of determining whether a corporation qualifies as an insurance company under the primary and predominant business activity test of present law. In the case of a corporation that fails to qualify as an insurance company because of disqualified shareholder insurance (i.e., a disqualified corporation), premiums with respect to disqualified shareholder insurance would not be deductible when paid. Special rules (described below) would apply in determining the deductions and income inclusions of both the disqualified corporation and the insured with respect to disqualified shareholder insurance.

Disqualified shareholder insurance would be an insurance or reinsurance policy issued directly or indirectly with respect to a person who is a "large shareholder" of the issuing corporation, or a person related to such a shareholder. An insurance or reinsurance policy would not constitute disqualified shareholder insurance if the ultimate insured is not a large shareholder or a related person (e.g., a third-party risk that is reinsured by the issuing company's affiliate).

A large shareholder would be any person who owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. For this purpose, the indirect and constructive ownership rules of section 958 would apply, other than section 958(b)(4). Policyholders of a mutual company would be treated as shareholders. A person would be considered to be related based on the application of rules similar to the rules of section 954(d)(3). Moreover, in the case of an insurance policy covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing such services would be treated as related to such corporation or partnership.

Treatment of disqualified corporation

Under the proposal, a disqualified corporation would not be subject to tax under subchapter L of the Code and would not be eligible for tax-exempt status under section 501(c)(15). The disqualified shareholder insurance generally would not constitute insurance for purposes of the Code.

The disqualified corporation would not include in income premiums for disqualified shareholder insurance. The disqualified corporation would include in income, in the year the insurance expires, the excess, if any, of the premiums received with respect to such insurance over the aggregate claims paid. The disqualified

corporation could deduct the excess, if any, of the aggregate claims paid with respect to such insurance over the premiums received.

Treatment of large shareholder and related persons

Under the proposal, premiums paid to a disqualified corporation for disqualified shareholder insurance would not be deductible. Claims paid with respect to such disqualified shareholder insurance would be includible in the income of the insured to the extent such aggregate payments exceed the premiums paid. The insured would be allowed a deduction, in the year the insurance expires, to the extent that the premiums with respect to such disqualified shareholder insurance exceed the aggregate claims paid. For purposes of section 165(a), the proceeds of such disqualified shareholder insurance would not constitute compensation by insurance or otherwise.

Application to reinsurance

For purposes of applying this proposal to arrangements involving reinsurance, premiums paid indirectly and claim amounts received indirectly would be taken into account. If any portion of disqualified shareholder insurance is ceded to a person that is not related to the ultimate insured with respect to such insurance, or to any person related to the ultimate insured, that portion would not constitute disqualified shareholder insurance. The proposal would not apply to reinsurance transactions between affiliated insurance companies, if the insured risks were not related party risks with respect to the ceding or the assuming insurance companies.

Foreign personal holding company income

In the case of a foreign corporation that is a disqualified corporation, the proposal would create a new category of foreign personal holding company income under subpart F for income with respect to disqualified shareholder insurance. This new category of foreign personal holding income would consist of the excess, if any, of the amount of premiums received with respect to disqualified shareholder insurance over the claims paid with respect thereto.

Application of excise tax

Disqualified shareholder insurance would be treated as insurance for purposes of the insurance excise tax if the ultimate insured with respect to such disqualified shareholder insurance claims a deduction on its tax return for premiums paid directly or indirectly for such insurance.

Information reporting

Under the proposal, recordkeeping and information reporting requirements would apply in cases in which a corporation issues an insurance or reinsurance policy where the person directly or indirectly insured is a shareholder of the corporation or a person related to a shareholder. In such a case, the shareholder or the related person would be required to maintain records and provide information as prescribed in Treasury guidance. If any person fails to satisfy these requirements with respect to any insurance or reinsur-

ance policy, no deduction would be allowed for premiums paid directly or indirectly by such person for such policy.

Regulatory authority

The Secretary of the Treasury would have authority to prescribe regulations as necessary or appropriate to carry out the purposes of the proposal. The Secretary could issue regulations (1) preventing avoidance of these rules through cross-insurance or multiple-contact arrangements or otherwise; (2) preventing items from being taken into account more than once; (3) providing that the determination of whether a corporation with disqualified shareholder insurance qualifies as an insurance company is made on the basis of the average of its net written premiums over multiple years; and (4) treating persons as related by reason of contractual arrangements or otherwise.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

3. Modify foreign tax credit carryover rules

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Proposal

The proposal would reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1997.

4. Reform treatment of foreign oil and gas income and dual-capacity taxpayers

Present Law

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign source income is al-

lowed for foreign taxes. The foreign tax credit is available only for foreign income, war profits, and excess profits taxes and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses only. Treasury regulations provide detailed rules for determining whether a foreign levy is a creditable income tax. A levy generally is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country. A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from such country is considered a "dual capacity taxpayer." Under a safe harbor provided in the regulations, the portion of a foreign levy paid by a dual capacity taxpayer that is creditable is determined based on the foreign country's generally applicable tax or, if the foreign country has no general tax, the U.S. tax (Treas. Reg. sec. 1.901-2A(e)).

The amount of foreign tax credits that a taxpayer may claim in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for specific categories of income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years. Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation). A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year. A recapture rule applicable to foreign oil and gas extraction losses treats income that would otherwise be foreign oil and gas extraction income as foreign source income that is not considered oil and gas extraction income; the taxes on such income retain their character as foreign oil and gas extraction taxes and continue to be subject to the special limitation imposed on such taxes.

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their shares of certain income earned by the corporation, whether or not such income is distributed to the shareholders. Such income includes foreign base company oil related income (sec. 954(g)). Foreign base company oil related income is foreign oil related income other than income derived from a source within a foreign country in connection with (1) oil or gas which was extracted from a well located in such foreign country or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within such country or is loaded in such country as fuel on a vessel or aircraft. Foreign base company oil related income does not include income of small producers (i.e., corporations whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would deny the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country by a dual-capacity taxpayer if the country does not impose a "generally applicable income tax." A generally applicable income tax would be an income tax that is imposed on the income derived from business activities conducted within that country, provided that the tax has substantial application to persons who are not dual capacity taxpayers and to persons who are citizens or residents of the foreign country. If the foreign country imposes a generally applicable income tax, the foreign tax credit available to a dual-capacity taxpayer would not exceed the amount of tax that would be imposed under the generally applicable income tax. The proposal would not apply to the extent contrary to any treaty obligation of the United States.

The proposal would replace the special limitation rules applicable to foreign oil and gas extraction income with a separate foreign tax credit limitation with respect to "foreign oil and gas income." For this purpose, foreign oil and gas income would include foreign oil and gas extraction income and foreign oil related income. The proposal would repeal the special carryover rules applicable to excess foreign oil and gas extraction taxes and would repeal the recapture rule for foreign oil and gas extraction losses.

The proposal would treat foreign oil and gas extraction income as income which is subject to current U.S. taxation under the rules of subpart F.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

5. Replace sales source rules with activity-based rule

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. A credit against U.S. tax on foreign source income is allowed for foreign taxes. Specific rules apply in determining whether income is from U.S. or foreign sources. Income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States is treated as partly from U.S. sources and partly from foreign sources. Under Treasury regulations, a taxpayer may treat 50 percent of such income as attributable to production activities and 50 percent of such income as attributable to sales activities. Alternatively, a taxpayer may determine the income from production activities based upon an independent factory price. The portion of the income that is attributable to production activities generally is sourced based on the location of the production assets. The portion of the income that is attributable to sales activities generally is sourced where the sale occurs.

Description of Proposal

Under the proposal, income from the sale or exchange of inventory property that is produced in the United States and sold or exchanged abroad would be apportioned between production activities and sales activities based on actual economic activity.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

D. Accounting Provisions

1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting

Present Law

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding \$1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding \$25 million. A family corporation is one where 50 percent or more of the stock of the corporation is held by one family (or in some limited cases, two or three families).

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

Description of Proposal

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change. In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 10-period, beginning with the first taxable year beginning after the effective date.

Effective Date

The proposal would be effective for taxable years ending after the date of first committee action.

2. Repeal lower of cost or market inventory accounting method

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in-first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in-first-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under a (1) cost method or (2) "lower of cost or market" ("LCM") method (Treas. reg. sec. 1.471-2(c)). Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Similarly, under the subnormal goods method, any goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, may be written down to net selling price.

Retail merchants may use the "retail method" in valuing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at yearend by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year,

with adjustments for mark-ups and mark-downs (Treas. reg. sec. 1.471-8(a)). Under certain conditions, a taxpayer using the FIFO method may determine the approximate cost or market of inventory by not taking into account retail price mark-downs for the goods available for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods of goods on hand at year end (Treas. reg. sec. 1.471-8(d)). As a result, such taxpayer may write down the value of inventory below both its cost and its market value.

Description of Proposal

The proposal would repeal the LCM method and the subnormal goods method. Appropriate wash-sale rules would be provided. The proposal would not apply to taxpayers with average annual gross receipts over a three-year period of \$5 million or less.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. Any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over a four taxable year period beginning with the first taxable year the taxpayer is required to change its method of accounting.

3. Repeal components of cost inventory accounting method

Present Law

Taxpayers using the LIFO method to account for inventories may use the "dollar-value" LIFO method. Under the dollar-value LIFO method, inventory items are expressed in terms of constant dollars and "base-year" costs (rather than units), and are grouped in inventory pools. Total base-year costs by pool, rather than the quantity of specific goods, are used to measure inventory increases and decreases. If ending inventory at base-year costs is greater than beginning inventory at base-year costs (i.e., there has been an increase in inventory), such increase is valued at current-year costs. Taxpayers define items in the pool under the "total product cost" ("TPC") method or the "components of cost" ("COC") method. Under the TPC method, ending inventory is determined by valuing the items in ending inventory by the base-year cost of producing such items. Under the COC method, taxpayers do not measure ending inventory with reference to the total product cost of producing the items in ending inventory, but rather treat the units of production (i.e., the amount of material, labor, and overhead) that were used to produce the inventory as separate items.

The proper application of the COC method to labor and overhead is unclear under present law.⁴⁵ Accordingly, the COC method as

⁴⁵The use of the COC method as applied by some taxpayers with respect to labor and overhead costs is not specifically provided for in the Code or regulations, but such method may be used for financial accounting purposes. Treasury regulations allow taxpayers to treat raw materials (and the raw material content of work-in-process and finished goods) as a separate item under the LIFO method (Treas. Reg. sec. 1.472-1(c)). The Internal Revenue Service ("IRS") has ruled under the particular facts and circumstances of one taxpayer that the application of the COC method by that taxpayer did not clearly reflect income (TAM 9405005).

applied by some taxpayers may produce different results than the TPC method whenever a taxpayer's production processes change between the base year and the current year. For example, assume that in the base year the taxpayer can produce an item by applying 5 units of material at \$8 a unit, 10 hours of direct labor at \$10 an hour, and 10 hours of overhead at \$5 an hour.⁴⁶ Thus, it costs \$190 to produce an item in the base year (5 times \$8, plus 10 times \$10, plus 10 times \$5). Further assume that: (1) the taxpayer's production processes change such that in the current year it now takes 5 units of materials, 5 hours of direct labor, and 5 hours of overhead to produce the same item; (2) the prices for materials, labor, and overhead have remained constant from the base year to the current year; and (3) one item of inventory remains at the end of the current year. Under the TPC method, because prices have remained constant, ending inventory would be valued at \$190 (the total product cost of producing one item in the base year). Under the COC method as applied by some taxpayers, ending inventory could be valued at \$115 (5 units of materials times \$8, plus 5 hours of direct labor times \$10, plus 5 hours of overhead times \$5).

Thus, in this example, application of the COC method in this manner would reduce taxable income by \$75 (\$190 less \$115) in the current year as compared to the TPC method. The \$75 reduction in taxable income is comprised of the following: (1) \$50 of direct labor reductions (5 less direct labor hours times the \$10 per hour labor rate) and (2) \$25 of overhead reductions. In this case, the reduction in labor hours is demonstrable. However, the reduction in overhead results because of the use of the burden rate that allocates overhead based on direct labor hours rather than because of a demonstrable reduction of the appropriate amount of overhead to be applied to inventory. In fact, a reduction of labor hours in the current year may be attributable to an increased reliance upon overhead costs in the production process (e.g., reductions in workforce may result because of increased mechanization).

Description of Proposal

The proposal would repeal the COC method.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis. For taxpayers switching to a FIFO or other method of valuing inventory, the proposal would be applied pursuant to the present-law rules governing such changes in methods of accounting.

The proposal is not intended to affect the determination of whether the COC method is an appropriate method under present law and it is intended that the IRS would not be precluded from challenging its use in taxable years beginning on or before the date of enactment.

⁴⁶ In this example, overhead is allocated to inventory pursuant to a burden rate based on direct labor hours. Such allocations are common.

E. Gain Deferral Provisions

1. Expansion of requirement that involuntarily converted property be replaced with property from an unrelated person

Present Law

Gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time (sec. 1033). Pursuant to a provision of H.R. 831, as passed by the Congress and signed by the President on April 11, 1995 (P.L.104-7), subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person.

Description of Proposal

The proposal would expand the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of \$100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual \$100,000 limitation would apply to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

The proposal would apply to involuntary conversions occurring after the first date of committee action.

2. Further restrict like-kind exchanges involving foreign personal property

Present Law

Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or both outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

Application of depreciation rules

Tangible personal property that is used predominantly outside the United States generally is accorded a less favorable depreciation regime than is property that is used predominantly within the United States. Thus, under present law, if a taxpayer exchanges depreciable U.S. property with a low adjusted basis (relative to its fair market value) for similar property situated outside the United States, the adjusted basis of the acquired property will be the same as the adjusted basis of the relinquished property, but the depreciation rules applied to such acquired property generally will be different than the rules that were applied to the relinquished property.

Description of Proposal

The proposal would provide that personal property predominantly used within the United States and personal property predominantly used outside the United States are not "like-kind" properties. For this purpose, the use of the property surrendered in the exchange will be determined based upon the use during the 24 months immediately prior to the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange. In addition, for purposes of the proposal, property used outside the United States but not subject to the depreciation rules applicable to such property would be treated as property used in the United States.

Effective Date

The proposal would be effective for transfers after the date of first committee action.

F. Administrative Provisions

1. Registration of confidential corporate tax shelters

Present Law

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a \$100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of 1 percent of the aggregate amount invested in the shelter or \$500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a \$250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (sec. 6112). A \$50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is \$100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or State law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350 percent of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

Description of Proposal

The proposal would require a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant would be required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of \$100,000.

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been

subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Effective Date

The proposal would apply to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements.

2. Information reporting on persons receiving contract payments from certain Federal agencies

Present Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is \$600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. Reg. 1.6041A-1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for \$25,000 or less (Treas. Reg. 1.6050M-1(c)(1)(i)).

Description of Proposal

The proposal would require reporting of all payments of \$600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the proposal would require that a copy of the information return be sent by the Federal agency to the recipient of the payment. An exception would be provided for certain classified or confidential contracts.

Effective Date

The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

3. Increased information reporting penalties

Present Law

Any person who fails to file a correct information return with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is \$15 per return, with a maximum penalty of \$75,000 per calendar year. If a person files a correct information return after the date that is 30 days after the prescribed filing date but on or before August 1 of that year, the penalty is \$30 per return, with a maximum penalty of \$150,000 per calendar year. If a correct information return is not filed on or before August 1, the amount of the penalty is \$50 per return, with a maximum penalty of \$250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of 1 percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed \$5 million. The maximum penalties for small businesses are: \$25,000 (instead of \$75,000) if the failures are corrected on or before 30 days after the prescribed filing date; \$50,000 (instead of \$150,000) if the failures are corrected on or before August 1; and \$100,000 (instead of \$250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty

for each such failure is generally increased to the greater of \$100 or ten percent of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from \$50 for each return to the greater of \$50 or 5 percent of the amount required to be reported correctly but not so reported. The \$250,000 maximum penalty for failure to file correct information returns during any calendar year (\$100,000 with respect to small businesses) would continue to apply under the proposal.

The proposal also would provide for an exception to this increase where substantial compliance has occurred. The proposal would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported for that calendar year is at least 97 percent of the aggregate amount required to be reported under that section of the Code for that calendar year. If this exception applies, the present-law penalty of \$50 for each return would continue to apply.

The proposal would not affect the following provisions of present law: (1) the reduction in the \$50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than \$5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722; (6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective Date

The proposal would apply to information returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

4. Disclosure of tax return information for administration of certain veterans' programs

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding \$5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs (DVA) of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1998.

Description of Proposal

The proposal would extend the DVA disclosure provision through September 30, 2002.

Effective Date

The proposal would be effective on the date of enactment.

5. Extension of withholding to certain gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed \$5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. No withholding tax is imposed on winnings from bingo or keno.

Description of Proposal

The proposal would impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed \$5,000, regardless of the odds of the wager.

Effective Date

The proposal would be effective for payments made after the beginning of the first month that begins at least 10 days after the date of enactment.

6. Reporting of certain payments made to attorneys

Present Law

Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, . . . or other fixed or determinable gains, profits, and income" (Code sec. 6041(a)). Treas. Reg. sec.

1.6041-1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099-Misc. If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.

Description of Proposal

The proposal would require gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds). The only exception to this new reporting requirement would be for any payments reported on either Form 1099-Misc under section 6041 (reports of payment of income) or on Form W-2 under section 6051 (payments of wages).

In addition, the present exception in the regulations exempting from reporting any payments made to corporations would not apply to payments made to attorneys. Treas. Reg. sec. 1.6041-3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported). Reporting would be required under both Code sections 6041 and 6045 (as proposed) for payments to corporations that provide legal services. The exception of Treas. Reg. sec. 1.6041-3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to be reported on Form K-1).

First, the proposal would apply to payments made to attorneys regardless of whether the attorney is the exclusive payee. Second, payments to law firms are payments to attorneys, and therefore would be subject to this reporting provision. Third, attorneys would be required to promptly supply their TINs. Persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to penalty under section 6723 and the payments being subject to backup withholding under section 3406. Fourth, the IRS should administer this provision so that there is no overlap between reporting under section 6041 and reporting under section 6045. For example, if two payments are simultaneously made to an attorney, one of which represents the attorney's fee and the second of which represents the settlement with the attorney's client, the first payment would be reported under section 6041 and the second payment would not be reported under either section 6041 or section 6045, since it is known that the entire payment represents the settlement with the client (and therefore no portion of it represents income to the attorney).

Effective Date

The proposal would be effective for payments made after December 31, 1997. Consequently, the first information reports would be filed with the IRS (and copies will be provided to recipients of the payments) in 1999, with respect to payments made in 1998.

7. Modify the substantial understatement penalty

Present Law

A 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax. For this purpose, an understatement is considered "substantial" if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, and (2) \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax shown on the return (reduced by any rebates of tax). The substantial understatement penalty does not apply if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement (the "reasonable cause exception"). The determination as to whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.

Description of Proposal

The proposal would treat a corporation's deficiency of more than \$10 million as substantial for purposes of the substantial understatement penalty, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

8. Establish IRS continuous levy and improve debt collection

a. Continuous levy

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand⁴⁷ by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,⁴⁸ unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.⁴⁹

In general, a levy does not apply to property acquired after the date of the levy,⁵⁰ regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure

⁴⁷ Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business. Code sec. 6303.

⁴⁸ Code sec. 6331.

⁴⁹ Code secs. 6335-6343.

⁵⁰ Code sec. 6331(b).

is insufficient to satisfy the liability.⁵¹ The only exception to this rule is for salary and wages.⁵² A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

A minimum exemption is provided for salary and wages.⁵³ It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which the taxpayer is entitled, divided by 52.⁵⁴ For a family of four for taxable year 1996, the weekly minimum exemption is \$325.⁵⁵

Description of Proposal

The proposal would amend the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments would be subject to continuous levy.

In addition, the proposal would provide that this levy would attach up to 15 percent of any salary or pension payment due the taxpayer. This rule would explicitly replace the other specifically enumerated exemptions from levy in the Code. Under the proposal, the continuous levy could apply to the entire amount of a Federal payment that is not salary or a pension payment.

Effective Date

The proposal would be effective for levies issued after the date of enactment.

b. Modifications of levy exemptions

Present Law

The Code exempts from levy workmen's compensation payments⁵⁶ and annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act⁵⁷ described above.

Description of Proposal

The proposal would provide that the following property is not exempt from levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

- (1) workmen's compensation payments,⁵⁸ and
- (2) annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act.

⁵¹ Code sec. 6331(c).

⁵² Code sec. 6331(e).

⁵³ Code sec. 6334(a)(9).

⁵⁴ Code sec. 6334(d).

⁵⁵ Standard deduction of \$6,700 plus four personal exemptions at \$2,550 each equals \$16,900, which when divided by 52 equals \$325.

⁵⁶ Code sec. 6334(a)(7).

⁵⁷ Code sec. 6334(a)(6).

⁵⁸ Many workmen's compensation payments are made by States. The heading of the new subsection of the Code (but not the text of the subsection itself) refers to "Federal" payments. A clarification of this matter may be desirable.

Effective Date

The proposal would apply to levies issued after the date of enactment.

G. Employment Taxes

1. Extension of Federal unemployment tax

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2 percent gross tax rate on the first \$7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States are supposed to use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has been subsequently extended through 1998.

Description of Proposal

The proposal would extend the temporary surtax rate through December 31, 2007.

Effective Date

The proposal would be effective for labor performed on or after January 1, 1999.

2. Deposit requirement for Federal unemployment taxes

Present Law

If an employer's liability for FUTA taxes is over \$100 for any quarter, it must be deposited by the last day of the first month after the end of the quarter. Smaller amounts are subject to less frequent deposit rules.

Description of Proposal

The proposal would require an employer to pay Federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was \$1,100 or more. The deposit with respect to wages paid during a month would be required to be made by the last day of the following month. A safe harbor would be provided for the required deposits

for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer would be required to pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be required to establish a monthly deposit mechanism but would be permitted to adopt a similar safe harbor mechanism for paying State unemployment taxes.

Effective Date

The proposal would be effective for months beginning after December 31, 2001.

H. Excise Taxes

1. Reinstate Airport and Airway Trust Fund excise taxes

Present Law

Before January 1, 1997, excise taxes were imposed on commercial air passenger and freight transportation and on fuels used in general aviation (i.e., transportation on non-common carrier aircraft which is not for hire) to fund the Airport and Airway Trust Fund (the "Airport Trust Fund"). The Airport Trust Fund was established in 1970 to finance a major portion of the costs of Federal Aviation Administration (the "FAA") services and grant programs for State and local government airports. Before establishment of the Airport Trust Fund, Federal aviation expenditures were financed from general revenues; General Fund domestic air passenger and fuels taxes were imposed during this period. The structure of the Airport Trust Fund excise taxes has remained generally unchanged, except for rates, since 1970.

Before 1997, the Airport Trust Fund excise taxes included three taxes on commercial air transportation:

- (1) a 10-percent excise tax on domestic air passenger transportation;
- (2) a \$6 per person international air passenger departure tax; and
- (3) a 6.25-percent domestic air freight excise tax.

During the same period, general aviation (e.g., corporate aircraft) was subject to Airport Trust Fund excise taxes on the fuels it used rather than the commercial aviation passenger ticket and freight excise taxes. The Airport Trust Fund rates for these excise taxes were 17.5 cents per gallon for jet fuel and 15 cents per gallon for aviation gasoline.

The Airport Trust Fund receives gross receipts attributable to the excise taxes described above. Present law provides that taxes received by the Treasury Department through the end of the period when the taxes were last imposed (i.e., through December 31, 1996)

are deposited in the Airport Trust Fund. Taxes received after December 31, 1996, may not be transferred to the Airport Trust Fund under present law.

Description of Proposal

The aviation excises taxes would be reimposed through September 30, 2007, at the same rates as in effect before January 1, 1997. Revenues from reinstatement of these taxes (and from taxes imposed during 1996 that were received by the Treasury after December 31, 1996) would be deposited in the Airport Trust Fund.

The President's budget states that the Administration intends to propose legislation to replace these taxes, effective October 1, 1998, with cost-based user fees, as part of the Administration's effort to place the operation of and funding for the FAA on a more business-like basis. The revised charges would be governmental receipts made available in appropriations acts to fund discretionary spending.

Effective Date

The reinstated excise taxes on air passenger transportation (including international departures) and freight waybills would apply to transportation during the period beginning seven days after the date of the proposal's enactment, but only with respect to amounts paid on and after that date.

The reinstated portion of noncommercial aviation fuels taxes would apply to aviation fuel sold and aviation gasoline removed during the period beginning seven days after the date of the proposal's enactment.

2. Reinstate Leaking Underground Storage Tank Trust Fund excise tax

Present Law

Before January 1, 1996, a 0.1-cent-per-gallon tax was imposed on gasoline, diesel fuel, special motor fuels, and fuels used on inland waterways. Revenues from this tax were deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.

Description of Proposal

The President's budget proposal would reinstate the LUST excise tax during the period after the date of the proposal's enactment and before October 1, 2007.

Revenues from reinstatement of the tax would be deposited in the LUST Trust Fund.

Effective Date

The proposal would be effective on the date of enactment.

3. Reinstate Superfund excise taxes and corporate environmental income tax

Present Law

Before January 1, 1996, four taxes were imposed to fund the Hazardous Substance Superfund Trust Fund ("Superfund") program:

- (1) an excise tax on petroleum and imported refined products;
- (2) an excise tax on certain hazardous chemicals, imposed at rates that varied from \$0.22 to \$4.87 per ton;
- (3) an excise tax on imported substances made with the chemicals subject to the tax in (2), above; and
- (4) an income tax on corporations calculated using the alternative minimum tax rules.

Description of Proposal

The President's budget proposal would reinstate the three Superfund excise taxes during the period after the date of the proposal's enactment and before October 1, 2007. The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1996, and before January 1, 2008.

Revenues from reinstatement of these taxes would be deposited in the Superfund Trust Fund.

Effective Date

The proposal would be effective on the date of enactment.

4. Reinstate Oil Spill Liability Trust Fund excise tax

Present Law

A 5-cents-per-barrel excise tax was imposed before January 1, 1995. Revenues from this tax were deposited in the Oil Spill Liability Trust Fund. The tax did not apply during any calendar quarter when the Treasury Department determined that the unobligated balance in this Trust Fund exceeded \$1 billion.

Description of Proposal

The President's budget proposal would reinstate the Oil Spill Liability Trust Fund tax during the period after the date of the proposal's enactment and before October 1, 2007. The proposal also would increase the \$1 billion limit on the unobligated balance in this Oil Spill Liability Trust Fund to \$2.5 billion.

Effective Date

The proposal would be effective on the date of enactment.

5. Kerosene taxed as diesel fuel

Present Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.3 cents per gallon. This tax is collected on all diesel fuel upon removal from a pipeline or barge terminal unless the fuel is indeli-

bly dyed and is destined for a nontaxable use. Diesel fuel also commonly is used as heating oil; diesel fuel used as heating oil is not subject to tax. Certain other uses also are exempt from tax, and some transportation uses (e.g., rail and intercity buses) are taxed at reduced rates. Both exemptions and reduced-rates are realized through refund claims if undyed diesel fuel is used in a qualifying use.

Aviation gasoline and jet fuel (both commercial and noncommercial use) currently are taxed at a rate of 4.3 cents per gallon. Before January 1, 1997, this aviation fuel was taxed at rates of 4.3 cents per gallon (commercial aviation); 21.8 cents per gallon (non-commercial aviation jet fuel); and, 19.3 cents per gallon (non-commercial aviation gasoline). Also, before January 1, 1996, an additional 0.1-cent-per-gallon tax was imposed to fund the Leaking Underground Storage Tank Trust Fund. Separate provisions of the President's budget proposal would reinstate those expired tax rates. The tax on non-gasoline aviation fuel is imposed on the sale of the fuel by a "producer," typically a wholesale distributor. Thus, this tax is imposed at a point in the fuel distribution chain subsequent to removal from a terminal facility.

Kerosene is used both as a transportation fuel and as an aviation fuel. Kerosene also is blended with diesel fuel destined both for taxable (highway) and nontaxable (heating oil) uses to, among other things, prevent gelling of the diesel fuel in cold temperatures. Under present law, kerosene is not subject to tax unless it is blended with taxable diesel fuel or is sold for use as aviation fuel. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department requirements for untaxed, dyed diesel fuel.

Clear, low-sulphur kerosene (K-1) also is used in space heaters, and often is sold for this purpose at retail service stations. As with other heating oil uses, kerosene used in space heaters, is not subject to Federal excise tax. Although heating oil often has minor amounts of kerosene blended with it in colder weather, this blending typically occurs before removal of the fuel from the terminal facilities where Federal excise taxes are imposed. However, it may be necessary during periods of extreme or unseasonable cold to add kerosene to heating oil after its removal from the terminal. Other nontaxable uses of kerosene include feedstock use in the petrochemical industry.

Description of Proposal

Kerosene would be subject to the same excise tax rules as diesel fuel. Thus, kerosene would be taxed when it is removed from a registered terminal unless it is indelibly dyed and destined for a nontaxable use. However, aviation-grade kerosene that is removed from the terminal by a registered producer of aviation fuel would not be subject to the dyeing requirement and would be taxed under the present law rules applicable to aviation fuel. Feedstock kerosene that a registered industrial user receives by pipeline or vessel also would be exempt from the dyeing requirement. Other feedstock kerosene would be exempt from the dyeing requirement to the extent and under conditions (including satisfaction of registra-

tion and certification requirements) prescribed by regulation. To accommodate State safety regulations that require the use of clear (K-1) kerosene in certain space heaters, a refund procedure would be provided under which registered ultimate vendors could claim refunds of the tax paid on kerosene sold for that use. In addition, the Internal Revenue Service would be given discretion to refund to a registered ultimate vendor the tax paid on kerosene that is blended with heating oil for use during periods of extreme or unseasonable cold.

Effective Date

The proposal would be effective for kerosene removed from terminal facilities after June 30, 1998. Appropriate floor stocks taxes would be imposed on kerosene held beyond the point of taxation on July 1, 1998.

6. Exempt Federal vaccine purchases from vaccine excise tax for one year

Present Law

Under present law, a manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: DPT, \$4.56 per dose; DT, \$0.06 per dose; MMR, \$4.44 per dose; and polio, \$0.29 per dose. Any component vaccine of MMR (measles, mumps, or rubella) is taxed at the same rate as the MMR combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would exempt vaccine purchases paid through grants from the Centers for Disease Control and Prevention and the Health Care Financing Administration from the vaccine excise tax for a 1-year period.

Effective Date

The proposal would be effective for vaccine purchases after September 30, 1997, and before September 30, 1998.

**Estimated Budget Effects of the Revenue Provisions in the
President's Fiscal Year 1998 Budget Proposal**

EXPLANATION OF ESTIMATES

This section contains two revenue tables prepared by the staff of the Joint Committee on Taxation and a Department of the Treasury table showing the effect of the President's proposal on receipts. The first Joint Committee revenue table provides the estimated budget effects of the revenue provisions contained in the President's fiscal year 1998 budget proposal. The second Joint Committee revenue table contains the estimated budget effects of the revenue provisions contained in the President's fiscal year 1998 budget proposal, based on the hypothetical assumption that such provisions will be enacted on a permanent basis (i.e., that such provisions will not be subject to the so-called "tax cut sunset" mechanism contained in the President's budget proposal).

The sections describing the President's budget proposal that were transmitted to the Congress on Thursday, February 6, 1997, indicated that a mechanism would apply to ensure that the budget is balanced in 2002 under both Office of Management and Budget ("OMB") and Congressional Budget Office ("CBO") economic assumptions. Specifically, the President's budget document states the following:

"The Administration is confident that its own assumptions will continue to prove the more accurate.

"Nevertheless, the budget includes a mechanism to ensure that the President's plan reaches balance in 2002 under OMB or CBO assumptions. *If OMB's assumptions prove correct, as we expect, then the mechanism would not take effect.* If, however, CBO proves correct—and the President and Congress cannot agree on how to close the gap through expedited procedures—then most of the President's tax cuts would sunset, and discretionary budget authority and identified entitlement programs would face an across-the-board limit."¹ (Emphasis added.)

The February 6, 1997, budget documents published by the Administration contain no additional detail with respect to the sunset mechanism as it relates to the President's tax proposals. Subsequent to transmittal of these documents, however, the Administration has provided additional detail concerning certain of its tax reduction provisions.

First, the Administration has provided specific statutory language relating to the following provisions: (1) the tax credit for families with young children, (2) the HOPE scholarship tuition tax credit, (3) the education and job training deduction, (4) the expanded Individual Retirement Arrangement ("IRA") provisions, and (5) the deduction for environmental remediation expenses ("Brownfields").² Under that language, these provisions are to terminate or "sunset" for taxable years beginning after December 31, 2000.

Second, the Administration provided an OMB outline description including certain conditions under which it is contemplated Congress could consider subsequent legislation after October 2000 to

¹Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998*, at p. 16.

²Memorandum for Ken Kies, Joint Committee on Taxation, from the Deputy Director of the Office of Management and Budget (February 26, 1997).

reinstate the tax reduction provisions that the Administration is proposing to sunset after December 31, 2000. This outline indicates that if certain deficit targets are achieved for fiscal year 2000, as determined pursuant to a Treasury Department report to be made in October 2000, ". . . a legislative fast track is provided for reenactment of the tax cuts that had been sunset. . . ." ³ A similar possible reenactment scenario is contemplated for fiscal year 2001.

Based on the information supplied by the Administration, the statutory language for the sunset mechanism provides that the specified tax cut provisions would be sunsetted after December 31, 2000. Contrary to language contained in the February 6, 1997, budget documents, this would be the case under either OMB or CBO economic assumptions.

The first revenue table contains the estimates of the staff of the Joint Committee on Taxation of the revenue provisions in the President's budget proposal taking account of the sunset of certain of the tax cut provisions as specified in the statutory draft provided by the OMB.

The second Joint Committee revenue table reflects a hypothetical revenue estimate of the revenue provisions in the President's budget as if those revenue provisions subject to sunset are permanent. This is a hypothetical estimate because subsequent congressional action after October 2000 would be required to make these provisions permanent.

³Office of Management and Budget, *Mechanism to Assure Balance on CBO Assumptions*, Received February 10, 1997.

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL
(INCLUDES SUNSET OF CERTAIN PROVISIONS)

Fiscal Years 1997-2007

(Millions of Dollars)

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
I. MIDDLE CLASS TAX RELIEF														
A. Tax Credit for Families with Children Under Age 13 (with sunset).....	lyba 12/31/96	-39	-8,878	-7,674	-8,065	-9,818	...	...	...	...	...	...	-34,474	-34,474
B. Education and Job Training Provisions														
1. HOPE scholarship tuition tax credit (for education commencing on or after 7/1/97) (with sunset) [1].....	pmo/a 1/1/97	[2]	-5,084	-5,868	-7,062	-5,616	...	...	...	...	...	...	-23,630	-23,630
2. Education and job training deduction (for education commencing on or after 7/1/97) (with sunset) [1].....	pmo/a 1/1/97	[2]	-1,988	-2,364	-2,850	-2,268	...	...	...	...	...	...	-9,470	-9,470
3. Tax incentives for expansion of student loan forgiveness.....	ana DOE	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[3]	[3]
4. Extension of employer-provided educational assistance for graduates (effective 6/30/96) and undergraduates; sunset 12/31/00.....	lyba 12/31/96	-213	-423	-660	-704	-477	...	...	...	...	...	...	-2,476	-2,476
5. Small business tax credit for employer-provided educational assistance.....	pmi lyba 12/31/97	-5	-14	-25	-33	-32	-19	-12	-7	-4	-2	-1	-129	-155
C. Provisions Relating to Individual Retirement Plans (with sunset).....	lyba 12/31/96	[2]	-2,254	-1,520	-2,433	-3,167	-2,160	-2,808	-3,601	-4,503	-5,563	-6,838	-11,534	-34,844
D. Exclusion of Capital Gains on Sale of Principal Residence.....	seo/a 1/1/97	-31	-589	-527	-538	-549	-560	-571	-582	-594	-606	-618	-2,794	-5,765
SUBTOTAL: MIDDLE CLASS TAX RELIEF.....		-288	-19,230	-18,638	-21,685	-21,927	-2,739	-3,389	-4,190	-5,101	-6,171	-7,457	-84,507	-110,814
II. DISTRESSED AREAS INITIATIVES														
A. Expand Empowerment Zones and Enterprise Communities.....	bia DOE; eii lyba DOE	-10	-110	-160	-166	-63	-8	-13	-17	-22	-29	-33	-518	-632
B. Expensing of Environmental Remediation Costs ("Brownfields") (with sunset).....	eia DOE	-15	-55	-198	-315	-266	-65	3	13	28	41	44	-934	-806
C. Provide Tax Credit for Investment in Community Development Financial Institutions.....	lyba 12/31/96	...	-2	-5	-8	-11	-15	-20	-21	-12	-2	[2]	-41	.95
SUBTOTAL: DISTRESSED AREAS INITIATIVES.....		-25	-167	-363	-489	-340	-108	-30	-25	-6	10	11	-1,493	-1,533

III. WELFARE-TO-WORK TAX CREDIT..... wpolc/a DOE..... -41 -75 -95 -77 -41 -16 -5 -1 - - -331 -353

IV. EXPANSION OF ESTATE TAX EXTENSION PROVISIONS FOR CLOSELY HELD BUSINESSES..... dda 12/31/97..... -239 -261 -284 -309 -300 -300 -300 -300 -300 -1,093 -2,593

V. OTHER TAX INCENTIVES

- A. Equitable Tolling of Statute of Limitations Period for Claiming Tax Refunds for Incapacitated Taxpayers..... ordl lyea DOE..... -18 -41 -47 -53 -58 -60 -63 -59 -338
- B. Extend and Modify Puerto Rico Tax Credit..... lyba 12/31/97..... -31 -115 -135 -155 -228 -557 -833 -1,135 -1,856 -2,375 -664 -7,420
- C. Extend Foreign Sales Corporations Benefits to Licenses of Computer Software for Reproduction Abroad..... lga DOE [3] -26 -41 -150 -171 -151 -175 -200 -225 250 -275 -539 -1,864
- D. Establish Distinct of Columbia Tax Incentive Program..... Proposal Not Specified.....

SUBTOTAL: OTHER TAX INCENTIVES..... [3] -57 -156 -285 -344 -420 -779 -1,086 -1,416 -2,166 -2,713 -1,262 -8,422

VI. EXTENSIONS OF EXPIRING TAX PROVISIONS

- A. Research Tax Credit (through 5/31/98)..... 6/1/97..... -387 -702 -476 -246 -174 -88 -18 - - -2,073 -2,091
- B. Contributions of Appreciated Stock to Private Foundations (through 5/31/98)..... 6/1/97..... -10 -102 -10 -3 - - - - -126 -126
- C. Work Opportunity Tax Credit [4]
 - a. Extend for one year through 9/30/98..... wpoia 9/30/97..... -108 -134 -78 -31 -12 -2 - - -362 -365
 - b. Add a new targeted group (through 9/30/00) [5]..... wpoia/a DOE..... -35 -57 -70 -54 -27 -10 -3 - - -243 -256
- D. Orphan Drug Tax Credit (through 5/31/98)..... 6/1/97..... -8 -11 -5 -1 [2] [2] - - -26 -26

SUBTOTAL: EXTENSION OF EXPIRING TAX PROVISIONS..... -405 -958 -682 -398 -259 -127 -30 -3 - - -2,830 -2,864

SUBTOTAL: SECTIONS I - VI..... -716 -20,453 -20,153 -23,213 -23,231 -3,744 -4,544 -5,609 -6,824 -8,627 -10,459 -91,516 -127,570

VII. CORPORATE REFORM PROVISIONS

- A. Provisions Relating to Financial Products
 - 1. Deny interest deduction on certain debt instruments..... no/a dolca 2 73 121 157 189 217 243 267 294 324 356 759 2,243
 - 2. Denier interest deduction on certain convertible debt..... dio/a dolca 1 14 26 40 54 66 74 83 93 104 116 201 671
 - 3. Limit dividends-received deduction
 - a. Reduce dividends-received deduction to 50%..... dpoaa 30da DOE 24 296 311 317 323 330 336 343 350 357 365 1,601 3,351
 - b. Modify holding period for dividends-received deduction..... dpoaa 30da DOE 4 12 15 15 16 16 16 17 17 17 18 78 162
 - c. Deny dividends-received deduction for preferred stock with certain non-stock characteristics..... dosia 30.a DOE 1 12 23 36 49 59 64 67 68 69 71 179 517

Provision

Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
4. Disallowance of interest on indebtedness allocable to tax-exempt obligations.....	...	13	29	38	48	57	67	76	85	93	101	185	608
5. Basis of substantially identical securities determined on an average cost-basis.....	...	725	287	397	387	377	368	359	350	341	332	2,173	3,923
6. Require recognition of gain on certain appreciated positions in personal property.....	[7]	15	20	25	30	35	40	45	50	55	60	125	375
7. Gains or losses from certain terminations with respect to property.....	...	15	27	25	25	25	25	25	25	25	25	117	242
8. Determination of original issue discount where pooled debt obligations subject to acceleration.....	...	66	239	311	277	246	87	91	95	99	103	1,139	1,814
B. Corporate Tax Reforms													
1. Require gain recognition for certain extraordinary dividends.....	165	440	-90	-51	-7	42	71	77	82	89	95	499	913
2. Repeal percentage depletion for certain nonfuel minerals mined on certain Federal lands.....	14	35	64	68	67	69	71	72	74	76	78	315	686
3. Modify net operating loss carryback and carryforward rules.....	52	104	958	1,139	806	563	428	355	314	293	286	3,519	5,195
4. Treat certain preferred stock as "boot".....	20	101	155	160	167	95	34	36	38	40	42	698	888
5. Conversion of large corporations into S corporations treated as complete liquidation.....	...	6	20	37	52	60	62	64	65	67	69	176	503
6. Require gain recognition on certain distributions of controlled corporation stock.....	15	75	50	50	50	50	50	50	50	50	50	290	540
7. Reform tax treatment of certain corporate stock transfers.....	[7]	10	5	5	5	5	5	5	5	5	5	30	55
C. Foreign Tax Provisions													
1. Expand subpart F provision regarding income from notional principal contracts and stock lending transactions.....	...	9	20	21	21	21	21	22	22	22	23	92	202
2. Taxation of certain captive insurance companies and their shareholders.....	...	20	15	5	5	5	5	5	5	5	5	50	75
3. Modify foreign tax credit carryover rules.....	[8]	80	520	468	441	416	390	275	271	267	263	1,925	3,391
4. Reform treatment of foreign oil and gas income and dual capacity taxpayers.....	[8]	155	305	328	352	379	407	438	471	506	544	1,519	3,885
5. Replace sales source rules with activity-based rule.....	[9]	889	1,676	1,802	1,937	2,083	2,239	2,407	2,587	2,781	2,990	8,387	21,391
D. Accounting Provisions													
1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting.....	[10]	54	72	73	74	75	76	77	78	79	69	357	735
2. Repeal lower of cost or market inventory accounting method.....	[11]	147	331	321	317	257	101	58	62	66	70	1,373	1,730
3. Repeal components of cost inventory accounting method.....	[11]	56	101	109	117	125	135	145	156	168	180	508	1,292

E. Gain Deferral Provisions
 1. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person.
 2. Further restrict like-kind exchanges involving foreign personal property.
F. Administrative Provisions
 1. Require registration of confidential corporate tax shelters.
 2. Information reporting on corporations receiving contract payments from certain Federal agencies.
 3. Increased information reporting penalties.
 4. Extend disclosure of tax return information for administration of certain Veterans' programs [12].
 5. Modify the substantial understatement penalty for corporations.
 6. Extension of withholding to certain gambling winnings.
 7. Reporting of certain payments made to attorneys.
 8. Reinstate Oil Spill Liability Trust Fund excise tax and raise Trust Fund ceiling to \$2.5 billion (sunset 9/31/07).
 9. Tax kerosene in the same manner as diesel fuel.
 10. Sunset extension of section 29 placed-in-service date of credit for biomass and coal facilities on 7/1/97.
G. Employment Taxes
 1. Extension of Federal unemployment tax [12].
 2. Deposit requirement for Federal unemployment taxes [12].

icoa dolca	[11]	1	4	6	8	11	13	15	17	19	21	30	115
Ta dolca	[11]	4	8	11	13	15	17	19	21	23	25	51	156
IsosaiTg	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[8]	[8]
rd 90da DOE	...	5	7	8	9	10	11	11	12	12	13	39	98
rd 90da DOE	...	7	15	23	24	25	27	28	29	31	32	94	241
dima 9/30/98	...	...	22	27	31	36	...	...	...	...	...	116	116
lyba DOE	...	...	...	...	...	...	10	20	20	20	20	...	90
pma fmba 10da DOE	2	22	3	3	3	3	3	3	4	4	4	36	54
pma 12/31/97	...	...	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[8]	[8]
DOE	14	203	205	208	209	210	65	53	53	54	52	1,050	1,327
7/1/98	...	44	43	49	46	44	43	44	47	49	52	226	462
DOE	[7]	20	44	52	59	70	75	77	79	82	84	245	642
lpo/a 1/1/99	...	...	1,063	1,763	1,797	1,733	661	-73	-71	-74	-73	6,356	6,726
mba 12/31/01	...	...	...	...	...	1,313	37	33	29	35	34	1,313	1,481
SUBTOTAL: CORPORATE REFORM PROVISIONS	220	3,728	6,714	8,044	8,001	9,143	6,377	5,689	5,947	6,253	6,560	35,951	66,695

VIII. OTHER TAX PROVISIONS
A. Excise Taxes
 1. Reinstate Airport and Airway Trust Fund excise taxes.
 2. Reinstate Leaking Underground Storage Tank Trust Fund excise tax.
 3. Reinstate Superfund taxes
 a. Superfund excise taxes (sunset 9/31/07).
 b. Superfund corporate environmental income tax [13].

lp7da DOE	257	5,172	5,521	5,865	5,228	6,612	7,016	7,445	7,901	8,385	8,895	29,653	69,295
DOE	14	130	128	128	129	131	134	136	139	142	145	660	1,357
DOE	42	610	617	625	629	632	635	638	641	644	647	3,155	6,359
lyba 12/31/96	326	546	559	582	610	639	670	702	736	771	808	3,262	6,949

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
4. Establish IRS authority for continuous levy and improve debt collection.	1a DOE	30	332	327	256	213	157	117	102	86	82	78	1,315	1,780
5. Exempt Federal vaccine purchases from vaccine excise tax for one year.	vpa 9/30/97	...	-98	...	...	...	...	...	...	...	...	...	-98	-98
B. Interest subsidy for State and local school construction.	10/1/97	...	-5	-40	-95	-163	-221	-244	-247	-247	-241	-231	-525	-1,734
SUBTOTAL: OTHER TAX PROVISIONS		669	6,687	7,112	7,361	7,646	7,950	8,328	8,776	9,256	9,783	10,342	37,422	83,908
SUBTOTAL: SECTIONS VII - VIII		889	10,415	13,826	15,405	15,647	17,093	14,705	14,465	15,203	16,036	16,922	73,273	150,603
NET TOTAL: SECTIONS I - VIII		171	-10,038	-6,327	-7,808	-7,584	13,349	10,161	8,856	8,379	7,409	6,463	-19,243	23,024

Joint Committee on Taxation, February 27, 1997

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column: aiiia = amount includible in income after;

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- da = distributions after
- dda = decedents dying after
- dio/a = debt issued on or after
- dma = disclosures made after
- DOE = date of enactment
- dolca = date of first committee action
- dosa = dividends on stock issued after
- jpoaa = dividends paid or accrued after
- eia = expenses incurred after
- eii = expenses incurred in
- lmba = first month beginning at least
- lpa = foreign taxes paid or accrued
- lcoa = involuntary conversions occurring after
- lola = instruments issued on or after
- lga = licenses granted after
- lia = levies issued after
- lpo/a = labor performed on or after
- mba = months beginning after

- seo/a = sales or exchanges occurring on or after
- oaa = obligations acquired after
- ordf = original returns due for
- pma = payments made after
- pmi = payments made in
- pno/a = payments made on or after
- rd = returns due
- ta = transaction after
- Ta = transfer after
- to/a = transaction on or after
- tyba = taxable years beginning after
- lyea = taxable years ending after
- lp7data = tickets purchased 7 days after date of enactment for travel 7 days after
- lsoanfg = tax shelters offered after issuance of Treasury guidance
- vpa = vaccine purchases after
- wpoia = wages paid or incurred after
- wpoia/a = wages paid or incurred on or after
- 10da = 10 days after
- 30da = 30 days after
- 90da = 90 days after

(Footnotes for Table #97-4 029 appear on the following page)

Footnotes for Table #97-4 030:

- [1] Effective for payments made on or after 1/1/97, for education commencing on or after 7/1/97.
- [2] Loss of less than \$500,000.
- [3] Loss of less than \$5 million.
- [4] Estimates include interaction with welfare-to-work tax credit.
- [5] This group is composed of individuals ages 18 - 50 who lost eligibility for food stamps under the Administration's proposal to impose time limits on food stamp eligibility.
- [6] Effective for constructive sales occurring either (1) after date of enactment, or (2) after 1/12/96, and before the date of enactment if the position giving rise to the constructive sales remains outstanding 30 days after the date of enactment. Estimate includes interaction with average cost-basis proposal.
- [7] Gain of less than \$500,000.
- [8] Gain of less than \$10 million.
- [9] Gain of less than \$50 million.
- [10] Provisions would be effective for taxable years ending after the date of first committee action, except that the 10-year period for restoring existing suspense accounts would begin with the first taxable years that begins after that date.
- [11] Gain of less than \$5 million.
- [12] Estimate provided by the Congressional Budget Office.
- [13] Estimates are presented net of the effect of the income tax deduction for the environmental tax

HYPOTHETICAL ESTIMATE OF THE BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL
AS IF CERTAIN TAX REDUCTION PROVISIONS SUBJECT TO SUNSET ON DECEMBER 31, 2000, ARE ENACTED ON A PERMANENT BASIS

Fiscal Years 1997-2007
(Millions of Dollars)

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
I. MIDDLE CLASS TAX RELIEF														
A. Tax Credit for Families with Children Under Age 13	lyba 12/31/96	-39	-8,878	-7,674	-8,025	-11,408	-11,337	-11,180	-11,003	-10,829	-10,657	-10,632	-47,362	-101,663
B. Education and Job Training Provisions														
1. HOPE scholarship tuition tax credit (for education commencing on or after 7/1/97) [1]	pma/a 1/1/97	[2]	-5,084	-5,868	-5,931	-5,993	-6,057	-6,121	-6,186	-6,251	-6,318	-6,385	-28,933	-60,193
2. Education and job training deduction (for education commencing on or after 7/1/97) [1]	pma/a 1/1/97	[2]	-1,988	-2,364	-2,392	-2,421	-2,449	-2,478	-2,507	-2,537	-2,567	-2,597	-11,814	-24,300
3. Tax incentives for expansion of student loan forgiveness	ama DOE	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[3]	[3]
4. Extension of employer-provided educational assistance for graduates (effective 6/30/96) and undergraduates; sunset 12/31/00	lyba 12/31/96	-213	-423	-660	-704	-477	---	---	---	---	---	---	-2,476	-2,476
5. Small business tax credit for employer-provided educational assistance	pma lyba 12/31/97	-5	-14	-25	-33	-32	-19	-12	-7	-4	-2	-1	-129	-155
C. Provisions Relating to Individual Retirement Plans	lyba 12/31/96	[3]	-2,254	-1,520	-2,433	-3,990	-5,690	-7,301	-8,479	-9,953	-11,777	-13,956	-15,887	-67,352
D. Exclusion of Capital Gains on Sale of Principal Residence	seo/a 1/1/97	-31	-589	-527	-538	-549	-560	-571	-582	-594	-606	-618	-2,794	-5,765
SUBTOTAL: MIDDLE CLASS TAX RELIEF		-288	-19,230	-18,638	-20,056	-24,870	-26,112	-27,663	-28,764	-30,168	-31,927	-34,189	-109,195	-261,904
II. DISTRESSED AREAS INITIATIVES														
A. Expand Empowerment Zones and Enterprise Communities	bia DOE;	-10	115	177	188	188	180	161	153	107	61	60	858	-1,422
B. Expanding of Environmental Remediation Costs ("Brownfields")	eia DOE	-15	55	188	268	284	292	298	298	294	290	287	-1,103	-2,571
C. Provide Tax Credit for Investment in Community Development Financial Institutions	lyba 12/31/96	---	-2	-5	-8	-11	-15	-20	-21	-12	-2	[2]	-41	-95
SUBTOTAL: DISTRESSED AREAS INITIATIVES		-25	-172	-370	-464	-483	-487	-479	-472	-413	-373	-347	-2,002	-4,068

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
6. Require recognition of gain on certain appreciated positions in personal property.....	[6]													
7. Gains or losses from certain terminations with respect to property.....		[7]	15	20	25	30	35	40	45	50	55	60	125	375
8. Determination of original issue discount where pooled debt obligations subject to acceleration		...	15	27	25	25	25	25	25	25	25	25	117	242
B. Corporate Tax Reforms		...	66	239	311	277	246	87	91	95	99	103	1,139	1,614
1. Require gain recognition for certain extraordinary dividends.....		165	440	-90	-51	-7	42	71	77	82	89	95	499	913
2. Repeal percentage depletion for certain nonfuel minerals mined on certain Federal lands		14	35	64	66	67	69	71	72	74	76	78	315	686
3. Modify net operating loss carryback and carryforward rules.....		52	104	958	1,139	806	563	428	355	314	293	286	3,519	5,195
4. Treat certain preferred stock as "boot"		20	101	155	160	167	95	34	36	38	40	42	698	888
5. Conversion of large corporations into S corporations treated as complete liquidation.....		...	6	20	37	52	60	62	64	65	67	69	176	503
6. Require gain recognition on certain distributions of controlled corporation stock.....		15	75	50	50	50	50	50	50	50	50	50	290	540
7. Reform tax treatment of certain corporate stock transfers.....		[7]	10	5	5	5	5	5	5	5	5	5	30	55
C. Foreign Tax Provisions														
1. Expand subpart F provision regarding income from nonqualifying principal contracts and stock lending transactions.....		...	9	20	21	21	21	21	22	22	22	23	92	202
2. Taxation of certain captive insurance companies and their shareholders.....		...	20	15	5	5	5	5	5	5	5	5	50	75
3. Modify foreign tax credit carryover rules.....		[8]	80	520	468	441	416	390	275	271	267	263	1,925	3,391
4. Reform treatment of foreign oil and gas income and dual capacity taxpayers.....		[8]	155	305	328	352	379	407	438	471	508	544	1,519	3,885
5. Replace sales source rules with activity-based rule.....		[9]	889	1,676	1,802	1,937	2,083	2,239	2,407	2,587	2,781	2,990	8,387	21,391
D. Accounting Provisions														
1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting.....		10	54	72	73	74	75	76	77	78	79	69	357	735
2. Repeal lower of cost or market inventory accounting method.....		[11]	147	331	321	317	257	101	58	62	66	70	1,373	1,730
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E. Gain Deferral Provisions														
1. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person.....		[11]	1	4	6	8	11	13	15	17	19	21	30	115

- 2. Further restrict like-kind exchanges involving foreign personal property.....
- F. Administrative Provisions
 - 1. Require registration of confidential corporate tax shelters.....
 - 2. Information reporting on corporations receiving contract payments from certain Federal agencies.....
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- G. Employment Taxes
 - 1. Extension of Federal unemployment tax [12].....
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SUBTOTAL: CORPORATE REFORM PROVISIONS.....

- VM. OTHER TAX PROVISIONS
 - A. Excise Taxes
 - 1. Reinstate Airport and Airway Trust Fund excise taxes.....
 - 2. Reinstate Leaking Underground Storage Tank Trust Fund excise tax.....
 - 3. Reinstate Superfund taxes
 - a. Superfund excise taxes (sunset 9/31/07).....
 - b. Superfund corporate environmental income tax [13].....
 - 4. Establish IRS authority for continuous levy and improve debt collection.....
 - 5. Exempt Federal vaccine purchases from vaccine excise tax for one year.....

	[11]	4	8	11	13	15	17	19	21	23	25	51	156
Ta dolca	[11]												
IsaolTg	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[8]	[8]
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rd 90da DOE		7	15	23	24	25	27	28	29	31	32	94	241
dna 9/30/98				22	31	38						116	116
tyba DOE							10	20	20	20	20		90
pma lmba 10da DOE	2	22	3	3	3	3	3	3	4	4	4	36	54
pma 12/31/97			[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[8]	[8]
DOE	14	203	205	208	209	210	65	53	53	54	52	1,050	1,327
7/1/98		44	43	49	46	44	43	44	47	49	52	226	462
DOE	[7]	20	44	52	59	70	75	77	79	82	84	245	642
lpo/a 1/1/99			1,063	1,763	1,797	1,733	661	.73	.71	.74	.73	6,356	6,726
mbs 12/31/01						1,313	37	33	29	35	34	1,313	1,481
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lia DOE	30	332	327	256	213	157	117	102	86	82	78	1,315	1,760
vpa 9/30/97		-98										-98	-98

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
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SUBTOTAL: SECTIONS VII - VIII		889	10,415	13,826	15,405	15,647	17,093	14,705	14,465	15,203	16,036	16,922	73,273	150,803
NET TOTAL: SECTIONS I - VIII		171	-10,043	-6,334	-6,154	-10,670	-10,403	-14,562	-16,165	-17,095	-18,730	-20,827	-43,440	-130,821
Joint Committee on Taxation, February 27, 1997														

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[Footnotes for Table #97-4 030 appear on the following page]

Footnotes for Table #97-4 030:

- [1] Effective for payments made on or after 1/1/97, for education commencing on or after 7/1/97.
- [2] Loss of less than \$500,000.
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- [5] This group is composed of individuals ages 18 - 50 who lost eligibility for food stamps under the Administration's proposal to impose time limits on food stamp eligibility.
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- [11] Gain of less than \$5 million.
- [12] Estimate provided by the Congressional Budget Office.
- [13] Estimates are presented net of the effect of the income tax deduction for the environmental tax

FEDERAL RECEIPTS AND COLLECTIONS: EFFECT OF PROPOSALS ON RECEIPTS

(in billions of dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
Provide tax relief and extend expiring provisions:													
Middle Class Bill of Rights:													
Provide tax credit for dependent children.....	-0.718	-9.889	-6.806	-8.552	-10.387	-10.369	-10.222	-10.002	-9.789	-10.396	-10.840	-46.003	-97.252
Expand Individual Retirement Accounts (IRAs).....	0.000	-1.454	-0.477	-0.753	-1.157	-1.674	-2.662	-2.850	-2.957	-3.209	-3.657	-5.515	-20.850
Provide tax incentive for education and training.....	-0.084	-0.044	-6.199	-7.848	-8.632	-9.386	-9.649	-9.910	-10.339	-10.537	-11.161	-36.109	-87.705
Subtotal, Middle Class Bill of Rights.....	-0.802	-15.387	-13.482	-17.153	-20.176	-21.429	-22.533	-22.762	-23.085	-24.142	-25.658	-87.627	-205.807
Provide targeted welfare-to-work tax credit.....	0.000	-0.068	-0.137	-0.163	-0.122	-0.061	-0.020	-0.005	-0.001	0.000	0.000	-0.551	-0.577
Provide capital gains exclusion on sale of principal residence.....	-0.071	-0.288	-0.301	-0.284	-0.268	-0.249	-0.228	-0.206	-0.183	-0.158	-0.132	-1.390	-2.297
Establish DC tax incentive program.....	0.000	-0.024	-0.046	-0.056	-0.068	-0.068	0.000	0.000	0.000	0.000	0.000	-0.260	-0.260
Provide estate tax relief for small business.....	0.000	-0.001	-0.164	-0.166	-0.174	-0.182	-0.174	-0.166	-0.156	-0.149	-0.142	-0.687	-1.474
Provide tax incentives for distressed areas.....	-0.040	-0.424	-0.500	-0.502	-0.469	-0.410	-0.355	-0.312	-0.277	-0.251	-0.228	-2.305	-3.728
Provide tax credit for investment in community development institutions (CDFI).....	0.000	-0.002	-0.005	-0.007	-0.009	-0.011	-0.013	-0.014	-0.015	-0.009	-0.002	-0.034	-0.087
Toll statute of limitations for incapacitated taxpayers.....	0.000	0.000	0.000	0.000	-0.006	-0.049	-0.072	-0.099	-0.121	-0.145	-0.164	-0.055	-0.656
Allow Foreign Sales Corporation (FSC) benefits for computer software licenses.....	-0.010	-0.090	-0.100	-0.110	-0.120	-0.130	-0.145	-0.160	-0.180	-0.200	-0.220	-0.550	-1.455
Extend exclusion for employer-provided educational assistance.....	-0.082	-0.645	-0.670	-0.758	-0.247	0.000	0.000	0.000	0.000	0.000	0.000	-2.320	-2.320
Extend R&E tax credit.....	-0.430	-0.787	-0.540	-0.234	-0.111	-0.041	-0.007	0.000	0.000	0.000	0.000	-1.713	-1.720
Extend orphan drug tax credit.....	-0.008	-0.019	-0.012	-0.003	-0.003	-0.001	0.000	0.000	0.000	0.000	0.000	-0.038	-0.038
Extend work opportunity tax credit.....	0.000	-0.128	-0.157	-0.053	-0.031	-0.010	-0.001	0.000	0.000	0.000	0.000	-0.419	-0.420
Extend deduction for contributions of appreciated stock.....	0.000	-0.034	-0.038	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	-0.072	-0.072
Modify phase-out of Puerto Rico economic-activity tax credit.....	0.000	-0.027	-0.068	-0.091	-0.109	-0.122	-0.128	-0.128	-0.128	-0.1050	-0.021	-0.417	-3.872
Subtotal, provide tax relief and extend expiring provisions.....	-1.443	-17.924	-16.220	-19.620	-21.911	-22.763	-23.676	-23.852	-24.146	-26.104	-28.567	-98.438	-224.783
Eliminate unwarranted benefits and adopt other revenue measures:													
Deny interest deduction on certain debt instruments.....	0.015	0.052	0.103	0.158	0.213	0.271	0.334	0.393	0.469	0.544	0.623	0.797	3.160
Defer original issue discount deduction on convertible debt.....	0.000	0.012	0.021	0.032	0.043	0.052	0.060	0.067	0.073	0.078	0.081	0.160	0.519
Limit dividends-received deduction (DRD):													
Reduce DRD to 50 percent.....	0.000	0.255	0.339	0.354	0.370	0.387	0.404	0.423	0.443	0.466	0.487	1.705	3.928
Eliminate DRD for certain stock.....	0.000	0.013	0.023	0.036	0.049	0.063	0.077	0.092	0.107	0.124	0.140	0.184	0.724
Modify holding period for DRD.....	0.000	0.036	0.026	0.027	0.028	0.029	0.030	0.031	0.033	0.034	0.035	0.146	0.309
Intention.....	0.000	-0.008	-0.008	-0.008	-0.009	-0.009	-0.009	-0.010	-0.010	-0.011	-0.011	-0.042	-0.093
Extend pro-rata disallowance of tax-exempt interest expense to all corporations.....	0.000	0.016	0.031	0.045	0.056	0.065	0.074	0.080	0.086	0.090	0.093	0.213	0.636
Require average-cost basis for stocks, securities, etc.....	0.000	0.638	0.601	0.594	0.589	0.589	0.595	0.606	0.623	0.644	0.663	3.011	6.142

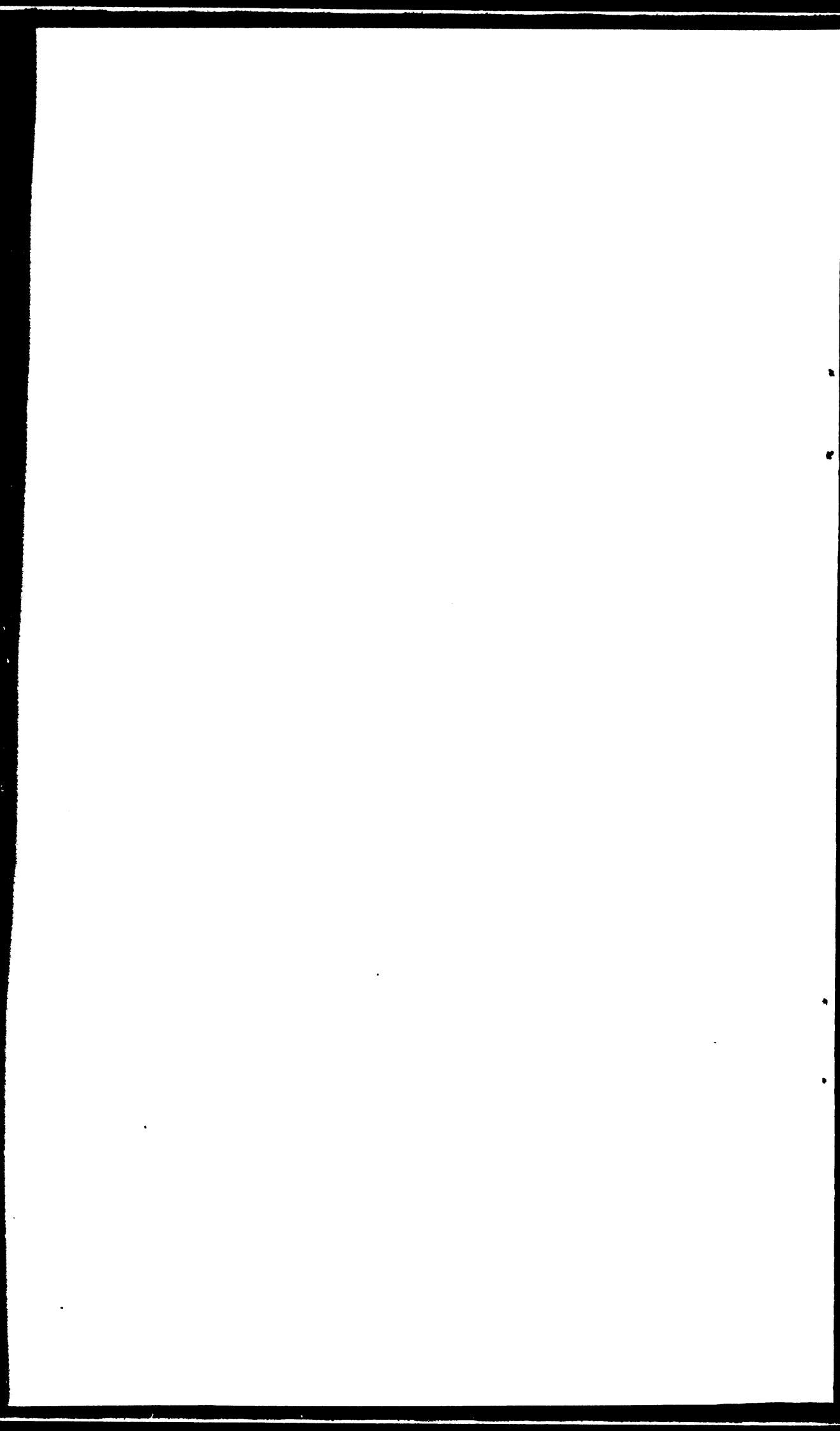
FEDERAL RECEIPTS AND COLLECTIONS: EFFECT OF PROPOSALS ON RECEIPTS
(in billions of dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
Limit extension of tax credit for producing fuel from a nonconventional source.....	0.014	0.064	0.096	0.099	0.101	0.102	0.104	0.106	0.108	0.111	0.113	0.462	1.004
Extend and modify FUTA provisions:													
Extend FUTA surtax 1/.....	0.000	0.000	0.862	1.218	1.295	1.333	1.417	1.460	1.336	1.226	1.059	4.708	11.206
Accelerate deposit of unemployment insurance taxes	0.000	0.000	0.000	0.000	0.000	1.320	0.036	0.032	0.028	0.033	0.032	1.320	1.481
Subtotal, Eliminate unwarranted benefits.....	0.629	4.123	6.323	7.320	7.635	8.894	6.830	7.686	7.924	8.152	8.433	34.295	73.320
Other provisions that affect receipts:													
Extend corporate environmental tax 2/.....	0.000	1.095	0.732	0.767	0.785	0.803	0.832	0.858	0.894	0.924	0.946	4.182	8.636
Extend Superfund excise taxes 1/.....	0.110	0.661	0.675	0.687	0.697	0.708	0.717	0.729	0.739	0.749	0.761	3.428	7.123
Extend LUST excise taxes 1/.....	0.016	0.120	0.126	0.128	0.131	0.134	0.135	0.137	0.139	0.140	0.142	0.639	1.332
Extend aviation excise taxes/new user fees 1/.....	2.291	5.017	6.678	6.647	6.824	7.007	7.197	7.389	7.589	7.794	8.006	32.173	70.148
Extend GSP and modify other trade provisions 1/.....	0.000	-0.665	-0.509	-0.648	-0.732	-0.771	-0.829	-0.871	-0.906	-0.453	-0.471	-3.325	-6.855
Assess fees for examination of FDIC-insured banks and bank holding companies (receipt effect) 1/.....	0.000	0.072	0.075	0.078	0.082	0.086	0.089	0.093	0.097	0.101	0.106	0.393	0.879
Modify method of reimbursing Federal Reserve Banks (receipt effect).....	0.000	0.122	0.125	0.129	0.132	0.136	0.140	0.144	0.148	0.152	0.156	0.644	1.384
Establish IRS continuous levy.....	0.000	0.402	0.398	0.364	0.269	0.212	0.138	0.086	0.065	0.044	0.037	1.645	2.015
Assess fees for NTSB aviation accident investigation activities 1/.....	0.000	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.025	0.050
Establish alien labor certification fee 1/.....	0.000	0.019	0.037	0.037	0.037	0.037	0.038	0.040	0.041	0.041	0.043	0.167	0.370
Exempt Federal vaccine purchases from the payment of vaccine excise taxes 1/.....	0.000	-0.072	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	-0.072	-0.072
Extend and increase FDA user fees 1/.....	0.000	0.178	0.189	0.200	0.211	0.223	0.229	0.234	0.242	0.248	0.254	1.001	2.208
Initiate HFCA Medicare survey and certification fee 1/.....	0.000	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.035	0.070
Increase employee contributions to CSRS and FERS.....	0.000	0.000	0.214	0.423	0.571	0.621	0.156	0.000	0.000	0.000	0.000	1.829	1.985
Adjust Federal pay raise (receipt effect).....	0.000	-0.164	-0.216	-0.213	-0.212	-0.212	-0.207	-0.201	-0.193	-0.185	-0.176	-1.017	-1.979
Subtotal, Other.....	2.417	6.797	8.536	8.611	8.807	8.996	8.647	8.650	8.867	9.567	9.816	41.747	87.294
Subtotal, Eliminate unwarranted benefits and other provisions that affect receipts.....	3.046	10.920	14.859	15.931	16.442	17.890	15.477	16.336	16.791	17.719	18.249	76.042	160.614
Total effect of proposals 1/.....	1.603	-7.004	-1.361	-3.689	-5.469	-4.873	-8.199	-7.516	-7.355	-8.385	-10.318	-22.396	-64.169
Paygo.....	1.603	-6.890	-1.270	-3.605	-5.389	-4.797	-8.132	-7.459	-7.310	-8.352	-10.296	-21.951	-63.502
Non-Paygo.....	0.000	-0.114	-0.091	-0.084	-0.080	-0.076	-0.067	-0.057	-0.045	-0.033	-0.020	-0.445	-0.667

1/ Net of income offsets.
2/ Net of deductibility for income tax purposes.

MEDICARE

The President's FY1998 budget includes proposed savings in Medicare which, based on the Administration's estimates, would save a net \$106.1 billion over the 5-year period, FY1998-FY2002. The Congressional Budget Office (CBO) has estimated the savings at a net \$81.6 billion for the same period. The following section summarizes the major Medicare provisions.



PART A

Hospitals

Annual hospital payment updates

Present Law

Medicare pays most acute care hospitals under a prospective payment system (PPS). A fixed predetermined amount is paid according to the patient's diagnosis. Certain types of hospitals and distinct-part units of hospitals are exempt from PPS (psychiatric, rehabilitation, long-term care, cancer and children's hospitals). A PPS-exempt hospital is paid the lower of its current Medicare allowable inpatient operating costs per discharge or a target amount. Payments to PPS hospitals and PPS-exempt hospitals and distinct-part units are updated annually using an update factor which is determined in part by the projected increase in the hospital market basket index (MBI) which measures the cost of goods and services purchased by hospitals.

Description of Proposal

The proposal would reduce the annual update by 1 percent for PPS hospitals for each year from FY1998–FY2002. PPS-exempt hospital and distinct-part unit updates would be reduced by 1.5 percent for each year from FY1998–FY2002.

Hospital-capital payments

Present Law

Medicare pays its proportionate share of certain hospital capital-related costs. Capital-related costs primarily include interest and depreciation related to construction of facilities and purchase of equipment. A 10-year transition to fully prospective payments for capital costs began in FY1992, during which capital payments are paid prospectively based on average capital costs per case in FY1989, updated for inflation and other cost changes.

From FY1992 through FY1995, Health Care Financing Administration (HCFA) updated base payment rates using a moving average of capital cost increases in previous years. During this period, the Congress required HCFA to adjust the payment rates in each year so that anticipated aggregate capital payments would equal 90 percent of anticipated aggregate costs. This provision expired on September 30, 1995, resulting in a 20.6 percent increase in the Federal capital payment rate for FY1996.

Description of Proposal

The proposal would reduce the 1998 hospital capital payment rate by 15.7 percent, which would effectively limit payments for capital to 90 percent of what they would have been under a reasonable cost system. In addition, the proposal would pay 85 percent of capital costs for PPS-exempt hospitals and distinct units.

Definition of hospital "transfer"

Present Law

PPS hospitals that move patients to PPS-exempt hospitals and distinct-part units, or skilled nursing facilities (SNFs) are currently considered to have "discharged" the patient and receive a full diagnosis related group (DRG) payment.

Description of Proposal

The proposal would define the moving of a patient as a "transfer" rather than as a "discharge" from the acute care hospital, and the PPS hospital payment would be determined on a per diem basis instead of the DRG payment.

Rural health provisions

Present Law

The Medicare program includes special payments for certain rural hospitals in order to maintain beneficiary access to health care services and providers.

Description of Proposal

The proposal would: (1) extend the Rural Referral Center program; (2) improve the Sole Community Hospital program; (3) expand the Rural Primary Care Hospital program; and (4) extend the Medicare Dependent Hospital program.

Graduate medical education payments

Present Law

Medicare pays teaching hospitals for its share of the costs of providing graduate medical education. Direct graduate medical education payments (direct GME) are based on a hospital's per resident costs (i.e., resident and faculty salaries and fringe benefits, and overhead costs related to teaching activities) and the number of full-time-equivalent residents the hospital employs. The indirect costs are reimbursed through the indirect medical education (IME) payment adjustment. This adjustment is designed to compensate teaching hospitals for their relatively higher costs attributable to the involvement of residents in patient care and the severity of illness of patients requiring specialized services available only in teaching hospitals. The IME adjustment to Medicare's hospital payments is currently increased approximately 7.7 percent for each 10 percent increase in a hospital's ratio of interns and residents to beds.

Description of Proposal

The proposal would: (1) cap the total number of residents and the number of non-primary care residency positions reimbursed under Medicare at the current level; (2) count work in non-hospital settings for the IME adjustment; and (3) allow direct GME payments to certain non-hospitals (e.g., Federally Qualified Health Centers) for primary care residents in those settings, when a hospital is not paying for the resident's salary in that setting.

In addition, the proposal would reduce the IME adjustment from its current level of about 7.7 percent to 7.4 percent in FY1998; 7.1 percent in FY1999; 6.8 percent in FY2000; 6.6 percent in FY2001; and 5.5 percent in FY2002 and years thereafter.

Disproportionate Share Hospital (DSH) payments

Present Law

Additional payments are made to hospitals that serve a disproportionate share of low-income patients. A hospital's disproportionate patient percentage is defined as the hospital's total number of inpatient days attributable to Federal Supplemental Security Income (SSI) Medicare beneficiaries divided by the total number of Medicare patient days, plus the number of Medicaid patient days divided by the total patient days.

Description of Proposal

The proposal would freeze hospital-specific disproportionate share hospital (DSH) adjustments at current levels for FY1998 and FY1999. The Secretary would be required to submit a legislative proposal to Congress by April 1, 1999 for revising the qualifying criteria and payment methodology for hospitals that incur higher Medicare costs because they serve a disproportionate share of low-income patients. If no action is taken by FY2000, the old (current law) formula would be reinstated.

Payment to teaching and disproportionate share hospitals from managed care rates

Present Law

In its calculation of payment rates to Medicare risk-contract HMOs, Medicare includes payments to teaching hospitals operating residency training programs and DSH that serve a disproportionate share of low-income persons.

Description of Proposal

The proposal would remove from amounts paid to Medicare risk-contract HMOs, the direct GME, IME and DSH payments. These amounts would then be distributed directly to teaching and DSH hospitals for Medicare managed care enrollees. These funds would also be available for managed care plans that run their own teaching programs. (See *Medicare Managed Care, Payment Rate Changes.*)

Other hospital proposals

Present Law

Long-term hospitals are exempt from PPS and instead are paid the lower of their current Medicare allowable inpatient operating costs per discharge, or a target amount. Medicare makes additional "outlier" payments to hospitals for beneficiaries whose care has been exceptionally costly or required an unusually long hospital stay. Under PPS, a separate standardized amount is set for determining Medicare payments to hospitals located in Puerto Rico (based on a 25 percent Federal/75 percent local blended rate).

Description of Proposal

The proposal would (1) make new long-term care hospitals subject to the PPS for acute care hospitals; (2) eliminate increased IME and DSH payments that are attributable to "outlier" payments, but allow hospitals to count IME and DSH as part of costs that trigger outlier payments, effective in FY1998; and (3) adjust the Puerto Rico payment rate to a blended amount of 50 percent Federal/50 percent local rate.

Skilled Nursing Facilities (SNFs)

Payment reform

Present Law

Currently, Medicare reimburses the great bulk of SNF care on a retrospective cost-based basis. This means that SNFs are paid after services are delivered for the reasonable costs (as defined by the program) they have incurred for the care they provide. For Medicare reimbursement purposes, the costs SNFs incur for providing services to beneficiaries can be divided into three major categories: (1) routine services costs that include nursing, room and board, administration, and other overhead; (2) ancillary services, such as physical and occupational therapy and speech language pathology, laboratory services, drugs, supplies and other equipment; and (3) capital-related costs.

Routine costs are subject to national average per diem limits. Separate per diem routine cost limits are established for freestanding and hospital-based SNFs. Freestanding SNF routine limits are set at 112 percent of the average per diem labor-related and nonlabor-related costs. Hospital-based SNF limits are set at the limit for freestanding SNFs, plus 50 percent of the difference between the freestanding limits and 112 percent of the average per diem routine services costs of hospital-based SNFs. Routine cost limits for SNF care are required to be updated every 2 years. In the interim, the Secretary applies a SNF market basket developed by HCFA to reflect changes in the price of goods and services purchased by SNFs. OBRA93 eliminated updates in SNF routine cost limits for cost reporting periods beginning in FY1994 and FY1995.

Ancillary service and capital costs are both paid on the basis of reasonable costs and neither are subject to limits.

Cost-based reimbursement has been cited as one of the reasons for significant growth in SNF spending since 1989. Spending has increased from \$3.5 billion in 1989 to \$11.7 billion in 1996, for an average annual rate of growth of 19 percent. Growth in SNF spending can be explained largely by the increasing number of persons qualifying for the benefit and increases in reimbursements per day of care. The number of persons served has nearly doubled since 1989, reaching 1.15 million persons in 1996. Average payments for care have grown from \$117 per day in 1989 to \$292 per day in 1996. Increases in ancillary service reimbursements explain much of this per diem payment growth.

Description of Proposal

The President's budget would implement a SNF prospective payment system beginning in July 1, 1998. A single payment would cover routine, ancillary, and capital-related SNF costs and would be case-mix adjusted to reflect patients' varying service needs. The PPS payment would be made on a per diem basis. Rates would be set to capture permanently the savings from the OBRA93 freeze on SNF cost limits.

Part A Premiums

Enrollment

Present Law

Most persons turning age 65 are automatically entitled to Medicare Part A based on their own or their spouse's work in covered employment. Most persons not automatically covered under Part A have coverage through a former government employer.

However, some persons may need Part A protection. If such an individual does not establish eligibility during his or her initial enrollment period (i.e. when he or she turns 65), that individual must wait until the next general enrollment period. A person who terminates coverage must also wait till the next general enrollment period, to reenroll. There is a general enrollment period from January 1 to March 31 of each year. Coverage does not begin until July 1 of that year. Persons wishing to buy into Part A must pay a monthly premium of \$311 per month.

Description of Proposal

The proposal would establish a continuous open enrollment period for persons not enrolling during their initial enrollment period. Coverage for these persons would begin 6-months later.

Working disabled

Present Law

Certain disabled persons may purchase Part A coverage under the voluntary enrollment provisions. These are beneficiaries who continue to be disabled, but who are no longer entitled to cash benefits solely because they have earnings in excess of the amount permitted.

Description of Proposal

The proposal would establish a 4-year demonstration project under which social security disability beneficiaries (SSDI) who return to work would receive free Part A coverage.

PART B

Physicians and Other Suppliers

Establish single conversion factor and reform method for updating physician fees

Present Law

Medicare pays for physicians services on the basis of a fee schedule. The fee schedule assigns relative values to services. Relative values reflect three factors: physician work (time, skill, and intensity involved in the service), practice expenses, and malpractice costs. These relative values are adjusted for geographic variations in the costs of practicing medicine. Geographically-adjusted relative values are converted into a dollar payment amount by a dollar figure known as the conversion factor. There are three conversion factors—one for surgical services, one for primary care services, and one for other services. The conversion factors in 1997 are \$40.96 for surgical services, \$35.77 for primary care services, and \$33.85 for other services.

The conversion factors are updated each year by a formula specified in the law. The update equals inflation plus or minus actual spending growth in a prior period compared to a target known as the Medicare volume performance standard (MVPS). (For example, fiscal year 1995 data were used in calculating the calendar 1997 update.) However, regardless of actual performance during a base period, there is a 5 percentage point limit on the amount of the reduction. There is no limit on the amount of the increase.

Description of Proposal

The President's proposal would set a single conversion factor beginning in 1998, based on the 1997 primary care conversion factor, updated to 1998 by a single average fee update. The proposal would replace the MVPS with a cumulative "sustainable growth rate" based on real gross domestic product (GDP) growth. This new target would begin affecting updates in 1999. The proposal would also place an upper limit on allowable fee increases—3 percentage points above inflation. The lower limit on decreases would change from inflation minus 5 percentage points to inflation minus 8.25 percentage points.

The Physician Payment Review Commission (PPRC), a congressional advisory body, has recommended use of a single conversion factor and replacing the MVPS with a sustainable growth rate. There are, however, a number of technical differences. PPRC has recommended using GDP plus 1 or 2 percentage points in calculation of the sustainable growth rate; it has also recommended the use of the same limits on fee increases and decreases.

Make single payment for surgery***Present Law***

Under certain conditions, Medicare will make an additional payment when a physician or physician assistant serves as an assistant-at-surgery to a primary physician. Where payment is allowed, the fee schedule amount for a physician cannot exceed 16 percent of the amount otherwise determined as the global fee for the service. When the service is provided by a physician assistant, payments equal 65 percent of the fee schedule amount that would be paid if a physician served as the assistant.

Description of Proposal

The proposal would make the same payment for surgery, regardless of whether or not the primary surgeon elects to use an assistant-at-surgery.

Create incentives to control high-volume physician services***Present Law***

In general, current law does not include a specific limit on the number or mix of physicians services provided in connection with an inpatient hospital stay. (However, the law does require that certain services provided in connection with a surgery be included in a global surgical package and not billed for separately.)

Description of Proposal

The proposal would establish limits on Medicare payments to groups of physicians practicing in hospitals whose volume and intensity of services per admission exceeded 125 percent of the national median for urban hospitals (120 percent beginning in 2002) and 140 percent for rural hospitals. There is an adjustment for teaching and disproportionate share hospitals. The Secretary would be required to provide for a withhold of 15 percent in payment amounts for physicians services to a hospital's medical staff if, for any year (beginning in 2000) the medical staff's relative value units for a year is projected to exceed the national limit. After the close of the year, the Secretary would compare actual relative value units per admission with the limit. For staffs above the limit, none or a portion of the withhold would be refunded, as appropriate. For staffs below the limit, the full amount would be refunded.

Direct payment to physician assistants, nurse practitioners, and clinical nurse specialists***Present Law***

Medicare makes direct payments to physician assistants, nurse practitioners and clinical nurse specialists under limited circumstances. Physician assistants are paid directly when services are provided under the supervision of a physician: (i) in a hospital, skilled nursing or nursing facility; (ii) as an assistant at surgery; or (iii) in a rural area designated as a health manpower shortage

area. Nurse practitioners are paid for services provided in collaboration with a physician when such services are furnished in a nursing facility. Nurse practitioners and clinical nurse specialists are paid directly for services provided in collaboration with a physician in a rural area. Payments for these services equal specified percentages of payments which would be made to physicians for the service under the physician fee schedule.

Description of Proposal

The proposal would authorize direct payment to these practitioners when services were provided in home and ambulatory settings, provided no separate facility or provider fee was charged. The proposal would be effective January 1, 1998.

Payment of acquisition costs for drugs

Present Law

Medicare does not pay for most outpatient prescription drugs. The program will, however, pay for certain drugs including drugs used in connection with home infusion or inhalation equipment, drugs prescribed for dialysis or transplant patients, and certain oral cancer drugs. Payment is generally based on the charge submitted by the physician or pharmacist.

Description of Proposal

Beginning January 1, 1998, the proposal would base Medicare's payment on the provider's acquisition cost of the drug. Payment could not exceed the national median cost of the drug.

Chiropractic services

Present Law

Medicare covers chiropractic treatment services; however the coverage is limited to treatment by means of manual manipulation of the spine. In addition, a chiropractor's services are covered only if the treatment is to correct a subluxation (i.e., misalignment) demonstrated to exist by X-ray; however, program regulations do not permit Medicare to pay for X-rays ordered by a chiropractor.

Description of Proposal

Effective January 1, 1998, the pre-treatment X-ray requirement would be eliminated.

Hospital Outpatient Departments (OPDs)

Payment for hospital outpatient departments (OPDs)

Present Law

Medicare's payment to hospital OPDs and hospital-operated ambulatory surgical centers (ASCs) for covered ASC procedures is equal to the lesser of the following two amounts: (1) the lower of the hospital's reasonable costs or customary charges less bene-

fiary deductibles and coinsurance, or (2) the amount determined based on a blend of the lower of the hospital's reasonable costs or customary charges, less beneficiary deductibles and coinsurance, and the amount that would be paid to a free-standing ASC in the same area for the same procedures. For cost reporting periods beginning on or after January 1, 1991, the hospital cost portion and the ASC cost portion are 42 percent and 58 percent, respectively.

Description of Proposal

The proposal would move to a prospective payment system (PPS) for hospital OPD services effective January 1, 1999. Rates would be established so that total payments to a hospital for OPD services would be equal to projected FY1999 hospital revenue (consisting of Medicare's payments and beneficiary coinsurance payments), less savings from eliminating a flaw in the current payment methodology (described below) and assuming extension of certain policies (primarily payment reductions extended by OBRA 1993) set to expire at the end of 1998.

Formula driven overpayment for hospital outpatient department care

Present Law

Medicare's share of the payment for certain ambulatory surgeries, radiology services, and some diagnostic services is supposed to be the total amount Medicare allows for payment minus beneficiary copayments. For facilities paid the blended amount, however, program payments are not reduced by the entire beneficiary copayment. This results in higher payments to hospital OPDs than the Congress intended.

Description of Proposal

The proposal would eliminate the flaw in the current payment methodology for hospital OPDs as a part of the move to a prospective payment system (PPS) for such services.

Beneficiary coinsurance for hospital outpatient department care

Present Law

OPDs are reimbursed by Medicare, in part, on the basis of reasonable cost, and because the facility's cost is not known at the time of service delivery, beneficiary coinsurance is calculated as 20 percent of the facility's charges. Because charges are almost always higher than the outpatient costs recognized by Medicare, beneficiary coinsurance for OPD services amounts to significantly more than 20 percent of Medicare's payment to the OPD.

Description of Proposal

The proposal would "buy-down" beneficiary coinsurance to 20 percent by the year 2007, as a part of the proposal to implement a prospective payment system for OPD services.

Other Providers

Ambulatory surgical centers (ASCs)

Present Law

Medicare pays for ASC services on the basis of prospectively determined rates. These rates are updated annually for inflation using the CPI-U. OBRA 1993 eliminated updates for ASCs for FY1994 and FY1995.

Description of Proposal

The proposal would reduce the annual CPI-U update for ASC fees by 2 percentage points for each year between FY1998 and FY2002.

Competitive bidding for laboratories, durable medical equipment and other items

Present Law

Medicare does not use competitive bidding for the selection of providers authorized to provide covered services to beneficiaries. Any provider meeting program requirements and agreeing to the program's payment rules may receive reimbursement for services.

Description of Proposal

The proposal would permit the Secretary of HHS to bid competitively for laboratory services, durable medical equipment, and other medical items and supplies covered under Part B. The items included in a bidding process, and the geographic areas selected for bidding, would be determined by the Secretary based on the availability of entities able to furnish the services and the potential for savings. Entities would have to meet specified quality standards. The Secretary would be permitted to exclude suppliers whose bid was above the cutoff bid determined sufficient to maintain access. An automatic reduction in rates would be triggered for clinical lab services, durable medical equipment, and prosthetic and orthotic devices if a 20 percent reduction had not been achieved by 2001.

Payment for automated laboratory tests

Present Law

Medicare currently pays individually for several common laboratory tests that are typically performed as a group (or "panel" of tests) on automated equipment. As a result, Medicare pays more for some common tests than most private insurers pay.

Description of Proposal

The proposal would add several chemistry tests to the existing list of tests that are classified and paid as automated tests.

Payment for ambulance services

Present Law

Medicare generally pays for ambulance services on a reasonable charge basis. Hospital-based services are paid on the basis of reasonable costs.

Description of Proposal

The proposal would create budget neutral fee schedules for the payment of all ambulance services.

Premiums

Part B premiums

Present Law

When Medicare was established in 1965, the Part B monthly premium was intended to equal 50 percent of program costs. The remainder was to be financed by Federal general revenues, i.e., tax dollars. Legislation enacted in 1972 limited the annual percentage increase in the premium to the same percentage by which social security benefits were adjusted for the cost-of-living (i.e., cost-of-living or COLA adjustments). As a result, revenues dropped to below 25 percent of program costs in the early 1980s. Since the early 1980s, Congress has regularly voted to set the premium equal to 25 percent of costs. Under current law, the 25 percent provision is extended through 1998; the COLA limitation would again apply in 1999.

Description of Proposal

The proposal would permanently set the Part B premium equal to 25 percent of program costs.

Part B enrollment and penalties for delayed enrollment

Present Law

People generally enroll in Part B when they turn 65. If an individual does not establish eligibility during his or her initial enrollment period, that individual must wait until the next general enrollment period. A person who terminates coverage must also wait until the next general enrollment period to reenroll. There is a general enrollment period from January 1 to March 31 of each year. Coverage does not begin until July 1 of that year.

Persons who delay enrollment after their initial enrollment period are subject to a premium penalty. This penalty is a surcharge equal to 10 percent of the premium amount for each 12 months of delayed enrollment. There is no upper limit on the amount of the surcharge that may apply. Further, the penalty continues to apply for the entire time the individual is enrolled in Part B.

Description of Proposal

The proposal would establish a continuous open enrollment period for persons not enrolling during their initial enrollment period. Coverage for these persons would begin 6 months after enrollment. The delayed enrollment penalty would be based on the actuarially determined cost of late enrollment.

Benefits

Mammography services

Present Law

Medicare provides coverage for screening mammograms. Frequency of coverage is dependent on the age and risk factors of the woman. For women ages 34–39, one test is authorized. For women ages 40–49, a test is covered every 24 months, except, an annual test is authorized for women at high risk. Annual tests are covered for women ages 50–64. For women aged 65 and over, the program covers one test every 24 months. Medicare's Part B deductible and coinsurance apply for these services.

Description of Proposal

The proposal would authorize coverage for annual mammograms for all women ages 40 and over. It would also waive the coinsurance and deductible for screening mammograms. These provisions would be effective January 1, 1998.

Colorectal screening

Present Law

Medicare does not cover preventive colorectal screening procedures. Such services are only covered as diagnostic services.

Description of Proposal

The proposal would cover four common screening procedures for the detection of colorectal cancer. These are barium enemas, colonoscopy, sigmoidoscopy, and fecal-occult blood tests. Regular cost-sharing would apply for these procedures. The provision would be effective January 1, 1998.

Preventive injections

Present Law

Medicare covers influenza vaccines, pneumococcal pneumonia vaccinations when prescribed by a doctor, and hepatitis B vaccinations for high or intermediate-risk beneficiaries. The benefit covers the reasonable cost of the vaccine and its administration. Cost sharing is waived for influenza and pneumococcal pneumonia vaccines.

Description of Proposal

The proposal would increase the payment for the administration of these vaccines and waive the cost-sharing for hepatitis B vaccines. The proposal would be effective January 1, 1998.

Diabetes self-management benefit

Present Law

Medicare covers home blood-glucose monitors and associated testing strips for certain diabetes patients. Home blood glucose monitors enable diabetics to measure their blood glucose levels and then alter their diets or insulin dosages to ensure that they are maintaining an adequate blood glucose level. Home glucose monitors and testing strips are covered under Medicare's durable medical equipment benefit.

Coverage of home blood glucose monitors is currently limited to certain diabetics, known as Type I diabetics, if: (1) the patient is an insulin-treated diabetic; (2) the patient exhibits poor diabetic control, as documented by a physician; (3) the patient is capable of being trained to use the monitor in an appropriate manner, or, in some cases, has a family member who can be trained; and (4) the device is designed for home rather than clinical use.

Description of Proposal

The proposal would extend Medicare coverage of blood glucose monitors to Type II (non insulin-dependent) diabetics. The proposal would also reduce payment for testing strips by 10 percent, based on evidence of overpayment for these items.

Respite benefit

Present Law

No provision.

Description of Proposal

Beginning in FY1998, the proposal would establish a Medicare respite benefit for families of beneficiaries with Alzheimer's disease or other irreversible dementia. Respite services provide relief to the caregivers of disabled persons. The benefit would cover up to 32 hours of care per year and would be administered through home health agencies or other entities, as determined by the Secretary of HHS.

PARTS A AND B

Home Health Services

Payment reform

Present Law

Medicare reimburses home health agencies on a retrospective cost-based basis. This means that agencies are paid after services are delivered for the reasonable costs (as defined by the program)

they have incurred for the care they provide to program beneficiaries, up to certain limits.

Cost limits are determined separately for each type of covered home health service (skilled nursing care, physical therapy, speech pathology, occupational therapy, medical social services, and home health aide). Cost limits, however, are applied to aggregate agency payments; that is, an aggregate cost limit is set for each agency that equals the agency's limit for each type of service multiplied by the number of visits of each type provided by the agency. Limits for the individual services are set at 112 percent of the mean labor-related and nonlabor per visit costs for freestanding agencies (i.e., agencies not affiliated with hospitals). To reflect differences in wage levels from area to area, the labor-related portion of a service limit is adjusted by the current hospital wage index. Cost limits are updated annually by applying a market basket index to base year data derived from home health agency cost reports.

Cost-based reimbursement for home health has been criticized as providing few incentives for maximizing efficiency, minimizing costs, or controlling volume of services. It is cited as one of the reasons for the significant growth in home health spending since 1989. Spending has increased from \$2.6 billion in 1989 to \$18.1 billion in 1996, for an average annual rate of growth of 32 percent. Most of the growth in spending has been the result of an increasing volume of services being covered under the program, both in terms of increases in the numbers of users as well as the number of covered visits per user.

Description of Proposal

The proposal would implement a home health prospective payment system (PPS) beginning October 1, 1999 (FY2000). Payments would be based on an episode of care for a time period as yet undefined. Budget neutral rates under the new PPS would be calculated after reducing expenditures that exist on the last day prior to implementation by 15 percent.

In the interim, home health agencies would be paid the lesser of: (1) the actual costs (i.e., allowable reasonable costs); (2) the per visit cost limits, reduced to 105 percent of the national median; or (3) a new agency-specific per beneficiary annual limit calculated from 1994 reasonable costs. In addition, beginning January 1, 1998, payments would be based on the location where services are rendered, rather than where they are billed.

Extend savings from home health cost limits freeze

Present Law

Home health limits are updated annually. The Omnibus Budget Reconciliation Act of 1993 (OBRA93) required that there be no updates in home health cost limits (including no adjustments for changes in the wage index or other updates of data) for cost reporting periods beginning on or after July 1, 1994, and before July 1, 1996.

Description of Proposal

The proposal would permanently extend the savings stream, but not the freeze, in setting future home health limits, by not allowing for the inflation that occurred during the freeze years.

Clarification of the definition of "homebound"

Present Law

In order to be eligible for home health care, a Medicare beneficiary must be confined to his or her home. The law specifies that this "homebound" requirement is met when the beneficiary has a condition that restricts the ability of the individual to leave home, except with the assistance of another individual or with the aid of a supportive device (such as crutches, a cane, a wheelchair, or a walker), or if the individual has a condition such that leaving his or her home is medically contraindicated. The law further specifies that while an individual does not have to be bedridden to be considered confined to the home, the condition of the individual should be such that there exists a normal inability to leave home, that leaving home requires a considerable and taxing effort by the individual, and that absences from home are infrequent or of relatively short duration, or are attributable to the need to receive medical treatment.

A March 1996 General Accounting Office (GAO) report on Medicare's home health benefit pointed to the law's broad criteria for defining "homebound" as resulting in few claims ever being denied on the basis that a beneficiary was not confined to home, and providing opportunities for abuse and overpayments.

Description of Proposal

The proposal would redefine the "homebound" requirement by adding several calendar month benchmarks to emphasize that home health coverage is only available to those who are truly unable to leave the home.

Provide secretarial authority to make payment denials based on normative service standards

Present Law

As long as they remain eligible, home health users are entitled to an unlimited number of visits.

Description of Proposal

The proposal would authorize the Secretary of HHS to establish a normative number of visits that would be covered for specific conditions or situations. Payments would be denied for visits that exceed the normative standard.

Reallocate Financing of Part of the Home Health Benefit to Part B

Present Law

Both Parts A and B of Medicare cover home health. Neither Part of the program applies deductibles or coinsurance to covered visits, and beneficiaries are entitled to an unlimited number of visits as long as they meet eligibility criteria. Section 1833(d) of Medicare law prohibits payments to be made under Part B for covered services to the extent that individuals are also covered under Part A for the same services. As a result, the comparatively few persons who have no Part A coverage are the only beneficiaries for whom payments are made under Part B.

Description of Proposal

The proposal would transfer the majority of financing of the home health benefit from Part A to Part B. Effective in FY1998, the first 100 visits following a 3-day hospital stay would be reimbursed under Part A. All other visits would be reimbursed under part B. These would include visits for persons needing more than 100 visits following a hospitalization, visits for persons who have not had a 3-day prior hospitalization, and visits for those persons with Part B coverage only. For up to 18 months after enactment, Part A would pay what would otherwise be Part B costs for Part A-only individuals; subsequently, Part A-only individuals would only have payments made for the newly defined Part A services.

The proposal has the effect of extending the solvency of the Part A trust fund by shifting some Part A costs to Part B. While Part B premiums generally equal 25 percent of total Part B costs, the premium would not be increased to reflect the cost of the additional Part B benefits.

Medigap

Medigap enrollment

Present Law

Medigap is the term used to describe individually-purchased Medicare supplement policies. In 1990, Congress provided for a standardization of Medigap policies; the intention was to enable consumers to better understand policy choices.

All insurers offering Medigap policies are required to offer a 6-month open enrollment period for persons turning age 65. This is known as guaranteed open enrollment. There is no guaranteed open enrollment provision for the under-65 disabled population (they must wait until they reach age 65).

At the time insurers sell a Medigap policy, whether or not during an open enrollment period, they are permitted to limit or exclude coverage for services related to a preexisting health condition; such exclusions cannot be imposed for more than 6 months. An individual who has met the preexisting condition limitation in one Medigap policy does not have to meet the requirement under the

new policy for previously covered benefits. However, an insurer could impose exclusions for newly covered benefits.

Federal requirements for open enrollment and limits on preexisting condition exclusions are designed to insure beneficiaries have access to Medigap protection. However, persons who disenroll (or wish to disenroll) from managed care plans may not have the same access to Medigap coverage if they wish to move back into fee-for-service Medicare.

Medigap insurers currently use three methods to price Medigap premiums. The first is community-rating under which all beneficiaries in an area pay the same price (except that a distinction may be made between the aged and the disabled). The second method uses age-at-issuance of the policy; future increases are limited to inflation and cost experience. The third method uses attained-age rating which factors in current age into the premium calculation. Younger beneficiaries may sign up at a relatively low cost but be unaware that the costs will increase substantially over their lifetimes. As a result, a number of States prohibit attained-age pricing.

Description of Proposal

The proposal would establish an annual guaranteed open enrollment period for all beneficiaries during which beneficiaries would be guaranteed the opportunity to enroll in any Medigap plan. The current 6-month limit on coverage of pre-existing conditions would not apply during a beneficiary's initial 6 month open enrollment period—but would apply during the annual enrollment periods. If an individual was previously covered by another Medigap policy or managed care plan (with no more than a 63-day lapse in coverage) the exclusion could only apply for the time period (if any) not met under the previous policy. Medigap plans would be required to be community-rated.

The proposal would also require the Secretary (after consulting with the National Association of Insurance Commissioners (NAIC) and other interested parties) to develop standardized packages of supplemental benefits that may be offered by managed care organizations. The Secretary, after receiving recommendations from the NAIC would restructure standardized packages in order to permit comparisons among Medigap and managed care plans.

Purchasing Initiatives

Centers of excellence

Present Law

HCFA is conducting a bundled payment demonstration project under which 10 facilities, considered "centers of excellence," are paid a flat fee to provide cataract surgery or coronary artery bypass (CABG) surgery. The facilities were selected on the basis of their experience, outcomes, and efficiency in providing these services.

Description of Proposal

The proposal would expand the demonstration to all urban areas by allowing Medicare to pay select facilities a single rate for all services associated with CABG surgery or other heart procedures, knee surgery, hip replacement surgery, and other procedures deemed appropriate by the Secretary. Selected facilities would have to meet special quality standards. The single rate paid to the center would have to represent a savings to the program. Beneficiaries would not be required to receive services at these facilities.

Other purchasing initiatives

Present Law

Medicare generally pays for services on the basis of payment rules established by law for each service.

Description of Proposal

The proposal would give the Secretary authority to pay on the basis of special arrangements. Two components of this plan, centers of excellence and competitive bidding, are discussed above. The proposal would also permit other payment arrangements. For example, the Secretary would be authorized to contract selectively with providers and suppliers to receive a global payment for a package of services directed at a specific condition or need of an individual (such as diabetes). Within the global payment, providers would have flexibility in determining how services are provided and could, subject to approval, offer additional benefits.

Coordination of Benefits, Program Integrity and Other Management Initiatives

Medicare secondary payer

Present Law

Generally, Medicare is the primary payer, that is, it pays health claims first, with an individual's private or other public plan filling in some or all of the coverage gaps. In certain cases, the individual's other coverage pays first, while Medicare is the secondary payer. This is known as the Medicare secondary payer (MSP) program. The MSP provisions apply to group health plans for the working aged, large group health plans for the disabled, and employer health plans (regardless of size) for the end-stage renal disease (ESRD) population.

The law authorizes a data match program which is intended to identify potential secondary payer situations. Medicare beneficiaries are matched against data contained in the Social Security Administration and Internal Revenue Service files to identify cases where a working beneficiary (or working spouse) may have employer-based health insurance coverage. Recent court action has made recoveries more difficult in certain cases.

Description of Proposal

The proposal would make permanent the provisions relating to the disabled, the ESRD population, and the data match program. The proposal would also require a beneficiary's other insurance to inform Medicare when that beneficiary is covered. The proposal would also clarify Medicare's recovery authority.

Consolidated billing for SNF services

Present Law

Current law does not require nursing homes to bill for all Part A and Part B services provided within the SNF. The HHS Office of Inspector General reports that some Part B suppliers bill for services that are never delivered to nursing home residents.

Description of Proposal

The proposal would require SNFs to bill Medicare for all of the services their residents receive, except for physicians services. Payments could not be made to other entities for services or supplies furnished to Medicare-covered beneficiaries.

Home health payments based on location of service

Present Law

Some home health agencies (HHAs) are established with the home office in an urban area and branch offices in rural areas. Payment is based on the higher wage rate for the urban area, even if the service was delivered in a rural area.

Description of Proposal

The proposal would base payment on the location where the service was rendered, not where the service was billed.

Periodic interim payments for home health

Present Law

Medicare pays home health providers under the periodic interim payment (PIP) system. A set amount is paid on a bi-weekly basis; at the end of the year, PIP is reconciled with actual expenditures.

Description of Proposal

The proposal would eliminate PIP payments for home health services.

Survey and certification

Present Law

HCFA's survey and certification budget has been held constant for several years, while the number of entities seeking entry continues to grow.

Description of Proposal

The proposal would permit the Secretary to charge entities a fee for the initial survey required by the program.

Fraud and Abuse

Advisory opinions

Present Law

P.L. 104-191, the Health Insurance Portability and Accountability Act, signed into law on August 21, 1996, added a number of new fraud and abuse provisions. Under the law, the Secretary of the HHS is directed to issue written advisory opinions regarding whether a proposed business transaction would violate certain Medicare and Medicaid statutory provisions. The opinions will be binding between the Secretary and the party requesting the opinion and will address issues such as what constitutes prohibited remuneration under the anti-kickback law; whether a proposed arrangement falls within one of the exceptions to the anti-kickback law; whether a proposed arrangement comes within an applicable safe harbor established by the Inspector General; what constitutes an inducement to reduce or limit services; and, whether a particular activity would be subject to penalties under the anti-kickback law, civil monetary law, or exclusion statutes. The Secretary is required to issue an advisory opinion within 60 days after it is requested, and the advisory opinion provisions apply to requests made during a 4 year period beginning 6 months after enactment of this provision, i.e., February 21, 1997.

Description of Proposal

The proposal would repeal this new provision.

Managed care exception in anti-kickback statute

Present Law

P.L. 104-191 added a new exception to the Medicare and Medicaid anti-kickback provisions set forth in section 1128B(b) of the Social Security Act. The anti-kickback provisions generally prohibit persons from providing or offering to provide remuneration in cash or in kind in return for a patient referral whose treatment is paid for in whole or in part by Medicare or Medicaid. This new exception allows remuneration between certain managed care organizations and individuals or entities providing items or services pursuant to a written agreement with such organizations, if the arrangement places the individual or entity at substantial financial risk for the cost or utilization of the items or services. The Secretary of HHS, using a negotiated rulemaking process, is to issue standards relating to this new exception to the anti-kickback penalties.

Description of Proposal

The proposal would repeal this new exception to the anti-kickback provisions.

Reasonable diligence***Present Law***

Civil monetary penalties may be imposed under section 1128A of the Social Security Act for various fraudulent activities relating to reimbursements under the Medicare or Medicaid programs. P.L. 104-191 changed the definition of the level of intent associated with such fraud violations. Under the new standard, similar to the False Claims Act standard, a person is subject to such civil monetary penalties if the person "knowingly" presents a claim that the person "knows or should know" falls into one of the prohibited categories. The term "should know" means that the person acted in deliberate ignorance of the truth or falsity of the information or acted in reckless disregard of the truth or falsity of the information.

Description of Proposal

The proposal would repeal this amendment. The level of intent standard for civil monetary penalties under Medicare or Medicaid would return to the prior definition which did not require proof that the person "knowingly" or consciously engaged in the prohibited activity, only that the person knew that the prohibited activity occurred.

MEDICARE MANAGED CARE**Payments and Plan Choice*****Payment changes******Present Law***

In 1983, Medicare began making payments to qualified "risk-contract" HMOs or similar entities that enrolled Medicare beneficiaries. The intent was to give Medicare beneficiaries the opportunity to enroll in HMOs as a more cost efficient alternative to fee-for-service health care. Under the risk contract program, a beneficiary in an area served by a qualified organization may voluntarily choose to enroll in the organization. Medicare makes a single monthly capitation payment for each of the organization's Medicare enrollees. This payment equals 95 percent of the estimated adjusted average per capita cost (AAPCC) of providing Medicare services to a given beneficiary under the fee-for-service system.

The AAPCC is Medicare's estimate of the average per capita amount it would spend for a given beneficiary (classified by certain demographic characteristics and county of residence) who was not enrolled in an HMO and who obtained services on the usual fee-for-service basis. The AAPCCs are further adjusted for enrollees on the basis of age, sex, whether they are in a nursing home or other institution, and whether they are also eligible for Medicaid, whether they are working and being covered under an employer plan, and the county of their residence. These AAPCC values are calculated in three basic steps:

- Medicare's national average calendar year per capita costs are projected for the future year under consideration. These numbers are known as the U.S. per capita costs (USPCCs) and are estimated average incurred benefit costs per Medicare enrollee and adjusted to include program administration costs. USPCCs are developed separately for Parts A and B of Medicare, and for costs incurred by the aged, disabled, and those with ESRD in those two parts of the program.
- Geographic adjustment factors that reflect the historical relationships between the county's and the Nation's per capita costs are used to convert the national average per capita costs to the county level. Expected Medicare per capita costs for the county count only fee-for-service beneficiaries by removing both reimbursement and enrollment attributable to Medicare beneficiaries in prepaid plans.
- Once the county AAPCC is calculated, it is then adjusted for the demographic variables described above such as age, sex, and Medicaid status.

For each Medicare beneficiary enrolled under a risk contract, Medicare will pay the HMO 95 percent of the rate corresponding to the demographic class to which the beneficiary is assigned. Wide variations exist in the AAPCC payments across counties. For example, payments in 1997 range from a low of \$221 per month for two rural Nebraska counties to a high of \$761 for Staten Island (Richmond County), New York or a difference of \$540. In counties with small numbers of Medicare beneficiaries, the AAPCCs can fluctuate dramatically from year to year as a result of changes in Medicare fee-for-service expenditures. Participation of managed care plans in low paid counties, which are disproportionately in rural areas, is very limited, in part, because risk plans do not exist in these counties.

Medicare fee-for-service payments for inpatient hospital stays include payments for indirect and direct graduate medical education costs (IME and direct GME respectively) incurred by teaching hospitals and extra payments to hospitals that serve a disproportionate share of low income beneficiaries (or DSH payments). These payments are retained in the expenditures used to calculate the AAPCCs paid to risk contract plans. As a result, the AAPCC reflects a county's average monthly per capita cost for fee-for-service graduate medical education and DSH. These amounts may not correspond with actual risk plan costs, however, because not all plans have medical education programs or use teaching or disproportionate share hospitals.

Description of Proposal

The proposal would affect the AAPCCs in five major ways: (1) payments would be updated annually by a percentage rate of increase determined by the Secretary based on the national average per capita growth in Medicare expenditures; (2) savings would be achieved indirectly because the rise in fee-for-service expenditures would be reduced as a result of provider payment changes in the Administration's plan; (3) the AAPCCs would be modified to correct for wide geographic disparities; (4) payments for direct graduate

medical education (direct GME), indirect medical education (IME), and disproportionate share hospitals (DSH) would be eliminated from the AAPCCs; and (5) payments to plans would be reduced from 95 percent to 90 percent of the AAPCC beginning in the year 2000.

(1) *Annual Updates.* The AAPCCs would no longer be calculated each year based on area fee-for-service expenditures. The Secretary would establish an update each year based on the per capita growth of Medicare expenditures nationwide. Under the Administration's proposal, the annual update is estimated to be about 5 percent each year. This change would uncouple payment rates from Medicare's fee-for-service expenditures in each county.

(2) *Savings From Fee-For-Service.* Payments for Medicare managed care are defined as 95 percent of the amount that would have been spent for the beneficiary in an area if that beneficiary had been in Medicare fee-for-service. This means that the growth in managed care payments are directly linked to the growth in Medicare fee-for-service payments. Under the President's proposal, reductions would be made in the rate of growth of payments for Medicare fee-for-service. These reductions would be reflected in a reduced rate of growth in payments to Medicare managed care plans.

(3) *Eliminate Direct GME, IME, and DSH Payments from the AAPCCs.* The proposal would eliminate ("carve out") direct GME, IME and DSH payments from the AAPCCs. The resulting amounts would then be distributed directly to teaching and disproportionate share hospitals for managed care enrollees and to managed care plans that run their own residency programs. The carve-out would be done over a 2-year period. Fifty percent of the total amount would be carved out in the first year (1998) and the remainder would be eliminated in the second year (1999). (There would be no net savings; however, because about the same amount of direct GME, IME, and DSH expenditures would be paid directly to teaching hospitals and managed care teaching programs.) The Physician Payment Review Commission estimated that for 1995, direct medical education and DSH payments totaled about 5.5 percent of the AAPCCs nationally. However, significant variations exist across counties. For example, for the most urbanized counties, they averaged about 8.4 percent whereas in the most rural counties, such payments averaged about 3.4 percent of the payments made to Medicare HMOs.

(4) *Modify the AAPCCs to Correct for Geographic Disparities.* The proposal would modify the AAPCC payments to reduce the existing variation in payment rates across counties. In general, it would raise payment levels for current low-payment counties. The proposal would also limit payment increases for counties whose rates have been inflated by high-service utilization in the fee-for-service sector. Specifically, AAPCCs would be updated in the following manner. Each year, starting in 1998, the payment rate would be set at the *highest of three amounts:*

- A blend of the local payment rate for the county (the AAPCC) and an input price adjusted national fee-for-service rate. (Input prices include such costs as hospital wages and physician practice costs.) The blend would start in 1998 at 90 percent of local costs and 10 percent of national Medicare fee-for-service costs.

Over 5 years, this blend would move to 70 percent of local costs and 30 percent of national fee-for-service costs. This modification would bring lower-paid and higher-paid counties closer to the national payment average.

- A minimum county payment rate (AAPCC) of \$350 in 1998 (but no higher than 150 percent of the previous year's rate). This new *floor* on payment rates is intended to ensure increases in 1998 for the lowest paid counties in the country. The floor would be updated in each year by the annual update factor (as described above).
- For 1998 and 1999, 100 percent of the 1997 AAPCC and 102 percent of the previous year's AAPCC thereafter. This provision would ensure that plans which otherwise might experience reductions in payments in 1998 and 1999 as a result of the carve out of GME, IME, and DSH would get their 1997 rates. For the year 2000 and thereafter, they would receive at least the previous year's rate plus 2 percent. It should be noted that in the year 2000, however, the rates would be reduced due to the effect of the "risk selection" adjustment described below.

This proposal is designed to be budget neutral. No new spending would be required because increased AAPCC payments for low-paid areas would be redirected from high-paid areas. Because of the minimum floor for some counties and the preset rates of increase in others (i.e., the freeze in 1998 and 1999 and 2 percent increase thereafter), budget neutrality would be achieved by reducing the amounts paid to plans in counties receiving blended rates.

(5) *Adjust Payments for Risk Selection by Reducing Payments to Plans to 90 percent of Fee-For-Service Payment.* The proposal would reduce Medicare payments to managed care plans to 90 percent of the AAPCC, beginning in the year 2000. The rationale for this change is that, on average, Medicare managed care plans experience favorable selection when compared to traditional Medicare. Some studies have shown that Medicare HMOs attract a healthier than average group of Medicare beneficiaries and as a result, cost HMOs less than 95 percent of what these beneficiaries would cost had they remained in Medicare fee-for-service. The Administration's proposal would delay implementation of the change from 95 percent to 90 percent until the year 2000 to enable health plans the chance to prepare for the new payment methodology. The reduction of payments from 95 percent to 90 percent of the AAPCC effectively means a 5.3 percent reduction in rates for all counties. Therefore, whatever the payment rate would have been under the adjustments described above (i.e., the blended rate, the floor, or 2 percent increase) would be reduced by 5.3 percent.

Increased plan choice and consumer information

Present Law

Under section 1876 of the Social Security Act, Medicare specifies requirements to be met by an organization seeking to become a managed care contractor with Medicare. In general, these include the following: (1) the entity must be organized under the laws of the State and be a federally qualified HMO or meet specified requirements (provide physician, inpatient, laboratory, and other

services, and provide out-of-area coverage); (2) the organization is paid a predetermined amount without regard to the frequency, extent, or kind of services actually delivered to a member; (3) the entity provides physicians' services primarily through physicians who are either employees or partners of the organization or through contracts with individual physicians or physician groups; (4) the entity assumes full financial risk on a prospective basis for the provision of covered services, except that it may obtain stop loss coverage and other insurance for catastrophic and other specified costs; and (5) the entity has made adequate protection against the risk of insolvency.

Provider Sponsored Organizations (PSOs) and Preferred Provider Organizations (PPOs) that are not organized under the laws of a State and are neither a federally qualified HMO or Competitive Medical Plan (CMP) are not eligible to contract with Medicare under the risk contract program. A PSO is a term used to describe a cooperative venture of a group of providers who control its health service delivery and financial arrangements. PPOs are generally groups of physicians and hospitals who contract with an insurer or employer to serve a group of enrollees on a fee-for-service basis at negotiated rates that are lower than those charged to nonenrollees. PPOs do not traditionally have primary care gatekeepers.

Point-of-service (POS) plans combine features of HMOs and PPOs. They feature networks of providers who agree to provide health care services in a managed care environment at a reduced rate. However, enrollees can decide to use the defined managed care program, or can go out of plan for services, with cost sharing responsibilities varying with the choice of provider (the highest cost sharing associated with the use of non-network providers). In 1995, HCFA issued guidelines to Medicare HMOs for operating, on an optional basis, a POS option. By early 1997, HCFA had approved POS options for about 30 plans. In an attempt to test additional types of managed care delivery and financing arrangements (including PPOs and PSOs), HCFA in April of 1996 selected 25 managed care plans in eight cities and five rural areas as final candidates for a new Medicare Choice demonstration program. As of December 1996, five plans had dropped out. In January 1997, the first six Medicare Choices demonstration plans began enrolling beneficiaries. An additional 13 plans are expected to begin enrollment in 1997.

Medicare HMOs/CMPs must provide enrollees, at the time of enrollment and annually thereafter, an explanation of rights to benefits, restrictions on services provided through nonaffiliated providers, out-of-area coverage, coverage of emergency and urgently needed services, and appeal rights. They must enroll individuals and provide covered services to enrollees who live within the geographic area served by the organization. Enrollment is carried out by the participating HMOs/CMPs. These organizations are required to provide an annual open enrollment period of at least 30 days duration.

Description of Proposal

The proposal would allow PPOs and PSOs that meet certain standards to participate as Medicare managed care plans. The pro-

posal defines a PPO as an entity that provides at least physicians' services performed by physicians and meets the requirements specified in the proposal for fiscal soundness, assumption of risk, and minimum private enrollment. The proposal defines a PSO as an entity which is a hospital, a group of affiliated hospitals, or an affiliated group consisting of a hospital or hospitals and physicians or other entities that furnish health services. It must provide at least physicians' services performed by physicians and inpatient hospital services. Moreover, the entity must itself provide a substantial portion of Medicare services and only a limited amount of services through contract. It too has to meet the proposal's specific solvency, risk, and minimum private enrollment requirements. For entities meeting the PSO requirements, State licensing laws that vary from Federal requirements would be preempted. However, if the Secretary determined that a State had met the criteria for participation in an alternative certification and monitoring program, the Secretary would require the PSO to obtain a license from the State.

Second, the proposal would improve information available to Medicare beneficiaries to enable them to make more informed choices about their insurance options. The Secretary would carry out the enrollment process, although plans with a good past record would be authorized to directly enroll individuals. The Secretary would develop and distribute standardized comparative materials about plans and Medicare supplemental policies to enable individuals to compare benefits, costs, and quality indicators. Plans would be assessed for a pro rata share of the costs associated with developing and disseminating this comparative information. Plan marketing materials would be subject to review by the Secretary. All plans would have to provide a 30-day open enrollment period during the month of November. Individuals would be able to enroll at other times, such as when they first enroll in Medicare Part B or when they move into a new service area. Special enrollment periods would apply for individuals losing coverage from another entity. Plans could not deny enrollment, or fail to re-enroll individuals, because of an individual's health status or need for health care services. PPOs would be required to provide a POS option. (PSOs would be prohibited from providing such an option.)

Third, the proposal would change Medigap law to enable beneficiaries that switch from an HMO to Medicare fee-for-service to obtain Medigap coverage without being subject to preexisting condition exclusions and without being charged a higher premium because of their medical history or health status. (See discussion of Medigap enrollment, above.)

Additional Proposals

Permit enrollment of ESRD beneficiaries

Present Law

Under current law, a beneficiary in a Medicare managed care plan who develops ESRD may remain in the plan but one who already has ESRD is prohibited from enrolling.

Description of Proposal

The proposal would allow a beneficiary with ESRD to enroll in a Medicare managed care plan.

Limits on charges for out-of-network services

Present Law

No provision.

Description of Proposal

The proposal would impose limits on charges for unauthorized, out-of-network services.

Coverage of out-of-area dialysis services

Present Law

Today, Medicare HMOs are only required to pay for out-of-area services in the event of emergency care and urgent care. Dialysis services are considered foreseeable and Medicare HMOs have no obligation to pay for them.

Description of Proposal

The proposal would require Medicare managed care plans to pay for out-of-area dialysis when an enrollee is temporarily out of a plan's service area so that an enrollee with ESRD is not prevented from leaving their home area.

Clarification of coverage for emergency services

Present Law

Currently, payment disputes have arisen where the plan has denied payment for an emergency room visit because of its view that the care sought was not for an actual medical emergency. The beneficiary, on the other hand, sought emergency room care because he or she believed the problem required emergency medical attention.

Description of Proposal

The proposal would clarify that Medicare managed care plans must pay for emergency services in cases where a "prudent layperson" would reasonably believe that such services were needed immediately to prevent serious harm to his or her health.

Permit States with programs approved by the Secretary to have primary oversight responsibility

Present Law

HMOs/CMPs that contract with Medicare generally have to be organized and licensed under State laws. However, it is up to the Secretary of HHS (through HCFA) to determine whether an HMO/CMP can contract with Medicare.

Description of Proposal

The proposal would authorize those States with approved programs to certify whether a plan is eligible to contract with Medicare and to monitor aspects of plan performance. Such certification and monitoring would be subject to Federal standards. User fees would be collected from plans for both the certification and monitoring activities.

Modify termination and sanction authority

Present Law

Current law requires that there first be a hearing prior to termination of a contract.

Description of Proposal

The proposal would authorize the Secretary to terminate a contract with an organization prior to a hearing in cases where the health and safety of Medicare beneficiaries are at risk. The proposal would also eliminate the current law requirement for corrective actions plans and for hearing and appeals prior to imposing intermediate sanctions.

Deem privately accredited plans to meet internal quality assurance standards

Present Law

No provision.

Description of Proposal

The proposal would authorize the Secretary to deem plans with private accreditation as meeting Medicare's requirement for an internal quality assurance program.

Replace 50/50 rule with quality measurement system

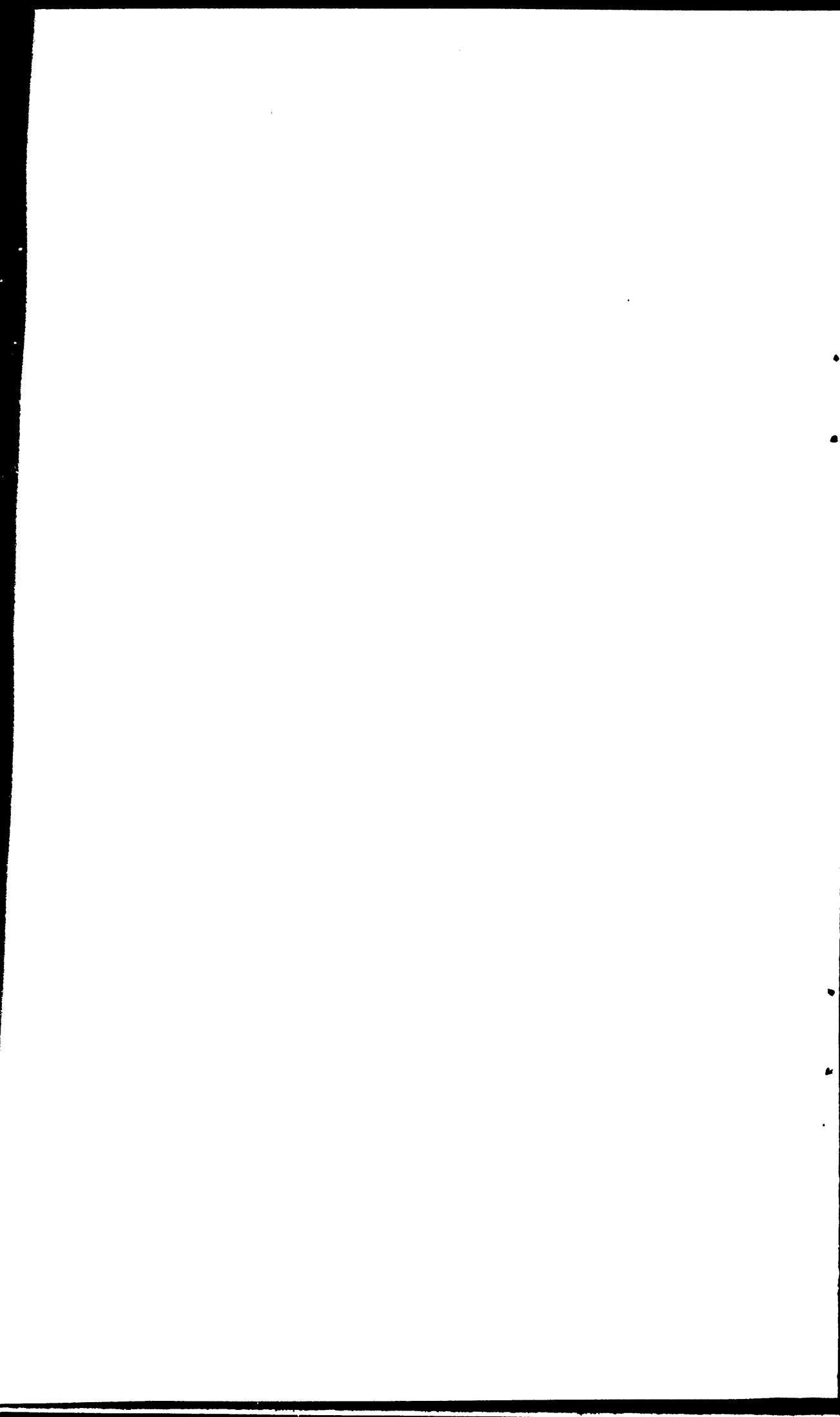
Present Law

Currently, no more than 50 percent of a Medicare HMO's enrollees may be Medicare or Medicaid beneficiaries; the rest must be privately funded (typically through employer groups). The requirement may be waived by the Secretary for certain specified reasons. Only a few waivers have ever been granted. This reflects the view that an organization which must compete in the private market is likely to provide services of higher quality than one formed solely for the purpose of obtaining government contracts.

Description of Proposal

The proposal would replace the 50/50 requirement once the Secretary, in consultation with consumers and the managed care industry, developed a system for quality measurement. The Secretary would be authorized to terminate contracts that do not meet standards under the quality measurement system. In the interim, the

proposal would expand the Secretary's authority to waive the 50/50 requirement for plans with good track records.



**CBO and OMB Estimates of the President's FY1998 Budget
Proposals for Medicare**

(151)

Vaccine Administration, Waive Hepatitis B Cost Sharing											
Recepte Care /S	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
Reduce Outpatient Cost Sharing	0.3	0.6	0.7	0.8	0.9	1.0	1.1	1.1	1.2	1.4	0.4
Reduce Part B Late Enrollment Penalty	0.3	1.2	1.5	1.9	2.3	6.4	7.2	8.1	9.1	11.0	3.3
Subtotal	1.2	3.0	3.8	4.5	5.0	9.4	10.6	11.9	13.3	15.7	48.8
Other Items											
Repeal HIPAA Provisions	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-1.0
Medicare Secondary Payer Extension	0.0	-1.7	-1.7	-1.8	-1.9	-2.0	-2.1	-2.2	-2.3	-2.4	-18.1
Medicare Secondary Payer Authority and Reporting	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.8
Social HIMO Demonstration /S /B	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Centers of Excellence	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Veterans Administration Subvention /I /B	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.8
PACE Program /B	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Subtotal	-0.2	-1.9	-2.0	-2.1	-2.3	-2.3	-2.5	-2.6	-2.7	-2.8	0.0
Premiums											
Maintain Part B Premium at 25 Percent /10	0.0	-0.8	-1.6	-2.5	-4.1	-6.4	-8.7	-11.1	-13.9	-17.1	-66.3
Reduce Part B Late Enrollment Penalty	0.0	-0.0	-0.0	-0.1	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-1.4
Part A Premium Interaction	0.2	0.2	0.3	0.3	0.4	0.5	0.5	0.6	0.6	0.7	4.3
Subtotal	0.2	-0.6	-1.4	-2.2	-3.8	-6.1	-8.4	-10.8	-13.6	-16.7	-63.4
TOTAL, MEDICARE	-2.8	-10.0	-17.7	-22.3	-28.8	-28.6	-32.6	-39.3	-44.8	-49.7	-81.6

MEMORANDUM:											
Monthly Part B Premium (By calendar year)											
Estimated Premium Under Proposal	\$45.80	\$49.50	\$52.50	\$55.90	\$61.20	\$68.00	\$74.10	\$80.60	\$87.80	\$95.80	\$95.80
Estimated Premium Under Current Law	\$45.80	\$47.10	\$48.50	\$50.00	\$51.50	\$53.00	\$54.60	\$56.20	\$57.90	\$59.70	\$59.70
Status of Hospital Insurance Trust Fund											
Income	131.4	137.7	144.3	150.8	157.5	164.3	170.9	177.9	184.9	191.8	191.8
Outlays	130.1	136.0	145.0	148.5	158.9	169.4	181.5	198.9	209.2	218.1	218.1
Surplus	1.3	1.7	-0.7	2.1	-1.4	-5.1	-10.6	-21.0	-24.3	-26.3	-26.3
Balance at End of Year	117.0	118.7	118.0	120.1	118.7	113.6	103.0	82.0	57.7	31.5	31.5
Home Health: FFS Spending Transferred to Part B	12.8	13.9	14.3	15.4	16.6	17.8	19.0	20.4	21.8	23.2	175.1
HIMO Interaction: Spending Transferred to Part B	1.8	2.4	2.7	3.1	3.6	4.2	4.9	5.6	6.5	7.5	42.3
Change in Outlays for Hospital Insurance	-18.5	-25.1	-31.5	-36.0	-42.8	-48.1	-53.1	-60.5	-65.9	-71.7	-453.2
Change in Outlays for Supplementary Medical Insurance	15.6	15.7	15.2	15.9	17.8	25.6	28.9	32.1	34.7	38.7	240.1
Change in Premiums	0.2	-0.6	-1.4	-2.2	-3.8	-6.1	-8.4	-10.8	-13.6	-16.7	-63.4
Total	-2.8	-10.0	-17.7	-22.3	-28.8	-28.6	-32.6	-39.3	-44.8	-49.7	-81.6

SOURCE: Congressional Budget Office.

NOTES: FFS = Fee-for-service, ASC = Ambulatory Surgical Centers, HIPAA = Health Insurance Portability and Accountability Act of 1996, DME = Durable Medical Equipment, PACE = Program of All-Inclusive Care for the Elderly.

CBO assumes that the policy to expand the definition of durable medical equipment to include items needed for essential community activities is not included in this proposal.

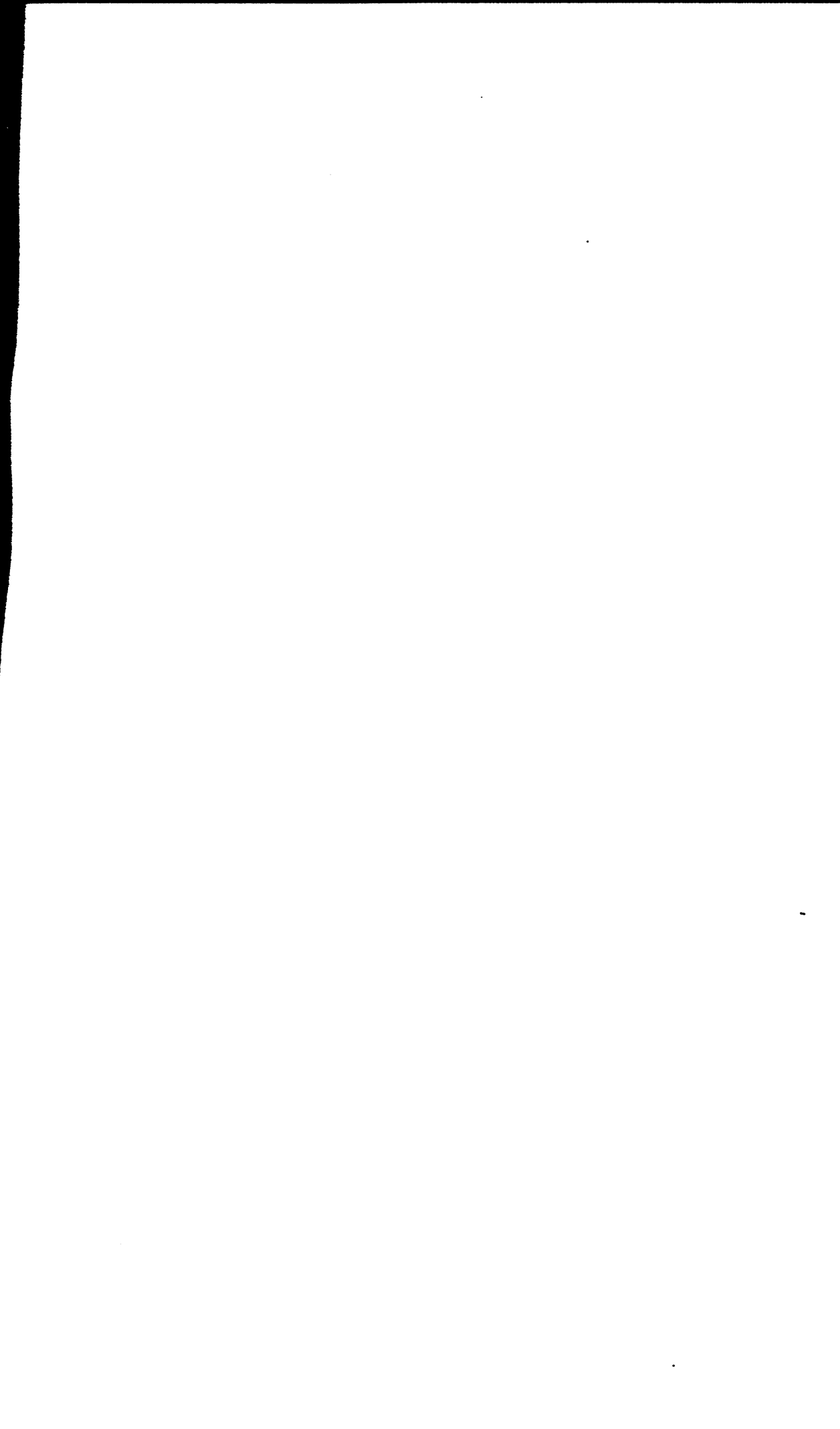
CBO Estimate of President's Budget Plan for Medicare
(By fiscal year, in billions of dollars)

Estimate Prepared: 03-Mar-97 03:57 PM

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002	1998-2007
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FOOTNOTES:

- 1 Additional payments to teaching and disproportionate share hospitals for inpatient care furnished to Medicare HMO enrollees.
- 2 Freeze the measure used to calculate the disproportionate share (DSH) payment adjustment.
- 3 The target for growth in physician spending would be based on growth in the Medicare Economic Index, fee-for-service enrollment, and real per-capita gross domestic product (GDP).
- 4 HMO payment rates (AAPCCs) reduced to remove amounts attributable to teaching-related and disproportionate share payments.
50 percent is removed in CY 1998, and 100 percent is removed in CY 1999.
- 5 Reimbursement updates for the respite care benefit would be limited to increases in the CPI.
- 6 Three year extension of Phase I and Phase II Social/HMO demonstrations.
- 7 Three-year eight-site demonstration of Medicare payment to VA for care provided to Medicare-eligible Category C veterans.
- 8 Grant permanent status to current PACE demonstration sites.
- 9 Permanent program or expanded demonstration could involve substantially higher costs.
- 10 Includes interactions.



OMB Estimate of President's Budget Plan for Medicare a/

(FY. \$'s in billions, positive numbers are savings, negative numbers are costs, sums may not add due to rounding)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	98-02	98-03	98-07
PART A PROPOSALS													
Managed Care													
Hospitals	1.3	3.4	6.7	8.5	10.1	11.4	12.9	14.6	16.4	18.3	30.0	41.4	103.6
Reduce Hospital PPS Update	0.7	1.4	2.2	3.1	4.0	4.4	4.6	4.9	5.1	5.4	11.4	15.7	35.8
Extend PPS Capital Reduction from OBRA 1990	1.2	1.2	1.3	1.3	1.4	1.4	1.5	1.6	1.6	1.7	6.4	7.8	14.2
Reduce PPS-Exempt Update w/ Rebasing	0.3	0.4	0.6	0.8	1.0	1.1	1.2	1.3	1.4	1.6	3.2	4.3	9.9
Reduce PPS-Exempt Capital Payments	0.1	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.8	0.8	0.8
Reform Base Puerto Rico Payment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Moratorium on Long-Term Care Hospitals	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.4	0.5	1.5
Expand Centers of Excellence	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.3	0.5
Lower IIME	0.2	0.4	0.7	0.9	2.0	2.3	2.5	2.7	2.9	3.1	4.2	6.5	17.6
GME Reform	0.2	0.4	0.7	0.9	1.2	1.5	1.9	2.3	2.7	3.1	3.4	5.0	14.9
Eliminate Add-Ons for Outliers	0.5	0.5	0.5	0.6	0.6	0.6	0.7	0.7	0.8	0.8	2.6	3.3	6.2
PPS Redefined Discharges	0.7	0.8	0.8	0.9	1.0	1.0	1.1	1.2	1.2	1.3	4.1	5.2	10.0
SCH Rebasing	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.6	-0.7	-1.2
RPCH Expansion	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.2
Medicare Dependent Hospitals	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Direct Pay of GME/IME/DSH Removed from AAPCC	-1.1	-1.9	-2.1	-2.6	-3.0	-3.5	-3.9	-4.4	-5.0	-5.7	-10.7	-14.2	-33.2
Interactions Among Hospital Proposals	0.0	0.0	-0.1	-0.2	-0.4	-0.5	-0.7	-0.8	-0.9	-1.0	-0.7	-1.3	-4.6
Home Health													
Extend Savings from OBRA 1993 Freeze	0.1	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.5	1.3	1.6	3.3
HH Interim System	0.9	1.3	1.5	1.8	2.1	2.4	2.8	3.1	3.4	3.7	7.7	10.2	23.1
HH PPS	0.0	0.0	1.5	1.6	1.7	1.8	2.0	2.1	2.2	2.4	4.7	6.5	15.2
Part A Benes Who Choose Not to Enroll in Part B b/	0.0	0.4	0.7	0.8	0.7	0.7	0.8	1.1	1.1	1.2	2.6	3.3	7.4
Fraud and Abuse													
Clarity and Enhance MSP Authority	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.4	1.0	1.3	2.6
Extend Expiring MSP Provisions	0.0	0.7	0.9	1.1	1.3	1.5	1.7	1.8	2.0	2.1	4.0	5.5	13.0
Revise HIPAA Provisions	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.2	0.3	0.5
Pay Home Health at Location of Service	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.5	0.9
Eliminate Home Health PIP	0.0	0.0	0.8	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.0	1.1	1.4
Require SNF Consolidated Billing	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.4	-0.8

Skilled Nursing Facilities																			
Extend Savings from OBRA 1993 Freeze																			
Establish SNF PPS	0.0	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	1.3	1.7	3.6			
Beneficiary Investments																			
Colorectal Screening	-0.1	-0.2	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-1.1	-1.4	-3.0			
HI Premium Free Working Disabled	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1			
Part A Premium Offset	-0.2	-0.2	-0.3	-0.4	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6	-0.6	-0.7	-0.7	-1.5	-2.0	-4.4			

TOTAL PART A	49	10.1	18.6	21.8	25.9	31.5	34.8	38.0	41.4	81.3	109.8	255.4							
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PART B PROPOSALS

Managed Care	-0.1	0.2	1.1	1.7	2.1	1.7	1.5	1.8	1.9	2.2	5.1	6.8	14.2						
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Hospitals

Outpatient PPS c/	0.0	1.8	1.8	2.1	2.5	3.7	3.4	4.1	5.0	5.8	8.2	11.9	30.2						
Outpatient GME Reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0						
Expand Centers of Excellence	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2						

Physicians and Other Practitioners

Single Conversion Factor, Reform Update	0.1	0.8	1.5	2.1	2.8	3.6	4.5	5.5	6.8	8.2	7.3	10.9	35.8						
Single Fee For Surgery	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.4	0.6	1.2						
Incentives for In-Hospital MD Services	0.0	0.0	0.3	0.5	0.7	0.9	0.9	1.0	1.1	1.2	1.5	2.4	6.7						
Direct Payment to PA, NP, CNS	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.6	-0.8	-1.7						
Pay Acquisition Costs for Drugs	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.8	1.0	2.0						
Increase Access to Chiropractors	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.5						
Interaction among Physician Proposals	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.3	-0.2	-0.3	-1.1						

Fraud and Abuse

Clarify and Enhance MSP Authority	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.6	0.8	1.8						
Extend Expiring MSP Provisions	0.0	0.3	0.4	0.5	0.6	0.8	0.9	1.0	1.2	1.3	1.9	2.6	7.1						
Require SNF Consolidated Billing	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.6						
Revise HIPAA Provisions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2						

Other Providers

Competitive Bid	0.0	0.0	0.0	0.5	0.8	0.9	1.0	1.1	1.2	1.3	1.4	2.3	7.0						
Reduce ASC Update	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.3	0.5	1.5						
Reform Lab Payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2						

OMB Estimate of President's Budget Plan for Medicare—Continued

(FY. \$'s in billions, positive numbers are savings, negative numbers are costs, sums may not add due to rounding)

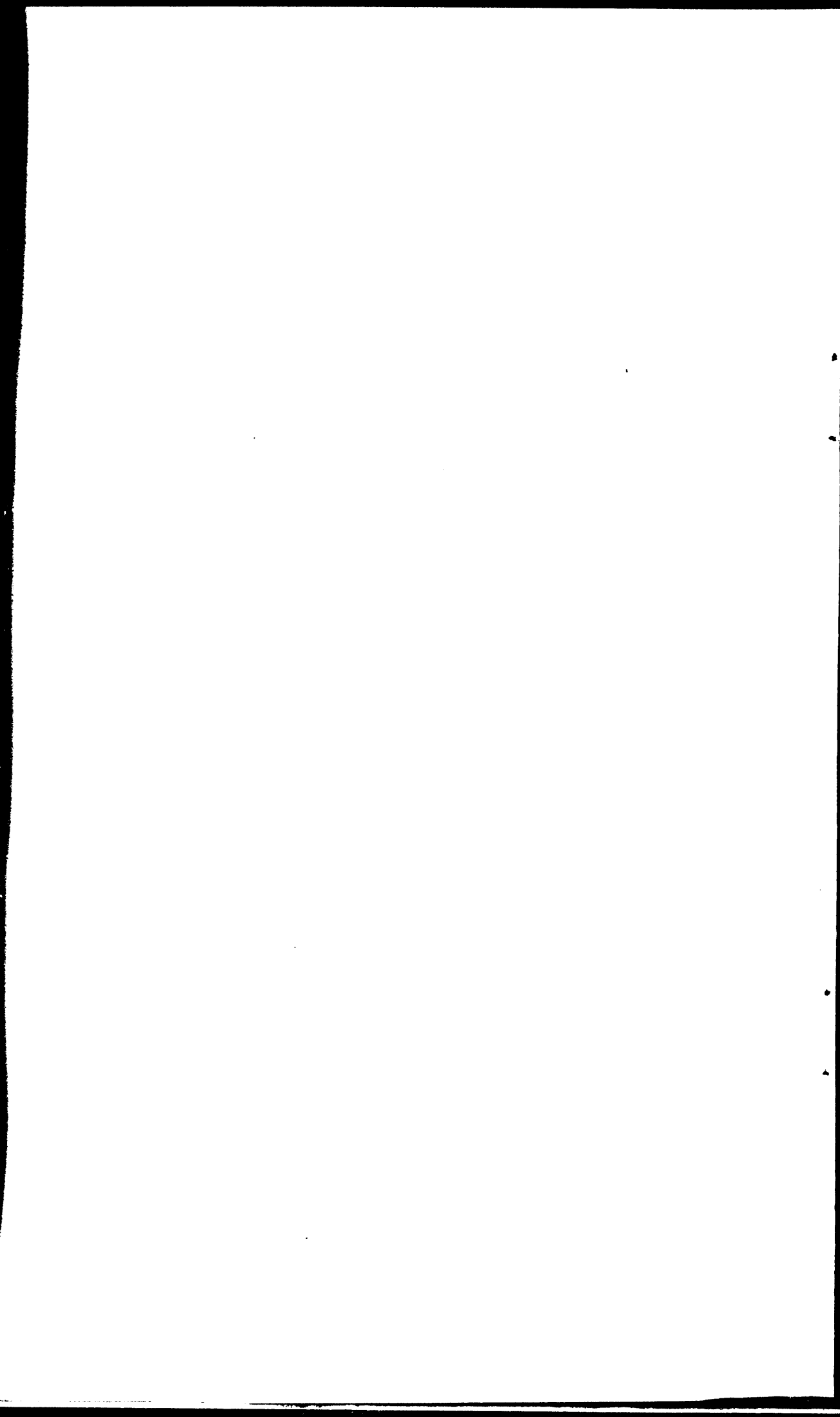
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	98-02	98-03	98-07
Part B Premium													
Extend 25% Premium Beyond 1998	0.0	1.0	2.5	4.1	5.9	8.1	11.0	14.0	17.3	21.0	13.6	21.7	84.9
Premium Offset	0.0	-0.3	-0.7	-1.2	-1.4	-0.9	-0.6	-0.7	-0.7	-0.7	-3.5	-4.4	-7.2
Beneficiary Investments													
Waive Mammography Costsharing	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.3	-0.6
Annual Mammogram	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.4	-0.5	-0.8
Respite Care	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-1.7	-2.0	-3.6
Colorectal Screening	0.0	-0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.7	-0.9	-2.2
Diabetic Screening	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-1.5	-1.8	-3.3
Blood Glucose Monitor Strips	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2
HI Premium Free Working Disabled	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Preventive Injections	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-1.1
Actuarially Determined Premium Surcharge	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.8	-1.0	-2.2
Appropriate Outpatient Coinsurance c/	0.0	-1.1	-1.3	-1.8	-2.6	-6.6	-8.5	-10.2	-12.4	-14.7	-6.8	-13.4	-59.2
TOTAL PART B	-0.4	2.0	4.9	7.8	10.6	11.2	13.2	16.7	20.2	24.3	24.9	36.1	110.5
NET SAVINGS FROM TOTAL PACKAGE	4.5	12.1	23.5	29.5	36.5	39.7	44.7	51.5	58.2	65.8	106.1	145.8	365.9
Home Health Reallocation													
Part A Home Health Spending Reallocated d/	14.4	15.6	15.8	17.3	18.9	20.5	22.2	24.0	25.8	27.8	82.0	102.4	202.1

Footnotes

- a/ The President's FY 1998 Budget submitted in February was scored by OMB at \$100 billion over 5 years. A few technical changes were made to this package after budget numbers were transmitted including changes to respond to CBO's different baseline assumptions. These changes took the package as scored by OMB up to \$108 billion. CBO however scored this revised package as saving \$82 billion over 5 years.
- b/ Includes interactions with other HHA proposals.
- c/ The net budget impact of the Outpatient PPS proposal is equal to the Federal costs of appropriate outpatient coinsurance (\$59.2 billion) net of the Federal savings of (1)(X) PPS (\$30.2 billion) or \$29.0 billion over 10 years. In addition, there is a net budget impact of OPD PPS on managed care equal to \$9.8 billion over 10 years.
- d/ These figures represent the total amount of the home health transferred from Part A, including the impacts on both the fee for service and managed care seniors. The line in the savings table titled Part A beneficiaries who choose Not to Enroll in Part B represents the fee for service effect. The managed care effects are included in the Part A managed care figures.

MEDICAID

Medicaid is a Federal-State program providing medical assistance for specified groups of low-income persons who are aged, blind, disabled, or members of families with children. Within Federal guidelines, each State designs and administers its own program. Thus, there is substantial variation among the States in terms of persons covered, types of benefits provided, and payment rates for covered services.



Federal Payments

Limitations on per capita rate of growth in Federal financial participation

Present Law

The Federal Government has an open-ended commitment to match each State's spending for Medicaid at the Federal matching rate for the State. In other words, the Federal Government shares in the cost of all allowable Medicaid expenses for eligible individuals. Federal Medicaid payments are based on quarterly reports that States submit to the Secretary of DHHS. States which, through section 1115 waivers, offer Medicaid to persons not otherwise eligible for benefits under the program, receive Federal payments at their regular matching rates.

Description of Proposal

The proposal establishes a limit in the annual growth in Federal Medicaid spending per beneficiary for each State, based on a specified growth index. For each State, the growth limit would apply to a per capita base for each of four beneficiary groups: non-disabled child, non-disabled adult, elderly, and disabled beneficiaries. Each State's group base rate would be the State's total 1996 Medicaid expenditures calculated on a per beneficiary basis. That is, for each State, the Secretary would determine the amount attributable to items and services furnished to individuals in each of the groups specified, and apportion the State's FY1996 administrative expenditures to each group according to the State's expenditures for items and services for the group. The State's total amount spent for each group would be divided by the number of *full-year equivalent individuals* in the group who were enrolled in the State's Medicaid program in FY1996 to arrive at the per capita base rate for each group. The annual Federal payment limit for each group would be the product of (1) the per capita base rate for the group, (2) the actual number of full-year equivalent individuals in the group in the year, (3) the State's Federal matching rate as under current law, and the *allowable Medicaid growth multiplier* for FY1997 and succeeding years.

For FY1998 and succeeding years, the limit on Federal Medicaid payments to a State would be an aggregate amount equal to the sum of the State's group limits except for certain items that would not be subject to the per capita cap. Spending for State fraud control units; payments for disproportionate share adjustments, for Medicare cost sharing and to Indian Health Service and other Indian health providers; expenditures for the Vaccines for Children program; spending for nursing facility certification; and amounts

attributable to the immigration status verification system would be excluded from the cap.

In their quarterly reports, each State would be required to indicate the share of total Medicaid expenditures attributable to each beneficiary group. The number of full-year equivalent enrollees in each group would be determined by the Secretary (based on State reports) taking into account the numbers of individuals who were not enrolled in a State's program for the entire fiscal year, or were within a group of individuals for only part of a fiscal year. A State that had a section 1115 waiver in effect during FY1996 would have the option of counting only the enrollees who would have been eligible for Medicaid in the absence of a waiver in the cap calculation. Those eligible only through the qualified Medicare beneficiary program and related programs (SLMBs) are excluded from the cap.

The allowable Medicaid growth multiplier would be used to update group limits from year to year. The multiplier for a fiscal year would be one plus the arithmetic average of the annual change in the nominal gross domestic product per capita for the five consecutive 12-month periods ending on June 30 of the preceding fiscal year, increased by two percentage points for each of fiscal years 1997 and 1998, and by one percentage point for each succeeding fiscal year.

Prior to the beginning of FY1998 and each succeeding fiscal year, the Secretary would publish each State's average per capita limit for each beneficiary group. Federal matching payments for States' Medicaid expenditures made after September 30, 1997 would be subject to per capita limits. For expenditures incurred before that date, States would be required to submit their claims for Federal matching funds by June 30, 1998.

Entitlement to Benefits Are Maintained

Reduction of disproportionate share payments

Present Law

Since 1981, States have been required to make supplemental payments to hospitals that serve a disproportionate number of Medicaid recipients and low-income patients. These payments are referred to as disproportionate share hospital (DSH) payments. Each State determines which hospitals receive DSH payments and the payment to each. States that contract with health maintenance organizations (HMOs) or other prepaid capitation managed care providers may include DSH expenses in the payment rates to the contractors. A major factor behind the growth in Medicaid expenditures between 1989 and 1992 was States' use of DSH and related financing mechanisms such as provider taxes and donations to generate Federal dollars. Although legislation enacted in 1991 and 1993 curtailed these State practices, Federal spending for DSH is about \$10 billion per year. Total annual Federal DSH spending and DSH spending in each State is limited to 12 percent of total annual Medicaid expenditures. The limit is being phased in through the use of State-specific DSH allotments.

Description of Proposal

Federal DSH spending would be reduced. The proposal would require that each State pay hospitals directly for DSH instead of including DSH payments in prepaid capitation contracts. In addition, the proposal would establish new State-specific DSH allotments to freeze DSH payments in FY1998 at FY1995 spending levels and gradually reduce DSH payments. Finally, for fiscal years 1999–2002, the proposal would provide for supplemental payments for States and other entities to ease the transition to per capita limits and reductions to DSH payments.

Beginning with FY1998, no Federal DSH payment would be made in excess of a State's new DSH allotment. For FY1998, each State's DSH allotment would be equal to the State's FY1995 DSH spending. For subsequent years, a State's DSH allotment would be a reduced portion of the State's FY1995 DSH spending. This proportional reduction applies to a *State multiplier* defined as the lesser of the State's FY1995 DSH spending, or 12 percent of the State's FY1995 Medicaid expenditures. For FY1999, a State's DSH allotment would be its FY1995 DSH spending minus 15 percent of the State multiplier. For FY2000 and each succeeding year, 25 percent of the State multiplier would be deducted from the State's FY1995 DSH spending. In other words, each State's DSH spending is reduced proportionally with certain DSH spending amounts—above 12 percent of total spending—excluded from reductions.

The proposal would authorize grants to States and other entities that the Secretary determines need grants to ease the transition from the current Medicaid program to a program operated with per capita caps and reductions in DSH payments. The Secretary would establish criteria for transition grants in regulations to be published by October 1, 1997. Amounts authorized for such grants would be \$400 million for FY1999, \$300 million for FY2000, \$200 million for FY2001, and \$100 million for FY2002.

Medicaid eligibility quality control (MEQC) requirements

Present Law

Under Medicaid quality control systems, each State monitors aspects of its own administrative performance. MEQC is the identification of eligibility errors that may result in improper Federal payments. If error rates exceed certain tolerances, Federal payment is disallowed.

Description of Proposal

The proposal would modify the current MEQC system to accommodate population components of the per capita cap. Specifically, the system would examine for whether enrollees were reported in the proper beneficiary group.

Nursing home survey and certification

Present Law

Nursing facilities participating in the Medicaid program are subject to survey and certification procedures. States are responsible

for conducting inspections to determine whether providers can be certified as meeting the standards and conditions for Medicaid participation. The Federal matching rate to States for most administrative expenses is 50 percent; the rate for survey and certification activities is 75 percent.

Description of Proposal

The Federal matching rate for nursing home survey and certification activities would be increased from 75 percent to 85 percent.

Eligibility

Disabled children who lose SSI benefits

Present Law

P.L. 104-193, the Personal Responsibility and Work Opportunity Act of 1996, established a definition of childhood disability for receipt of benefits under the Supplemental Security Income (SSI) program. Under the new definition, some children will lose their SSI benefits. Due to the loss of SSI, the children will lose their Medicaid eligibility as it is linked to SSI eligibility.

Description of Proposal

The proposal would allow disabled children who are currently receiving Medicaid to retain their Medicaid coverage if they lose SSI because of the new definition.

State option to permit workers with disabilities to buy into Medicaid

Present Law

States must continue Medicaid coverage for "qualified severely impaired individuals under the age of 65." These are disabled and blind individuals whose earnings reach or exceed the SSI benefit standard. (The current law threshold for earnings is \$1,053 per month.) This special eligibility status applies as long as the individual (1) continues to be blind or have a disabling impairment; (2) except for earnings, continues to meet all the other requirements for SSI eligibility; (3) would be seriously inhibited from continuing or obtaining employment if Medicaid eligibility were to end; and (4) has earnings that are not sufficient to provide a reasonable equivalent of benefits from SSI, State Supplementary Payments (if provided), Medicaid, and publicly funded attendant care that would have been available in the absence of those earnings. To implement the fourth criterion, the Social Security Administration compares the individual's gross earnings to a "threshold" amount that represents average expenditures for Medicaid benefits for disabled SSI cash recipients in the individual's State of residence.

Description of Proposal

States would have the option of creating a new eligibility category for disabled SSI beneficiaries with higher incomes than current law allows. Beneficiaries would "buy into" Medicaid by paying

a premium. Premium levels would be on a sliding scale, based on the individual's income as determined by the State.

Extension of coverage to additional individuals

Present Law

Medicaid law limits eligibility to members of families with children, and to individuals who are elderly, blind, or disabled. Eligibility rules are linked to a State's rules for its Aid to Families with Dependent Children (AFDC) program, or to rules of the Federal SSI program. There is variation in the rules for the 50 potentially eligible groups that can be covered by Medicaid. Some States have obtained waivers of Federal law to expand Medicaid coverage to low-income uninsured people who do not fall into one of the eligibility categories and who have higher incomes than current law allows.

Description of Proposal

At their option, States would be able to cover new groups of individuals with incomes up to 150 percent of the Federal poverty level without waivers. Expansions would be approved only if they were demonstrated to be cost neutral. Administration would be simplified so that instead of the many different rules for different groups, States could use the same rules for everyone eligible under the percent-of-poverty option. Individuals enrolled under this provision could not be counted in State reports of numbers enrolled or included in calculation of the Federal payment limit.

Elimination of authority for new statewide eligibility expansion demonstrations

Present Law

Section 1115(a) of the Social Security Act gives the Secretary authority to waive statutory requirements for Medicaid in order to conduct statewide demonstration projects "likely to assist in promoting the objectives" of the program. Under 1115(a) waivers, some States have extended Medicaid eligibility to individuals who, in the absence of a waiver, would not be eligible for categorical or financial reasons.

Description of Proposal

The proposal would amend section 1115 to eliminate the Secretary's authority to grant waivers that would expand the number of individuals eligible for Medicaid.

Continuous eligibility for children

Present Law

In general, Medicaid coverage can be provided only to individuals who continue to meet all the requirements for eligibility. For some individuals and families, income fluctuates so that there are frequent interruptions in eligibility. Medicaid law makes an exception to provide continuous eligibility for pregnant women and infants

regardless of changes in income. The law specifies that a pregnant recipient continues to be eligible for Medicaid until 60 days after the pregnancy ends. Further, a child born to a woman receiving medical assistance remains eligible for medical assistance for 1 year so long as the child is a member of the woman's household and the woman remains (or would remain if pregnant) eligible for medical assistance.

Description of Proposal

States would be permitted to provide a full continuous 12 months of eligibility for children who are over age 1 and under 18, 19, 20, or 21 as specified by the State.

Upper income limit on "less restrictive" eligibility methodologies

Present Law

Under section 1902(r)(2) of the Social Security Act, States are allowed to use more liberal methodologies for determining income and resource eligibility than those used for the AFDC program to determine Medicaid financial eligibility. Disregarding additional amounts of income and resources, States can qualify certain categories of populations for Medicaid eligibility who are not entitled to benefits under categorical eligibility criteria. The provision has been used to expand eligibility for pregnant women and children with household incomes up to 300 percent of the Federal poverty line.

Description of Proposal

The proposal would establish a 150 percent of poverty income eligibility limit on individuals who can be determined eligible through this provision. States can maintain their income eligibility limit in effect in FY1996 (including 1115 demonstrations) if higher than the 150 percent limit.

Managed Care

Present Law

Medicaid programs use three main types of managed care arrangements. These vary according to the comprehensiveness of the services they provide and the degree to which they accept risk. Under primary care case management (PCCM) a Medicaid beneficiary selects, or is assigned to a single primary care provider. Numerous provisions of current law apply to contracts between States and managed care organizations (MCOs). States may offer services through a MCO on a voluntary basis. However, to mandate that beneficiaries enroll in MCOs, or to limit MCO services to specific populations or geographic areas, States must obtain waivers of Federal laws. Generally, waivers of freedom-of-choice, comparability, and statewideness provisions are obtained under section 1915(b) of the Social Security Act. They are for 2 years and may be renewed. As of February 1997, 42 States had 96 1915(b) waivers.

States' payments under contracts with MCOs must be established on an actuarially sound basis. By regulation, payment rates may not exceed what the State would have paid for similar services for a beneficiary not enrolled in a MCO. This upper payment limit is known as the fee-for-service equivalent. States may pay less than the upper limit. However, some States argue that the upper limit is inadequate to attract plans to participate. All State contracts with MCOs must receive prior approval by the Secretary if expenditures are expected to be over \$100,000. Cost-sharing charges such as deductibles or copayments, may not be imposed on Medicaid enrollees in HMOs (Note: not all MCOs are HMOs under the law). As a proxy for quality, Federal law requires that less than 75 percent of an MCO's enrollment must be Medicaid or Medicare beneficiaries. For some MCOs, the 75/25 rule has been bypassed through State demonstration waivers or through specific Federal legislation.

Description of Proposal

The proposal establishes a definition of PCCM, sets contractual requirements for PCCM arrangements, adds PCCM services to the list of Medicaid covered services, and repeals waiver authorization for PCCM.

States would be permitted to mandate enrollment in PCCM or other managed care arrangements *if* a Medicaid beneficiary had a choice of at least two entities or managers and other conditions were met. States would be permitted to require beneficiaries to remain in a managed care arrangement for up to 6 months; States would also (as under current law) be permitted to guarantee 6 months of eligibility for enrollees. Prior to establishing a mandatory managed care enrollment requirement, a State would have to provide for public notice and comment.

The payment limit and actuarial soundness standards would be modified to require that capitated payment amounts be set at rates that have been determined, by an actuary meeting the standards of qualification and practice established by the Actuarial Standards Board, to be sufficient and not excessive with respect to the estimated costs of services provided. The threshold for Federal review of contracts would be raised from \$100,000 to \$1 million. States would be permitted to impose nominal copayments on HMO enrollees.

The 75/25 rule would be eliminated. The Secretary would be authorized to require reporting of detailed individual encounter data to monitor care furnished under managed care arrangements. States that have agreements with HMOs, PCCMs, and other managed care entities would be required to develop and implement quality assessment and improvement strategies consistent with standards established by the Secretary.

Benefits

Home and community-based services

Present Law

Under 1915(c) waivers, States have the option of providing a broad range of home and community-based services to elderly, mentally retarded, and other disabled and chronically ill persons who would otherwise require nursing home care or other forms of institutional care. The 1915(c) authority is known as a waiver program because States must request, through a special application, that the Secretary waive certain requirements that would normally apply to services covered under their Medicaid plans.

Description of Proposal

States would be able to create a home and community-based services program without a Federal waiver. Instead, a State would amend its State plan for Medicaid to include the program.

Elimination of requirement to pay for private insurance

Present Law

States are required to identify cases in which it would be cost-effective to enroll a Medicaid-eligible individual in a private insurance plan and, as a condition of eligibility, require that the individual enroll in the plan. In case of enrollment, the Medicaid program would pay insurance premiums as well as cost-sharing obligations for items and services covered by Medicaid.

Description of Proposal

Identification and enrollment requirements would be eliminated. States would have the option of purchasing private insurance.

Individuals covered during transition to work

Present Law

Prior to enactment of the welfare reform law (P.L. 104-193) and the repeal of AFDC, an individual who increased earnings from employment faced the loss of AFDC and Medicaid coverage. Medicaid eligibility is still determined by AFDC rules. Medicaid law extends at least 6 months of coverage to families who would lose AFDC because of earnings. States are required to provide full Medicaid coverage or "wrap-around" coverage. Under the wrap-around option, States can pay expenses for insurance premiums, deductibles, and coinsurance for health care offered by the employer. States are permitted to extend Medicaid coverage for a second 6 months and to impose premiums for that period. Premiums may not exceed 3 percent of the family's average gross monthly earnings.

Description of Proposal

The proposal specifies that under the wrap-around option, States would be permitted to limit the amount of payment for any deductible or coinsurance to what the State would pay if the item or serv-

ice had been furnished by a provider participating in the State's Medicaid program. The premium limit would be eliminated.

Copayments in health maintenance organizations

Present Law

Enrollment fees, coinsurance, or other cost-sharing charges may not be imposed on Medicaid recipients for services furnished by HMOs.

Description of Proposal

The proposal would eliminate the prohibition on fees for services furnished by HMOs.

Provider Participation and Payment Rates

Methods for establishing provider payment rates

Present Law

Generally, States develop their own methods and standards for reimbursement of Medicaid services though there are Federal statutory requirements for some services. Among these are the so-called Boren amendments that require States to pay hospitals and nursing homes rates that are reasonable and adequate to cover the cost of efficient and economically operated facilities. States are required to receive and audit cost reports by hospitals, nursing facilities, and intermediate care facilities for the mentally retarded (ICFs/MR). States are required to pay federally qualified health centers (FQHCs) and rural health clinics (RHCs) rates that are equal to 100 percent of the facility's reasonable costs, subject to any reasonableness test developed for the same services under Medicare rules (or, for Medicaid services not covered under Medicare, as would be allowed under principles similar to Medicare's).

Description of Proposal

The proposal would repeal the Boren amendments and establish a public notice process for setting payment rates for services provided by hospitals, nursing facilities, and intermediate care facilities for the mentally retarded. Not later than 4 years after enactment, the Secretary would be required to report to Congress on the effects of States' rate-setting methods on access to and quality and safety of services. Beginning with FY1999, the requirement to pay RHCs and FQHCs at 100 percent of costs would be eliminated.

The proposal would require the Secretary to make quarterly grants to eligible FQHCs and RHCs for each of fiscal years 1999-2002. Such grants would be made according to criteria and payment methodology established by the Secretary and published in regulation by October 1, 1997. Amounts authorized for these grants would be \$500 million for FY1999, \$400 million for FY2000, \$300 million for FY2001, and \$200 million for FY2002.

Physician qualification requirements***Present Law***

Medicaid law establishes special minimum qualifications for a physician who furnishes services to a child under age 21 or to a pregnant woman.

Description of Proposal

The provision would be repealed.

Elimination of obstetrical and pediatric payment rate requirements***Present Law***

Under section 1926 of the Social Security Act, States are required to assure adequate payment levels for obstetrical and pediatric services and provide annual reports on their payment rates for the services.

Description of Proposal

Section 1926 would be repealed.

Program for all-inclusive care for the elderly (PACE)***Present Law***

OBRA 86 required the Secretary to grant waivers of certain Medicare and Medicaid requirements to not more than 10 public or non-profit private community-based organizations to provide health and long-term care services on a capitated basis to frail elderly persons at risk of institutionalization. These projects are known as the Programs for All-Inclusive Care for the Elderly, or PACE projects. OBRA 90 expanded the number of organizations eligible for waivers to 15.

Description of Proposal

The proposal would establish PACE as a provider type and require sites to meet minimum requirements included in a PACE protocol.

State Plan Administration***Elimination of personnel requirements******Present Law***

For Medicaid, States are required to maintain personnel standards on a merit basis, and train and use subprofessional staff with emphasis on employment of recipients and other low-income persons.

Description of Proposal

Particular personnel requirements would be eliminated. A State would be required to provide methods of administration that the

Secretary finds to be necessary for the proper and efficient operation of its Medicaid plan.

Elimination of duplicative inspection of care requirements for ICFs/MR and mental hospitals

Present Law

States that provide services in mental hospitals and in ICFs/MR must provide for periodic inspections of care for each Medicaid beneficiary who receives services in the institution. Inspections of care have been conducted to assure that persons are receiving the appropriate level of care of adequate quality. The DHHS has established a new survey outcome-oriented process for mental hospitals and ICFs/MR.

Description of Proposal

Inspection of care reviews in mental hospitals and ICFs/MR would be eliminated. Survey and certification reviews for the facilities would remain in place.

Public process for developing state plan amendments

Present Law

Each State is required to maintain a State Medicaid plan—a comprehensive statement that describes the nature and scope of the State's Medicaid program. State plans must be amended when necessary due to changes in laws, regulations, or policies. State plans and amendments are subject to approval of the Secretary. Current Medicaid law has no provisions for the development of State plan amendments.

Description of Proposal

States would be required to establish a public notice and review process for the development of Medicaid State plan amendments.

Alternative sanctions for non-compliant ICFs/MR

Present Law

ICFs/MR must meet certain requirements and standards for safety and for the proper provision of care. If a State finds that a facility is out of compliance with the requirements, the facility's participation in Medicaid can be terminated until the deficiencies have been corrected. States have limited sanctions available for the use of ICFs/MR that are found to have deficiencies.

Description of Proposal

The proposal would provide for alternative sanctions similar to those that are available for nursing facilities.

Modification of MMIS requirements

Present Law

Beginning October 1, 1986 States have been required to maintain mechanized claims processing and information retrieval systems better known as Medicaid Management Information Systems (MMIS). Failure to meet the 1986 deadline resulted reduced Federal Medicaid funds. An MMIS is reviewed at least once every 3 years by the Health Care Financing Administration of DHHS. Failure to pass a systems performance review could result in reduction of the usual 75 percent Federal Medicaid match rate for operation of an approved MMIS.

Description of Proposal

The proposal would delete the statutory language that related to 1980s requirements for MMIS. It would require each State to operate a system that is adequate to provide efficient, economical, and effective administration, is compatible with the claims processing and information retrieval systems that are used to administer the Medicare program, and provides for electronic transmission of claims data.

Nurse aide training and competency evaluation programs

Present Law

Nursing facilities are prohibited from offering a nurse aide training program by or in the facility if within the previous 2 years it has had a waiver of the registered nurse staffing requirement, or has been subject to an extended survey, or has been subject to sanctions for noncompliance with requirements.

Description of Proposal

This provision would allow otherwise prohibited nurse aid training programs, which are offered in (but not by) nursing facilities to do so, if the State determines that there would be no other program offered within a reasonable distance, provided notice of the approval to the State long-term care ombudsman, and assured through an oversight effort that an adequate environment exists for the program. The proposal would also clarify that a survey finding of substandard care, rather than the mere occurrence of an extended survey, would be the event that triggers the prohibition on nurse aide training.

Elimination of repayment requirement for States imposing alternative remedies on non-compliant nursing facilities

Present Law

States have available to them a range of sanctions they may take against nursing facilities found to be out of compliance with the requirements for participation in Medicaid. These include termination of participation in the program, denial of payment for new admissions, civil money penalties, appointment of temporary management; and authority to close the facility or transfer residents.

For facilities that are not terminated and that are taking steps to eliminate deficiencies according to an approved plan of correction, the Secretary of DHHS is authorized to continue Federal Medicaid matching payments to the State for no longer than 6 months. States, however, are required to repay to the Federal Government any payments made to facilities that fail to take corrective action according to the approved plan and timetable.

Description of Proposal

The proposal would eliminate the requirement for States to repay Federal funds for failure of a facility to correct deficiencies according to an approved plan of correction.

Miscellaneous Provisions

Commission on Medicaid

Present Law

No provision.

Description of Proposal

The proposal would establish a Commission on State Health Reform and Medicaid Equity. The Commission would monitor the status and progress of Medicaid, report to the public concerning progress made by States, provide for the promotion of information exchange between the States and the Federal Government, and recommend program improvements and other State health reform initiatives to the President and the Congress. Also, the Commission would review and recommend suggestions for achieving equity among the States in States' per capita base year and growth rates. The Commission will also review and recommend appropriate changes in the Federal Medicaid matching rate to reflect demographics, health care utilization changes, and economic differences.

The Commission would be required to make a final report to the Secretary and the Congress 2 years after its initial meeting. For FY1998, \$2 million would be authorized to be appropriated for the Commission.

Effective Date

Present Law

No provision.

Description of Proposal

Unless otherwise specified, the Medicaid amendments would take effect on and after October 1, 1997. The proposal provides for an extension in the case of a State that the Secretary determines requires State legislation to comply with the amendments.

Increase Federal payment cap for Puerto Rico

Present Law

The Federal Government matches Puerto Rico's Medicaid spending at a 50 percent rate up to statutory limits that are specified in section 1108 of the Social Security Act. Beginning with \$116,500,000 in FY1994, the Medicaid limit increases annually by the percentage increase in the medical care component of the consumer price index for all urban consumers, rounded to the nearest \$100,000.

Description of Proposal

The Federal Medicaid payment to Puerto Rico would be increased by \$30 million in FY1998 and by an additional \$10 million in each of the succeeding fiscal years 1999–2002.

Increase Federal payment to the District of Columbia

Present Law

Under Medicaid law, the District of Columbia is a State. States are required to pay at least 40 percent of the non-Federal share of Medicaid costs. This means that States, by law, can require local jurisdictions to share Medicaid costs, up to a certain proportion, instead of bearing the entire non-Federal share. The District's Federal Medicaid matching rate is 50 percent.

Description of Proposal

The District's share of Medicaid costs would be reduced to 30 percent, the maximum amount that the District, as a local government, could be required to contribute if it were located within a State with a Federal matching rate of 50 percent (60 percent of the non-Federal share—50 percent).

Medicaid eligibility for non-citizens

Present Law

P.L. 104–193, the Personal Responsibility and Work Opportunity Act of 1996, bars most aliens from receiving benefits under the Supplemental Security Income (SSI) program for the elderly, blind, and disabled. Many people are eligible for Medicaid *because* they receive SSI benefits. Without SSI, an individual would not be eligible for Medicaid unless the State of residence could determine the individual eligible under one of the State's optional eligibility categories. States have the option of continuing Medicaid coverage to legal aliens in the country as of August 22, 1996 including those who lose Medicaid due to loss of SSI benefits. A State can continue coverage by determining eligibility under an existing optional eligibility category in the State's Medicaid program. However, some States have not chosen to exercise the optional Medicaid eligibility categories that would be appropriate for the population. A State that has no applicable category must deny coverage or expand its entire program.

Under P.L. 104-193, aliens who enter the U.S. after the date of enactment are barred from Medicaid for 5 years after arrival *except* for certain aliens including refugees and asylees. Refugees and asylees who otherwise meet Medicaid eligibility requirements may be eligible for Medicaid for up to 5 years. For aliens not exempted from the 5-year ban, States are permitted to provide Medicaid after the 5 years have passed.

In general, the Immigration and Nationality Act excludes from entry aliens who appear "likely at any time to become a public charge." Sponsors of prospective aliens must pledge support of aliens whom they sponsor. Amendments enacted in P.L. 104-193 expand the use of *sponsor-to-alien deeming*. Under the deeming provisions, a sponsor's income and assets are taken into account when an alien applies for a means-tested benefit such as Medicaid.

Description of Proposal

Immigrants who become disabled after entry to the United States, or who are children, would be exempted from the ban on SSI benefits and on Medicaid benefits. This applies to immigrants in the country before enactment and those arriving after that date—August 22, 1996. The 5-year period during which refugees and asylees can receive Medicaid benefits would be extended to 7 years. The sponsor-to-alien deeming requirements would not apply to disabled immigrants or to immigrant children.

**CBO and OMB Estimates of the FY 1998
President's Budget Medicaid Proposals**

CBO Estimates of the Final FY 1998 President's Budget Medicaid Proposals
(dollars in billions)

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>	<u>FY 2001</u>	<u>FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>	<u>Total</u> <u>1998 - 2002</u>	<u>Total</u> <u>1998 - 2007</u>
CBO 1/97 Baseline	105.3	113.6	122.9	132.8	143.8	155.9	168.7	183.1	192.9	216.2	618.4	1,541.2
Savings												
Per Capita Cap 1/	0.0	-0.5	-1.5	-2.6	-3.9	-5.4	-6.8	-8.7	-11.1	-13.8	-8.5	-54.3
DSH	-0.3	-2.1	-3.8	-4.7	-5.6	-6.6	-7.7	-8.9	-10.2	-11.6	-16.6	-61.5
Pool Amounts												
FQHC/RHC	0.0	0.5	0.4	0.3	0.2	0.1	0.0	0.0	0.0	0.0	1.4	1.5
Transition Pool 1/	0.0	0.4	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.0	1.0	1.1
Subtotal Savings	-0.3	-1.7	-4.6	-6.8	-9.2	-11.8	-14.5	-17.6	-21.3	-25.4	-22.7	-113.2
Welfare												
Legal Immigrant Provisions	0.9	0.9	1.1	1.3	1.6	1.9	2.3	2.8	3.3	3.8	5.8	19.9
Keep Medicaid for Disabled Kids	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.4	1.0	2.5
Refugee/Asylee Exemption	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Kids Initiatives												
12 Month Eligibility	0.9	0.9	1.0	1.0	1.1	1.2	1.2	1.3	1.4	1.4	4.9	11.4
Outreach - Kids Health Demos	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.8	1.8
Other												
Puerto Rico	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.8
Extension of VA Sunset	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.5	1.1	3.1
Working Disabled	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Raise IM FMAP to 70%	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.9	2.3
Eliminate Vaccine Excise Tax	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1

Interactions																				
Part B Premium Interactions	0.0	0.1	0.2	0.2	0.4	0.6	0.8	1.1	1.3	1.6	0.9									
Total Net Savings	1.8	1.1	-1.6	-3.3	-5.1	-7.0	-8.9	-11.2	-14.0	-17.1	-7.0									6.3
New Outlays	107.1	114.7	121.3	129.5	138.7	148.9	159.8	171.9	185.0	199.1	611.3									1,476.0

1/ Memorandum: The per capita cap and transition pool policies assumed in the initial CBO estimates do not reflect final policy decisions. The per capita cap growth rate in the final policy is equal to the growth in nominal GDP per capita plus 2% in 1997 and 1998 and 1% thereafter. Additionally, the transition pool in the final policy totals \$1.0 billion over five years. CBO provided unofficial estimates of the final policy. CBO unofficially estimated gross savings of \$22.7 billion over five years and net savings of \$7.0 billion over five years from the final policy.

OMB Estimates of the FY 1998 President's Budget Medicaid Proposals
(dollars in billions)

	<u>FY 1998</u>	<u>FY 1999</u>	<u>FY 2000</u>	<u>FY 2001</u>	<u>FY 2002</u>	<u>FY 2003</u>	<u>FY 2004</u>	<u>FY 2005</u>	<u>FY 2006</u>	<u>FY 2007</u>	<u>Total</u> <u>1998 - 2002</u>	<u>Total</u> <u>1998 - 2007</u>
FY 1998 President's Budget Baseline	104.4	111.2	119.6	129.1	139.2	150.8	163.4	177.4	192.2	208.4	603.4	1,495.5
Savings												
Per Capita Cap	0.0	0.0	-0.8	-2.4	-4.0	-6.6	-9.9	-13.6	-17.7	-22.3	-7.2	-77.2
DSH (net of pools)	0.2	-1.6	-3.3	-4.9	-5.6	-7.0	-7.6	-8.2	-8.9	-9.6	-15.2	-56.4
Subtotal Savings	0.2	-1.6	-4.1	-7.3	-9.7	-13.6	-17.5	-21.8	-26.6	-31.8	-22.4	-133.6
Welfare												
Legal Immigrant Provisions	0.6	0.8	1.0	1.2	1.3	1.5	1.6	1.7	1.9	2.0	4.9	13.5
Keep Medicaid for Disabled Kids	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.3	0.6
Refugee/Asylee Exemption	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Kids Initiatives												
12 Month Eligibility	0.3	0.5	0.7	1.0	1.2	1.3	1.4	1.5	1.6	1.8	3.6	11.2
Indirect Impact of Kids Health Demos	0.1	0.1	0.2	0.3	0.4	0.4	0.4	0.5	0.5	0.5	1.1	3.4
Other												
Puerto Rico	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.6
Extension of VA Sunset	0.0	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	1.2	3.2
Working Disabled	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Raise DC FMAP to 70%	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.9	2.3
Interactions												
Part B Premium Interactions	0.0	0.0	0.1	0.2	0.4	0.6	0.9	1.2	1.5	1.8	0.8	6.8
Total Net Savings	1.4	0.4	-1.4	-3.9	-5.8	-9.0	-12.4	-16.1	-20.3	-24.9	-9.3	-91.9
New Outlays	105.8	111.6	118.2	125.2	133.4	141.8	151.0	161.3	171.9	183.5	594.2	1,403.6

HEALTH INSURANCE

In addition to the existing public programs which provide health care, the Administration's budget proposes to create three new programs to increase health insurance coverage. The Administration also proposes to extend Medicaid coverage of children.

Initiative To Maintain and Expand Workers' Coverage

Temporary premium assistance for families between jobs

Present Law

There is no provision in current law for direct subsidies of private health insurance premiums. (Title XIX of the Social Security Act authorizes State Medicaid programs to purchase private health insurance for certain individuals.) Some premium assistance is provided under the Internal Revenue Code, in the form of the individual medical expense deduction for unreimbursed medical expenses, the self-employed deduction for a portion of the cost of health insurance, and the exclusion from taxable income of employer contributions for health insurance.

COBRA continuation coverage was established under the Internal Revenue Code, the Employee Retirement Income Security Act (ERISA), and the Public Health Service Act. It requires employer-sponsored group health plans with 20 or more employees to provide employees and their families the option of continuing under the group health plan for 18 to 36 months, depending on the qualifying event. Qualifying events include changes in job and family status that would otherwise result in the loss of the group health plan. The event of a job loss or reduction in hours entitles a COBRA-eligible individual up to 18 months of continued coverage. Employers are allowed to charge COBRA enrollees up to 102 percent of the total plan premium. The requirement is known as COBRA after the Consolidated Omnibus Budget Reconciliation Act (P.L. 99-272), a law enacted in 1986 which included this provision.

Description of Proposal

The proposal authorizes the Secretary of Health and Human Services (HHS) to establish a demonstration program of grants to the States for fiscal years 1998 through 2001, to enable them to provide temporary health insurance premium assistance for eligible unemployed workers and their families. The Secretary could operate (directly or through contract) a program in a State that failed to establish a federally approved program.

The proposal would authorize \$1.738 billion in FY1998. This amount would be increased annually by an amount linked to the growth in unemployment compensation and the growth in the economy. The program's authorization would sunset at the end of FY2001.

To become eligible for a grant, a State would have to submit a plan providing specific information such as how it would use the funds, the plan's methodology for determining eligibility, and how the State would notify individuals of the availability of premium assistance. The plan would be approved unless the Secretary noti-

fied the State within 90 days that the plan was disapproved (and the reasons for such or that specific information was needed).

The State program funded under the Federal grant would be required to provide premium assistance to eligible unemployed individuals and their eligible family members in obtaining health benefit coverage through payment of all or part of the premium cost for COBRA continuation coverage or coverage that (1) is equivalent to the Blue Cross/Blue Shield standard option under the Federal Employees Health Benefit program (FEHBP), or (2) meets the conditions of approval as specified by the Secretary. The coverage would have to be economical compared to other coverage options considered by the State and would have to comply with specified provisions of the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191).

The amount of premium assistance would be related to income. It would be available for up to 6 months for those who had employer-based coverage in their prior job, are now receiving unemployment benefits, and have incomes below certain thresholds. A full subsidy would be provided up to 100 percent of the Federal poverty level; it would be phased out from 100 percent to 240 percent of the poverty level. An individual would not be qualified if he or she was eligible for Medicaid or had an employed spouse with health insurance coverage. (An individual would be eligible if the spouse was not covered under group coverage and the spouse's employer did not offer family coverage or contributed less than 50 percent of the premium.) Federal subsidies would be limited to the amount of money authorized under the proposal. States would be allocated funds based on specific criteria (e.g., the different rates of unemployment and prices for health care among States).

The proposal includes amendments to the Unemployment Compensation program. State agencies would be required to disclose to the relevant government officials, upon request and on a reasonable basis, wage and unemployment compensation claims information.

The Secretary of HHS, in conjunction with the Secretary of Labor, would be required to study the effects of the premium assistance program on insurance coverage and on the unemployed and to report to the Senate Committee on Labor and Human Resources and the House Committees on Commerce and Education and the Workforce on the findings of the study.

Voluntary Purchasing Cooperatives

Present Law

None.

Description of Proposal

The proposal would establish a Federal grant program to States to encourage the development of voluntary health insurance purchasing cooperatives for employer groups of 1 to 50 employees. The purposes of the cooperatives would be to enable small businesses to bargain collectively for lower premium rates and obtain a greater array of choices of plans for their employees than otherwise

would be available. An amount of \$25 million per year for 5 years (1998–2002) in grants would be available for technical assistance, for setting up voluntary purchasing cooperatives, and for allowing these purchasing cooperatives to access health plans sold through the FEHBP grant fund may not be used for operating costs after the first 6 months of operation.

Entities eligible for grants would include State agencies, non-profit cooperatives, and for-profit cooperatives whose profits were shared on a pro-rata basis among cooperative members. Eligible cooperatives could not bear insurance risk and must ensure members are free of conflicts of interest. Eligible cooperatives could not deny membership to small employers on the basis of the health status of their employees and would have to offer multiple, competing health plans. The cooperatives must demonstrate financial liability and be capable of becoming self-sustaining.

Under the FEHBP alternative, a State could request the Secretary of HHS to establish a cooperative in coordination with FEHBP. Such a cooperative would be a separately-rated group, distinct from any group of Federal employees. Grant funds from this proposal could be used by the Secretary to establish this cooperative. It could use the FEHBP name in marketing, and require FEHBP plan providers that sell coverage in the private market to offer appropriate health benefit coverage to the small group market, at prices negotiated with the cooperative. The cooperative also could negotiate with providers not participating in FEHBP to sell coverage to the small group market. These cooperatives coordinating with FEHBP cannot collect or distribute premiums.

State laws restricting or prohibiting combinations of groups for the purchase of health insurance benefits would be preempted for cooperatives that meet the requirements of this bill. Also preempted for such cooperatives would be State laws imposing rate requirements that prohibit a health plan issuer from offering to a cooperative lower rates reflecting the issuer's administrative savings due to the size of the cooperative.

Children's Health Initiative

Grants to the States

Present Law

None.

Description of Proposal

The proposal would provide an appropriation of \$750 million for FY1998 and each succeeding fiscal year for grants to States to expand children's health insurance coverage. The intent of the program is to allow States to expand existing programs or to establish new programs providing access to health insurance for children who are not currently eligible for Medicaid, and who do not have access to adequate and affordable individual or family coverage.

Each State would have to apply and obtain Secretarial approval of an initial application and of amendments to the application made annually and when the State made significant changes to its program. The Secretary could establish minimum standards for the

specific health care benefits to be provided including quality standards. State applications would have to include the health insurance need in the State, descriptions of existing State efforts to insure uninsured children, new program design features including eligibility, benefits covered, and beneficiary cost sharing. The application also would have to include descriptions of the outreach activities the State planned to use, the public program development process, how the State intended to coordinate with other insurance programs, and the State's plans for annual assessment. A State plan would be considered approved unless the Secretary notified the State within 90 days that it had been disapproved (and why) or that specified additional information was needed. It would ensure that the insurance provided under the State program did not substitute for employment-related health insurance. The State must collect data and keep records. A State must submit an evaluation by March 31, 2000 that included specified elements such as an assessment of the State program in increasing the number of children with health insurance coverage. The Secretary would be required to submit a report to Congress and the public by December 31, 2000, based on the evaluations submitted by the States containing any conclusions and recommendations that the Secretary considered appropriate.

Of the appropriation provided, 1.5 percent would be distributed among the territories with each receiving at least \$100,000. Each State with an approved application would receive a base allotment of \$1 million. The remaining funds would be allotted to each State having an approved application based on the States' allotment percentage.

In FY1998, 1999, and 2000 the allotment percentage is defined as the average number of uninsured children in the State during 1993-1995 divided by the average number of uninsured children in all States during the same period based on Current Population Surveys of the Bureau of the Census for those years. In fiscal years after 2000 the allotment percentage is defined as the average number of uninsured children in the States during 1993-1995 divided by the average number of uninsured children in all States having approved applications during the same period. The Secretary would adjust the States' allotment for relative price differences among the States. In 2001, an additional allotment would be made of funds not allocated from the 1998, 1999 and 2000 authorizations. (There would presumably be funds remaining since not all States will immediately have approved applications.) Each State would be paid (from its allotment) an amount up to the Medicaid Federal medical assistance percentage of expenditures under the State's program for: (1) health insurance assistance for eligible children and (2) expenditures (which could not exceed 10 percent of the total expenditures under the program) for outreach and for administrative costs. Expenditures under the State program for which Federal matching payments could be made could include any expenditures from State or local public funds, or from private funds, in excess of the amount spent by the State in calendar year 1995 for children's coverage.

Investments to expand Medicaid coverage

Present Law

Medicaid provides health insurance coverage to over 21 million low-income children whose family incomes fall below the eligibility thresholds in each of the State programs. GAO estimates that there are about 2.9 million Medicaid-eligible children that are not enrolled and are uninsured. Other Medicaid children may become uninsured during the year if their family income rises above the Medicaid eligibility thresholds.

Description of Proposal

The President's plan includes proposals to encourage coverage of Medicaid-eligible children. States would be provided with an option to allow continuous coverage for current child beneficiaries, age 1 and older, for 1 year after eligibility is determined, regardless of whether they would otherwise lose coverage during the year (as described in the Medicaid section). The additional coverage, is estimated to reach about 1 million children and to cost \$4.9 billion over 5 years (CBO scoring under Medicaid).

The plan includes a non-budget item intended to increase the effectiveness of Medicaid outreach. The focus of the enhanced outreach would be to increase enrollments among those eligible for Medicaid by identifying other Federal programs that conduct eligibility determinations for low-income children including the proposed new grant program for children's health. In addition, the President's plan proposes to identify "best practices" among States with respect to outreach activities.

HEALTH INSURANCE PROVISIONS IN THE PRESIDENT'S FY 1998 BUDGET ¹

(In millions of dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-2007
Temporary premium assistance for families between jobs ²	1,738	2,472	2,688	2,924	0	0	0	0	0	0	9,822	9,822
Voluntary purchasing cooperatives	25	25	25	25	25	0	0	0	0	0	125	125
Grants to States for Children's Health Initiative	750	750	750	750	750	750	750	750	750	750	3,750	7,500

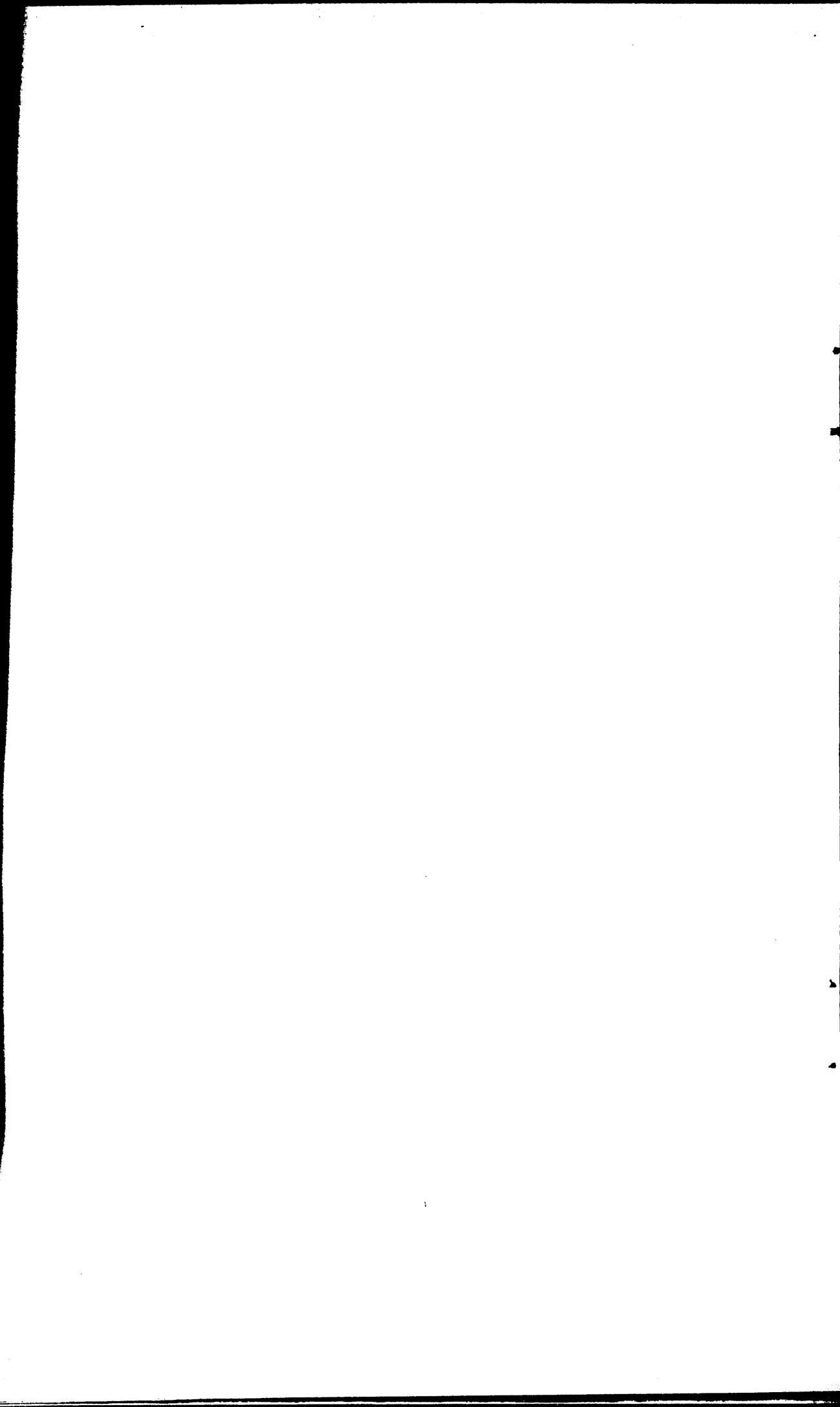
The OMB and CBO estimated cost of these programs are the same.

¹ Medicaid child health proposals are included in Medicaid scoring.

² \$1,738 billion is appropriated for FY 1998; funding for 1999, 2000, and 2001 is linked to the growth in unemployment compensation and the growth in the economy. The Secretary's authority to conduct this program ceases at the end of FY 2001.

INCOME SECURITY AND SOCIAL SECURITY

The Administration's budget proposes to increase spending on income security programs, including restoring welfare benefits to certain individuals, a new vocational rehabilitation initiative for SSDI/SSI beneficiaries, and extending unemployment compensation taxes.



A. SSI and Medicaid Benefits for Legal Immigrants

1. SSI eligibility for legal immigrants¹

Present Law

The Personal Responsibility and Work Opportunity Act of 1996 (P.L. 104-193) bars legal immigrants from Supplemental Security Income (SSI). *Current recipients* will be screened during a 1-year period after enactment of the welfare law (August 22, 1996) for SSI eligibility. Legal immigrant children are ineligible for SSI on the same basis as other legal immigrants.

Refugees and asylees are eligible for SSI for 5 years after entering as refugees or being granted asylum.

Description of Proposal

The President's proposal would provide SSI eligibility for legal immigrants who become blind or disabled after their admission to the United States regardless of their date of entry. It would also make legal immigrant children (under 18) eligible for SSI. This would include currently disabled children as well as children who are disabled when they enter the country. Finally, it would extend the SSI eligibility period for refugees and asylees from 5 to 7 years.

2. Medicaid eligibility for legal immigrants

Present Law

States may exclude legal aliens who entered the United States before August 22, 1996, from Medicaid beginning January 1, 1997. Legal immigrants entering the United States *after* August 22, 1996, are barred for 5 years from all but emergency medical assistance. After 5 years, the Medicaid bar becomes a State option, subject to the "deeming" rule. In the case of immigrants entering with sponsors after enactment, the sponsor's income will be deemed to be available to them in determining their eligibility for Medicaid until they naturalize or meet the 10-year work requirement.

Additionally, to the extent that legal immigrants' receipt of Medicaid is based only on their eligibility for SSI, they may lose Medicaid because of their ineligibility for SSI.

Eligible refugees and asylees can qualify for full Medicaid benefits for 5 years after entering as refugees or being granted asylum.

¹The term "legal immigrants" refers to "qualified aliens," defined by P.L. 104-193 (as amended by P.L. 104-208) to include legal permanent residents, refugees, aliens paroled into the United States for at least 1 year, aliens granted asylum or related relief, and certain abused spouses and children. The restrictions on SSI and Medicaid noted here do not apply to "qualified aliens" who meet a 10-year work requirement, or who are veterans, certain active duty personnel, and their families.

Description of Proposal

The President's proposal would make eligible legal immigrants who became blind or disabled after admission to qualify for Medicaid regardless of their date of entry and without regard to the "deeming" provision. This would cover both those immigrants who would lose their Medicaid eligibility because of the loss of SSI eligibility (\$2.3 billion), and those immigrants (including children) who would be subject to the Medicaid bans and deeming requirements of the welfare law (\$2.5 billion). The President's proposal would also extend the Medicaid eligibility period for eligible refugees and asylees to 7 years (\$25 million).

B. Medicaid Eligibility for Disabled Children

Present Law

In most States eligibility for SSI confers eligibility for Medicaid as well. The 1996 welfare reform law established a separate definition of childhood disability for SSI benefits. As a result, some children will lose their SSI benefits and automatic eligibility for Medicaid. Although some may qualify for Medicaid on other grounds, such as low income, some will not.

Description of Proposal

The proposal would preserve Medicaid eligibility for children who had Medicaid coverage as disabled recipients of SSI but who lose SSI eligibility under the new definition.

C. Welfare-to-Work Measures

1. Welfare-to-work jobs challenge

Present Law

The new welfare law has replaced AFDC, its education, work and training component, known as JOBS (Job Opportunities and Basic Skills Training Program), and Emergency Assistance with a fixed yearly block grant of \$16.5 billion for Temporary Assistance to Needy Families (TANF), effective July 1, 1997 at the latest. State TANF grants equal Federal funding received in a recent year for the replaced programs and currently generally exceeds amounts they would have received from AFDC/JOBS, since welfare enrollment has declined from the base level. The law places heavy stress on moving welfare recipients to work. States must require recipients to engage in work, as defined by States, after a maximum of 24 months of TANF aid; they must achieve minimum rates of participation in creditable "work activities" specified in the law; and they must impose a 5-year lifetime limit on TANF benefits. States may use TANF funds in any manner that they were authorized to use AFDC, EA, and JOBS funds, but no part of the TANF grant is earmarked for a specific function.

Description of Proposal

The Administration proposes a "performance-based Welfare-to-Work Jobs Challenge" to help States and cities create job opportu-

nities for the "hardest-to-employ" welfare recipients. The proposal would provide \$3 billion in mandatory funding designed to move a million recipients into jobs by the year 2000. Funds could be used for job placement, job creation, subsidies and other incentives to private employers. The Administration said it also would encourage States and cities to use "voucher-like" arrangements to provide recipients with tools and choices that would help them get jobs and keep them.

(Note: The Administration placed the Welfare-to-Work Jobs Challenge in the budget of the Labor Department.)

2. Work Opportunity Tax Credit

Present Law

The Small Business Job Protection Act of 1996, signed into law as P.L. 104-188 on August 20, 1996, established the Work Opportunity Tax Credit (WOTC), effective for FY1997 only. It entitles employers to an income tax credit of 35 percent of the first \$6,000 earned in a year (maximum credit, \$2,100) by an eligible person in one of six groups. (There is a smaller credit for summer youth.) Eligible groups include members of families who received cash welfare benefits (from AFDC or its successor, TANF) for at least 9 months before being hired. Also eligible are some food stamp recipients: 18 to 24-year-olds who received food stamps for 6 months before being hired or who received benefits for at least 3 months out of the last 5 before being hired (but who have been disqualified for continued food stamp benefits because of the program's new work requirement. Employers must retain all eligible hires except summer youth for at least 180 days or 400 hours in order to receive the WOTC. (The WOTC is a successor to the Targeted Jobs Tax Credit, which expired on January 1, 1995.)

Description of Proposal

The FY1998 budget proposes "a greatly-enhanced and targeted" WOTC. The proposed credit would entitle employers to a credit of 50 percent of the first \$10,000 earned in a year by persons who were "long-term" recipients of welfare (AFDC or TANF). Long-term recipients would include members of families who received aid for at least 18 months and those who lost eligibility for cash aid because of either Federal or State time limits. The credit could be claimed for up to 2 years; the maximum credit would be \$5,000 per year. Employers who hired long-term cash welfare recipients could include some fringe benefits in "wages" eligible for the credit, namely, amounts paid for certain educational, health, and dependent care assistance. The proposal also would greatly expand coverage of the existing, smaller WOTC for food stamp recipients (for example, by extending the eligible age range to 50 years). Employers could claim credits for hiring members of these two groups—long-term cash welfare recipients and food stamp recipients subject to the new work rule—through FY2000. Finally, the proposal would extend the present WOTC for 1 year, through FY1998.

3. Transportation to jobs and other supportive services

Present Law

As noted above, the TANF block grant does not earmark funds for specified purposes.

Description of Proposal

The Administration proposes to establish an "Access to Jobs and Training" initiative in the Transportation Department "to help assure that efforts to reform welfare will be successful." State and local governments and non-profit organizations could apply for funds for new or modified transportation services that ensure access to work for low-income persons, especially current welfare recipients. (For this initiative, funds from the mass transit account of the Highway Trust Fund would be used.)

The Administration also proposes to expand an existing demonstration program of the Department of Housing and Urban Development known as "Bridges to Work," which links low-income persons in central cities to job opportunities in surrounding suburbs. The proposal would offer grants to units of local government, preferably for communities designated as Empowerment Zones or Enterprise Communities, to develop strategies for Bridges to Work programs, including assistance for transportation, job search, child care, and other supportive services to increase job opportunities.

\$110 million in FY1998 (\$100 million for Access to Jobs and Training Initiative and \$10 million for Bridges to Work).

D. Unspecified Welfare Reform "Technical Corrections"

In addition to the above proposals, the budget proposes outlays of \$40 million a year (\$200 million in FY1998-FY2002) for unspecified welfare reform "technical corrections." No details are available.

E. Vocational Rehabilitation Services for SSDI/SSI Beneficiaries

Present Law

Under current law, the Social Security Administration (SSA) refers Social Security disability insurance (SSDI) and disabled Supplemental Security Income (SSI) beneficiaries who might be expected to benefit from vocational rehabilitation (VR) services to State VR agencies. SSA may also refer a SSDI or disabled SSI beneficiary to an alternate public or private VR provider if a State VR agency declines to provide services to that individual. SSA reimburses for VR services provided to SSDI and disabled SSI beneficiaries only when these services contributed to the beneficiary's performance of substantial gainful activity for a continuous period of 9 months.

Description of Proposal

This proposal would allow SSA to initiate a new VR services program, to be implemented as a 10-year phased-in pilot in selected

States. Under the proposal, all SSDI and disabled SSI beneficiaries—except those expected to recover—would be issued a “ticket” when they begin receiving disability benefit payments. Beneficiaries may assign the ticket to a participating provider of his or her choice who is willing to accept assignment in exchange for providing VR or other employment services. If the SSDI or disabled SSI beneficiary returns to work and stops receiving disability benefit payments because of earnings, the VR service provider holding the ticket at the time the beneficiary returns to work would receive a percentage (e.g., 50 percent) of the disability benefit payments for a specified period (e.g., 5 years). At the end of the 10-year pilot, the Commissioner would recommend whether the pilot be terminated or expanded.

F. Railroad Retirement Benefits

Present Law

Social Security old-age, survivors, and disability insurance (OASDI) and Railroad Retirement tier 1 benefits are generally equivalent; however, certain Social Security OASDI provisions are more generous than Railroad Retirement, and vice versa. For example, unlike Social Security, Railroad Retirement does not provide cash benefits for children of living retired or disabled railroad workers. Railroad Retirement permits a current spouse to take a lump-sum survivor's benefit; however, if this benefit is elected, no other survivor (i.e., divorced spouse or children) is allowed a survivor's benefit.

Description of Proposal

This proposal would conform Railroad Retirement benefits to Social Security OASI provisions where Social Security is more generous. Specifically, this proposal would: (1) provide benefits to children of retired and disabled railroad workers; currently only children of deceased workers are eligible for benefits; (2) provide tier 1 benefits to survivors, even if a residual lump-sum benefit had been paid; (3) provide a new benefit for divorced spouses where the railroad worker is eligible but has not yet retired; (4) provide a new benefit for a spouse and a divorced spouse for a disabled railroad worker; and (5) allow an otherwise eligible individual (e.g., worker or spouse) to receive Railroad Retirement benefits even though that individual is engaged in rail service (currently, eligible individuals working in the railroad industry are not allowed Railroad Retirement benefits).

G. Unemployment Compensation

1. Extension of the FUTA surtax

Present Law

A Federal payroll tax authorized by the Federal Unemployment Tax Act (FUTA) funds certain activities of the Federal-State unemployment compensation (UC) system. The FUTA tax is paid by private-sector employers for each employee in a job covered by the UC

system. FUTA revenue is used to pay for Federal and State UC administration, operations of the U.S. Employment Service, the Federal share of extended UC benefits in States with high unemployment, and loans to States with insolvent benefit accounts in the Unemployment Trust Fund. The FUTA tax applies to the first \$7,000 of annual wages of each covered worker. The permanent tax rate is 0.6 percent, but a temporary rate of 0.8 percent has applied every year since 1977. The additional 0.2 percent tax, which has been extended four times, is scheduled to expire on January 1, 1999.

Description of Proposal

The President's budget proposes that the 0.2 percent "surtax" be extended again through December 31, 2007.

Estimated Cost

This proposal would raise additional revenue as follows (OMB scoring):

FY1999.....	\$862 million
FY2000.....	1,218 million
FY2001.....	1,295 million
FY2002.....	1,333 million

2. Monthly payment of unemployment taxes

Present Law

Private-sector employers pay both the FUTA tax to the U.S. Treasury and a State UC tax, used to fund UC benefit payments, to their State's revenue agency. These taxes are generally paid on a quarterly basis.

Description of Proposal

The President's budget would require private-sector employers with 20 or more full-time employees to pay these taxes on a monthly basis beginning after December 31, 2001.

Estimated Cost

This proposal would raise additional revenue as follows (OMB scoring):

FY2002.....	\$1,333 million
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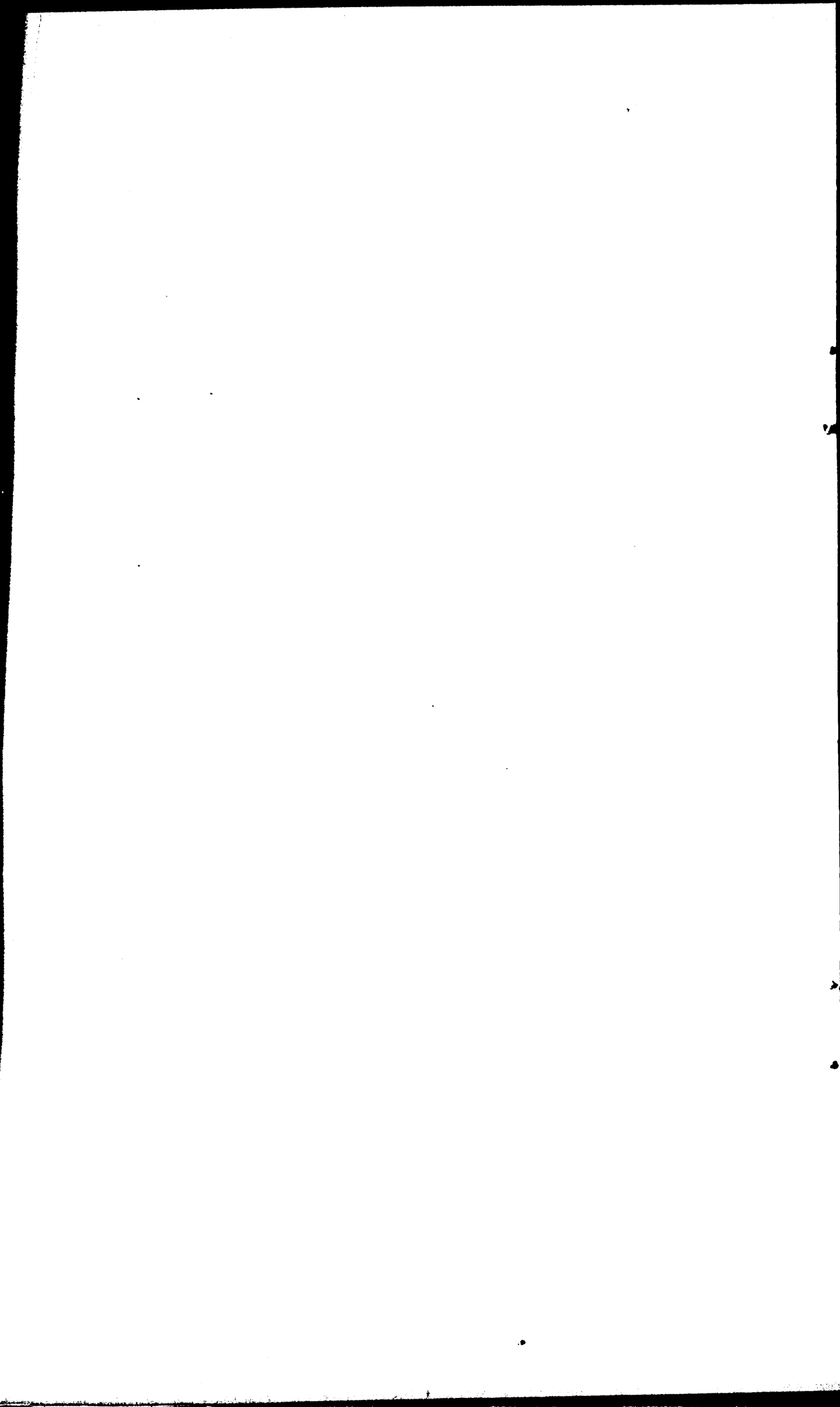
INCOME SECURITY AND SOCIAL SECURITY

(By fiscal year, in millions of dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-2007
As reestimated by CBO:												
Railroad retirement (raise benefits to Social Security levels)	31	46	46	47	47	48	48	49	49	50	217	461
FUBA (extend NAFTA program) .....	.....	28	29	30	30	31	32	33	34	36	117	283
UI (health insurance for unemployed)	200	210	220	230	.....	.....	.....	.....	.....	.....	860	860
UI (Reed Act legislation) .....	.....	.....	-200	-208	-216	.....	.....	.....	.....	.....	-624	-624
SSI return-to-work demonstration .....	.....	.....	-4	-4	-2	.....	2	2	1	1	-10	-4
SSI legal aliens (welfare reform rollback) ¹	1,925	1,875	1,925	1,550	1,800	1,950	2,075	2,350	2,300	2,225	9,075	19,975
Social Security return-to-work demonstration .....	.....	1	.....	5	12	20	28	30	31	31	18	158
Total	2,156	2,160	2,016	1,650	1,671	2,049	2,185	2,464	2,415	2,343	9,653	21,109
As estimated by Administration:												
Railroad retirement (raise benefits to Social Security levels)	31	46	46	47	47	48	48	49	49	50	217	461
FUBA (extend NAFTA program) .....	.....	17	24	25	26	27	28	30	31	32	92	240
UI (health insurance for unemployed) .....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....
UI (Reed Act legislation) .....	.....	.....	-200	-200	-200	.....	.....	.....	.....	.....	-600	-600
SSI return-to-work demonstration	-4	-4	-4	-3	-3	-3	-4	-5	-5	-5	-18	-40
SSI legal aliens (welfare reform rollback) ²	1,707	1,824	2,096	1,907	2,184	2,308	2,433	2,762	2,698	2,610	9,718	22,529
Social Security return-to-work demonstration .....	.....	-5	1	7	13	19	19	19	18	18	16	109
Total	1,734	1,878	1,963	1,783	2,067	2,399	2,524	2,855	2,791	2,705	9,425	22,699

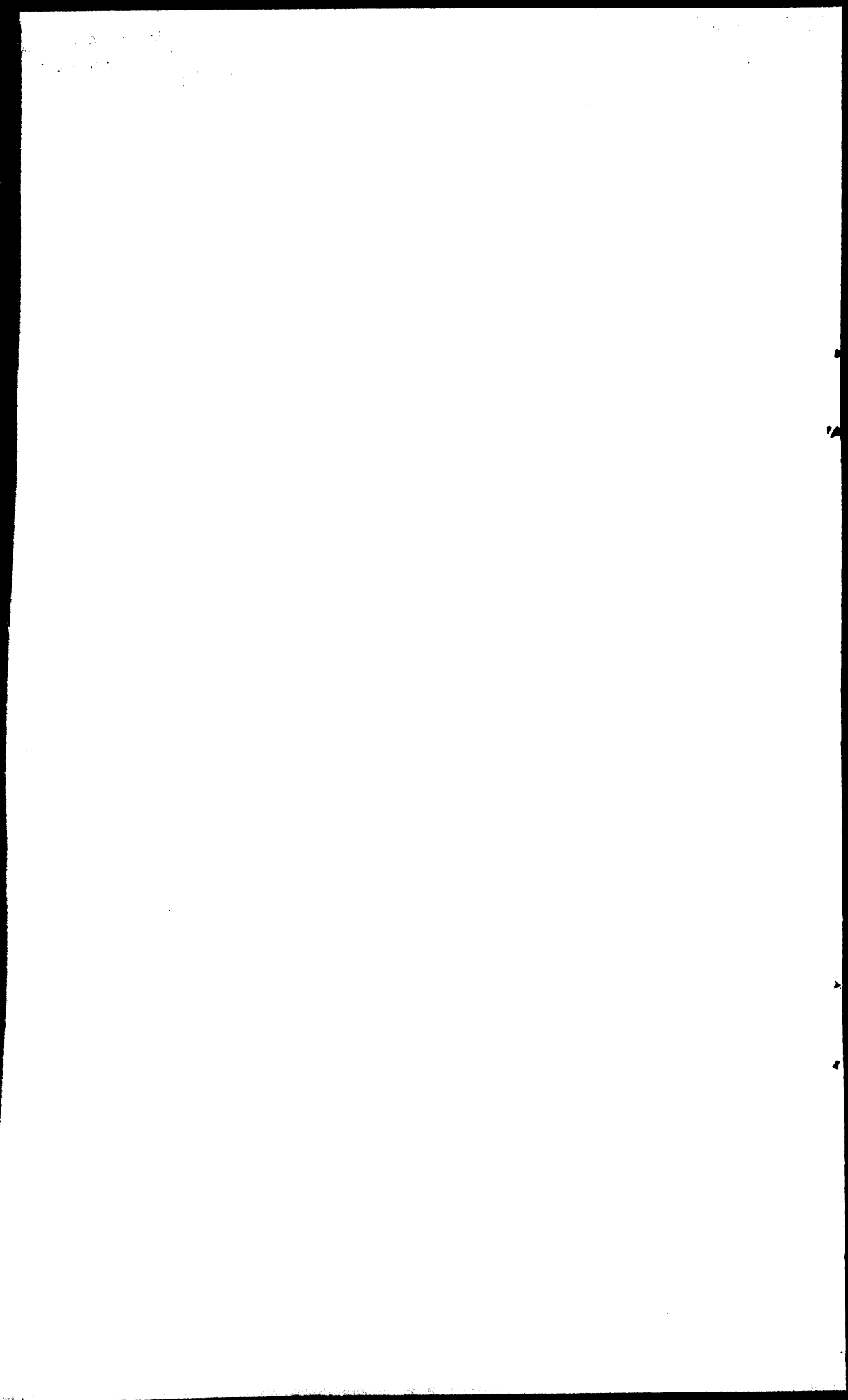
¹ Also estimated by CBO to have costs of \$325 million in 1997.

² Also estimated by Administration to have costs of \$224 million in 1997.



TRADE

The Administration's budget proposes total spending of \$6.855 billion over 10 years from fiscal year 1998 on three trade initiatives: (1) reauthorization of the Generalized System of Preferences; (2) extension of trade benefits to Caribbean Basin Initiative countries; and (3) implementation of the Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry (negotiated under the auspices of the Organization for Economic Cooperation and Development).



Administration Proposals

Generalized System of Preferences

Present Law

The United States and other industrial countries established the Generalized System of Preferences (GSP) in the 1970s to promote economic development in developing countries through increased trade. The U.S. program provides duty-free treatment to imports of specified products from designated beneficiary countries, providing a competitive advantage for those imports. To obtain GSP benefits under U.S. law on over 4,000 products (excluding certain import-sensitive items such as apparel and footwear), a developing country must satisfy certain criteria concerning its level of economic development, trade and foreign policy. Among the trade criteria considered are whether a country provides adequate and effective protection to U.S. intellectual property rights, and whether the country provides its citizens with certain internationally recognized worker rights. The President has authority to withdraw or suspend GSP benefits based on these criteria, as well as the authority to "graduate" advanced developing countries. GSP benefits may also be withdrawn if a country's imports of a particular product exceed a specified level—the so-called competitive need limit.

The program is intended to give temporary assistance to developing countries until their exporters are able to compete on world markets without preferential treatment.

The U.S. program expired on July 31, 1995. After more than a 1-year lapse, Congress passed and President Clinton signed legislation to renew GSP retroactively through May 31, 1997, when it will again expire.

Description of Proposals

The Administration will propose a 10-year reauthorization of the GSP program, as well as certain changes in eligibility. This may reduce the overall cost of the program while expanding the benefits available under GSP to the least-developed countries, particularly in Sub-Saharan Africa.

Caribbean Basin Initiative

Present Law

In February 1982, President Reagan proposed a comprehensive program—the Caribbean Basin Initiative (CBI)—“to promote economic revitalization and facilitate expansion of economic opportunity in the Caribbean Basin region.” The centerpiece of the CBI is the Caribbean Basin tariff preference. This preference and some

other less comprehensive benefits were enacted in 1983 by the Caribbean Basin Economic Recovery Act (CBERA) and put into effect January 1, 1984. The CBERA has been amended several times, most substantively by the Caribbean Basin Economic Recovery Act of 1990 ("CBI II"), which added several improvements in the trade and tax benefits and made the program permanent.

The CBERA authorizes unilateral duty-free treatment for eligible articles imported from 24 Caribbean countries designated as beneficiaries. While most otherwise dutiable products are eligible for duty-free treatment under CBERA, the statute specifically excepts from the preference certain textiles, apparel and footwear, canned tuna, petroleum and its products, and watches and watch parts containing any material originating in countries denied Most Favored Nation (MFN) status.

Description of Proposals

To prepare for a future free trade agreement, the Administration proposes to phase in expanded trade benefits by authorizing duty-free treatment to products now excluded from CBI (e.g., textiles and apparel) for Caribbean Basin countries that satisfy new eligibility criteria. The proposed expanded program would expire on September 30, 2005.

OECD Shipbuilding Subsidies Agreement

Present Law

After 5 years of negotiations under the auspices of the Organization for Economic Cooperation and Development (OECD), key shipbuilding nations (the United States, the European Union (EU), Japan, South Korea, and Norway) signed the Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry (Shipbuilding Agreement) on December 21, 1994.

The Shipbuilding Agreement applies to construction and repair of self-propelled seagoing vessels of 100 gross tons and above and tugs of 365 kilowatts or more, and covers approximately 80 percent of world shipbuilding capacity for vessels engaged in worldwide shipping. It has four main provisions: (1) elimination of virtually all shipbuilding subsidies granted either directly to shipbuilders or indirectly through ship operators; (2) an injurious pricing code, modeled on the World Trade Organization (WTO) Antidumping Code, under which countries can fine foreign shipyards that sell ships at unfairly low (i.e., dumped) prices; (3) a comprehensive set of rules on government financing for export and domestic ship sales; and (4) binding dispute-settlement procedures in the OECD. The Shipbuilding Agreement also contains a "standstill" requirement, under which the signatories agree not to give their shipyards additional subsidies or to increase existing subsidies before the Agreement enters into force.

For the United States to complete its ratification, legislation must be enacted by Congress to bring U.S. law into compliance with the Agreement.

Description of Proposals

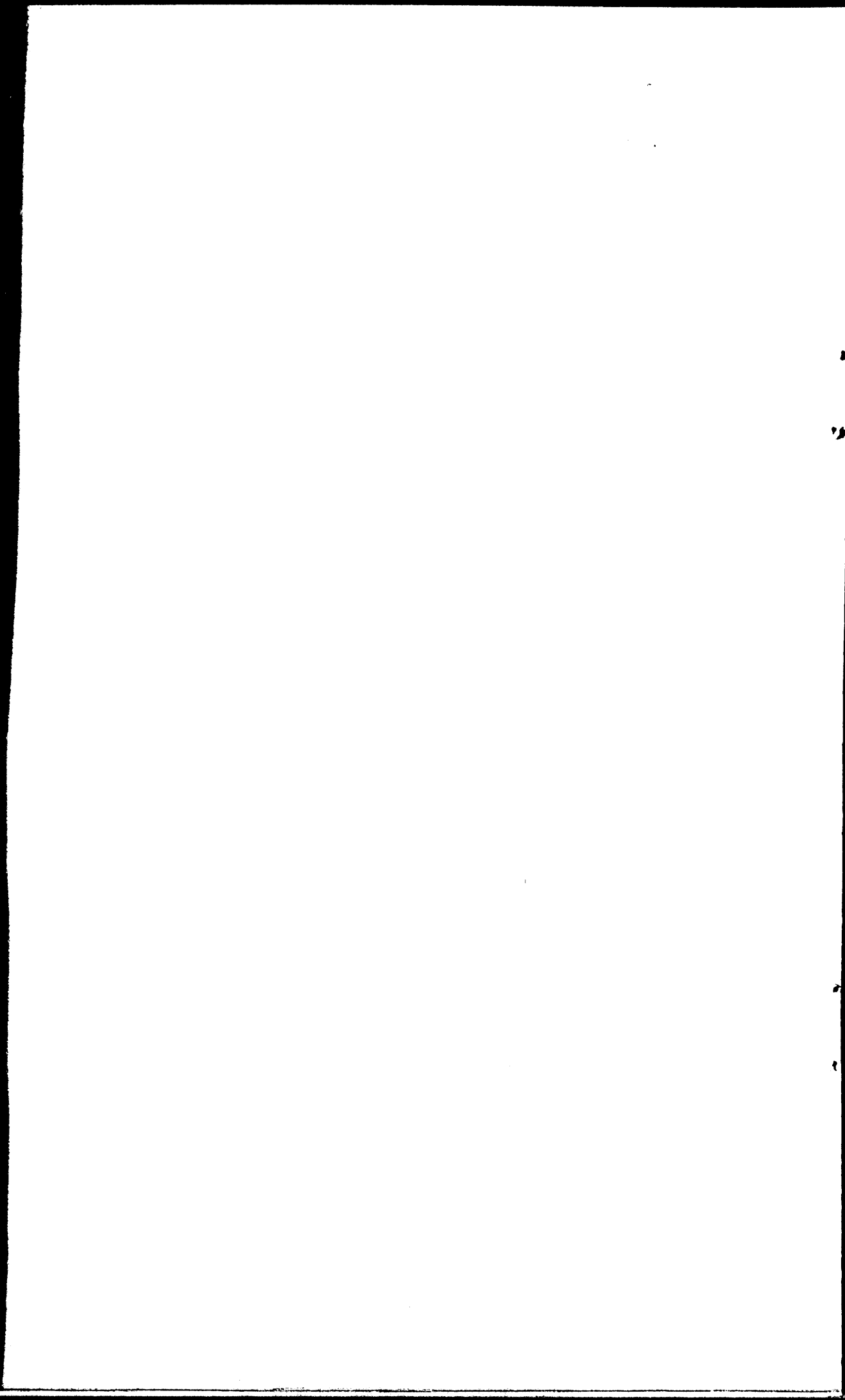
The Administration has requested funds for implementation of the OECD Shipbuilding Agreement.

CBO REESTIMATE OF THE TRADE PROPOSALS IN THE 1998 PRESIDENT'S BUDGET

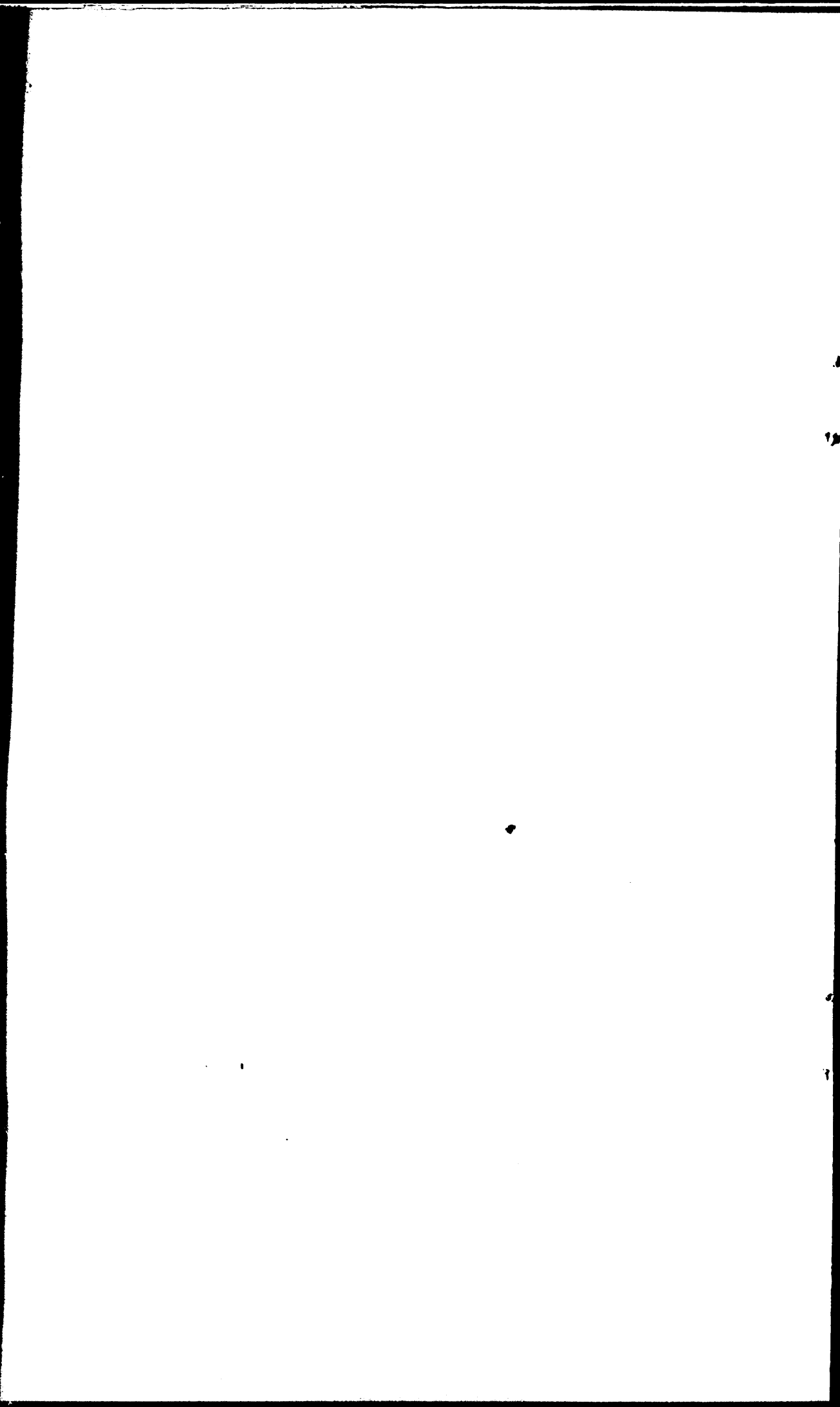
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GSP:										
CBO	-454	-318	-324	-343	-362	-383	-404	-430	-458	-489
ADM	-555	-361	-360	-364	-376	-391	-407	-423	-440	-457
Total difference ...	101	43	36	21	14	8	3	-7	-18	-32
CBI:										
CBO	-83	-122	-227	-282	-311	-343	-377	-414	0	0
ADM	-101	-137	-277	-356	-383	-427	-452	-471	0	0
Total difference ...	18	15	50	74	72	84	75	57	0	0
OECDSHIP:										
CBO	-8	-8	-7	-7	-7	-7	-7	-7	-7	-7
ADM	-10	-11	-11	-11	-12	-12	-12	-12	-13	-13
Total difference ...	2	3	4	4	5	5	5	5	6	6
Total trade:										
CBO	-544	-448	-559	-631	-680	-732	-788	-851	-465	-496
ADM	-666	-509	-648	-731	-771	-830	-871	-906	-453	-470
Total difference ...	122	61	89	100	91	98	83	55	-12	-26

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NET INTEREST AND DEBT LIMIT



NET INTEREST

Interest costs are a significant portion of the Federal budget, currently representing 15 percent of all Federal outlays. Under CBO's assumption of stable interest rates throughout the projection period and assuming that discretionary spending rises with inflation, interest payments will decline to 13 percent of the budget by 2007. In dollar terms, net interest will rise from \$241 billion in 1996 and increase steadily to an expected level of \$340 billion in 2007. Debt held by the public is projected to rise during that period from \$3.7 trillion to \$6 trillion. As a percentage of GDP, interest costs are expected to decline slowly from 3.2 percent this year to 2.7 percent in 2007, and debt held by the public will stabilize at about 48 percent of GDP.

CBO Baseline Projections of Interest Costs (by fiscal year)

	Actual 1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Net Interest Outlays (Billions of dollars)												
Interest on Public Debt (Gross interest) ^a	344	360	368	380	389	399	412	426	442	458	475	493
Interest Received by Trust Funds												
Social Security	-37	-43	-48	-53	-58	-63	-69	-76	-82	-89	-96	-104
Other trust funds ^b	-62	-62	-61	-60	-59	-58	-56	-54	-51	-48	-43	-38
Subtotal	-98	-106	-109	-113	-117	-121	-125	-129	-133	-137	-139	-142
Other Interest ^c	-5	-6	-6	-6	-6	-6	-7	-8	-8	-10	-10	-11
Total, Net Interest Outlays	241	248	253	261	267	272	279	289	300	312	325	340

SOURCE: Congressional Budget Office.

- a. Excludes interest costs of debt issued by agencies other than Treasury (primarily the Tennessee Valley Authority).
- b. Principally Civil Service Retirement, Military Retirement, Medicare, unemployment insurance, and the Highway and the Airport and Airway Trust Funds.
- c. Primarily interest on loans to the public.

Interest costs are generally not covered by the enforcement provisions of the Budget Enforcement Act because they are not directly controllable. Rather, interest depends on the outstanding amount of government debt and on interest rates. The Congress and the President influence the former by making decisions about taxes and spending and thus about borrowing. Beyond that, they exert no direct control over interest rates, which are determined by market forces and Federal Reserve policy.

Net interest is the most useful measure of the government's current debt-service costs. Some budget-watchers stress gross interest (and its counterpart, the gross Federal debt) instead of net interest

(and its counterpart, debt held by the public). But that choice exaggerates the government's debt-service burden because it overlooks billions of dollars in interest income received by the government.

The government has sold more than \$3.7 trillion in securities to finance deficits over the years. But it has also issued \$1.4 trillion in securities to its own trust funds (mainly Social Security and the other retirement funds). Those securities represent the past surpluses of the trust funds, and their total amount grows approximately in step with the projected trust fund surpluses. The funds redeem the securities when needed to pay benefits; in the meantime, the government both pays and collects the interest on those securities. It also receives interest income from loans and cash balances. Broadly speaking, gross interest encompasses all interest paid by government (even to its own funds) and ignores all interest income. Net interest, by contrast, is the net flow to people and organizations outside the Federal Government.

Net interest is only about two-thirds as large as gross interest. CBO estimates that the government will pay \$360 billion in gross interest costs this year. Of that amount, however, \$106 billion is simply credited to trust funds and does not leave the government or add to the total deficit. The government also collects \$6 billion in other interest income. Net interest costs therefore total \$248 billion.

DEBT LIMIT

Raising the Debt Limit

Since 1917, the Congress by statute has set an overall dollar ceiling on the amount of debt that the Treasury can issue. That ceiling is increased periodically, with each change giving the Treasury authority to issue debt for a couple of years before another increase is necessary. As fiscal year 1996 began, the Treasury's authority to issue debt, last raised in August 1993 to \$4.9 trillion, was once again becoming inadequate.

Legislation increasing the debt limit has historically been viewed by the Congress as "must pass" legislation and has been used as a vehicle for enacting other measures important to the Congress. For example, the Balanced Budget and Emergency Deficit Control Act of 1985 was passed as part of legislation raising the debt ceiling. In 1995 and 1996, the Congress also attempted to use such legislation to achieve deficit reduction. The resulting deadlock over measures to reduce the deficit led to the longest impasse ever regarding the debt limit, stretching from November 15, 1995 to March 28, 1996, a total of 135 days.

CBO Baseline Projections of Federal Debt (by fiscal year)

	Actual 1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Federal Debt, End of Year (Billions of dollars)												
Gross Federal Debt	5,182	5,436	5,688	5,960	6,249	6,532	6,830	7,135	7,447	7,778	8,113	8,454
Debt Held by Government Accounts												
Social Security	550	628	709	796	891	989	1,093	1,202	1,316	1,435	1,562	1,694
Other government accounts ^a	<u>899</u>	<u>940</u>	<u>969</u>	<u>991</u>	<u>1,000</u>	<u>1,004</u>	<u>997</u>	<u>978</u>	<u>947</u>	<u>895</u>	<u>828</u>	<u>748</u>
Subtotal	1,449	1,567	1,678	1,787	1,891	1,993	2,090	2,180	2,263	2,331	2,390	2,442
Debt Held by the Public	3,733	3,869	4,009	4,173	4,358	4,539	4,740	4,954	5,184	5,448	5,723	6,011
Debt Subject to Limit ^b	5,137	5,392	5,643	5,915	6,205	6,487	6,785	7,090	7,402	7,734	8,069	8,409
Federal Debt as a Percentage of GDP												
Debt Held by the Public	49.9	49.4	49.0	48.7	48.5	48.2	48.0	47.9	47.9	48.1	48.4	48.6

SOURCE: Congressional Budget Office.

- a. Principally Civil Service Retirement, Military Retirement, Medicare, unemployment insurance, and the Highway and the Airport and Airway Trust Funds.
b. Differs from the gross Federal debt primarily because most debt issued by agencies other than the Treasury is excluded from the debt limit.

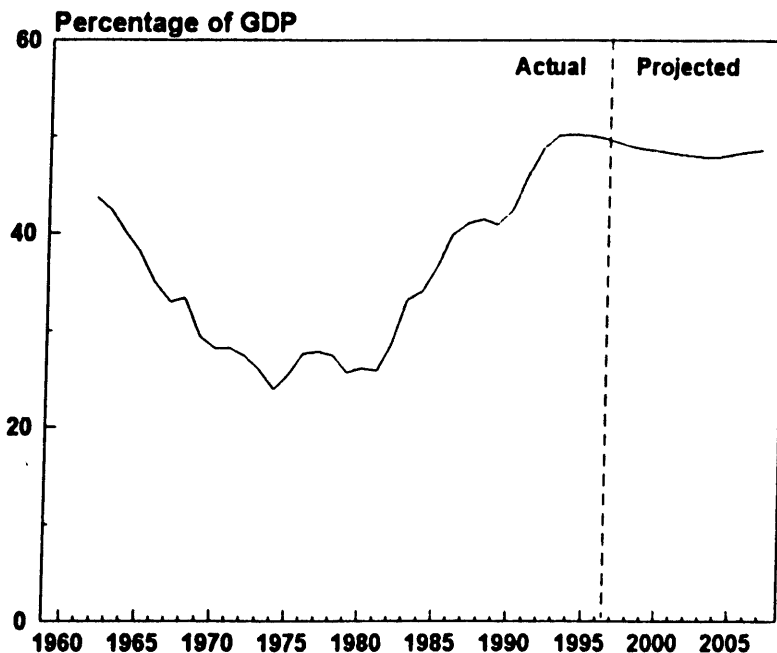
Because the debt limit covers both debt sold to the public and government securities held by trust funds and other government accounts, the Treasury can disinvest (convert to uninvested balances) holdings of government accounts and thereby create room under the debt limit to raise cash from the public. As negotiations on achieving a balanced budget continued past the start of the fiscal year, Treasury Secretary Robert E. Rubin authorized the use of that technique to ensue that the government would be able to make its November 15 quarterly interest payment to holders of public debt securities. The Secretary disinvested holdings of the Government Securities Investment Fund of the Thrift Savings Fund (a tax-deferred savings plan for Federal employees) and the Civil Service Retirement and Disability Fund because statute permits it and provides that the funds be restored in full with interest.

The continued inability of the President and the Congress to agree on legislation to balance the budget required the use of other techniques to allow the government to remain below the debt ceiling and continue borrowing. The Secretary withheld the semi-annual interest payment to the Civil Service Retirement and Disability Fund, which is normally made in December, to prevent the debt ceiling from being reached (interest payments are invested in government account securities). Then, in order to make the February 15 quarterly interest payment to holders of public debt securities, the Secretary extended disinvestment of that fund, authorized withdrawals from the Exchange Stabilization Fund, and swapped agency securities of the Postal Service and the Tennessee Valley Authority held by the Federal Financing Bank with government accounts series securities held by the Civil Service Retirement and Disability Fund.

As the Treasury Secretary warned that the continued impasse over the debt limit threatened the timely payment of Social Security benefits for the month of March, the Congress passed legislation enabling the Treasury to borrow about \$29 billion (the size of the March Social Security benefits) that would not be counted against the debt limit until March 15. That legislative technique was new; in prior impasses, the Congress had generally enacted temporary increases in the debt ceiling. As March 15 approached, the temporary exemption was extended through March 30 and amended to exclude inflows to government accounts from the debt ceiling.

Finally, on March 28, the Congress passed an increase in the debt limit to \$5.5 billion. The bill also terminated Supplemental Security Income benefits for drug addicts and alcoholics and included an increase in the exempt earnings amount for Social Security beneficiaries who continue to work. Under the Congressional Budget Office's baseline projections, the new ceiling will be sufficient through the beginning of fiscal year 1998.

Debt Held by the Public as a Percentage of GDP



SOURCE: Congressional Budget Office.