TAX FOUNDATION

SPECIAL REPORT

September 1996, No. 63

Analysis of the Four New Tax Laws

Congress Passes Bills Prior to August Recess

By J.D. Foster, Ph.D.
Executive Director and Chief Economist

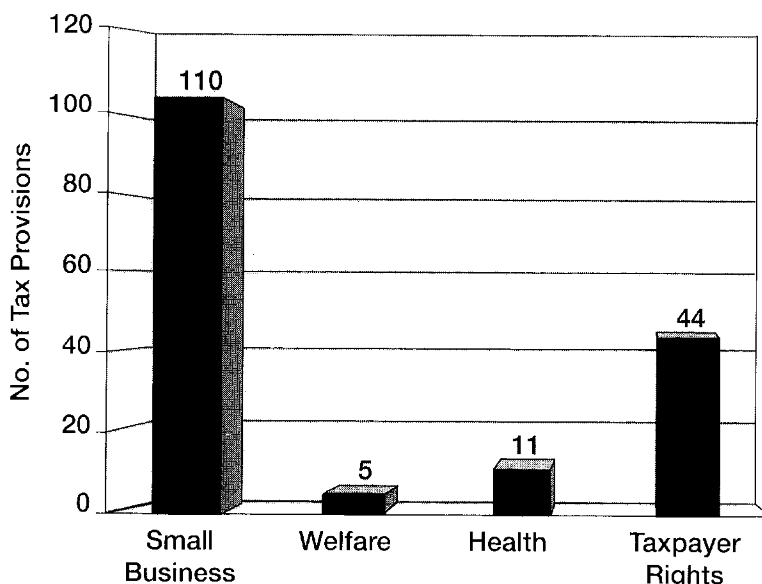
Prior to its August recess, the Congress passed four important pieces of legislation with significant tax elements. The bills, all of which were signed by the President, relate to health care reform (H.R. 3103), providing taxpayers with more effective protections against IRS actions (H.R. 2337), welfare reform (H.R. 3734), and a combination minimum wage increase, small business tax relief, and miscellaneous tax provisions bill (H.R. 3448). Considered individually, the bills' respective tax elements represent narrow, but important, changes in tax policy. Taken together, however, the tax provisions in the four bills represent an important correction in the direction of tax policy.

In total, the four bills make 170 changes either directly affecting taxes owed or tax administration. In purely dollar terms, the small business tax relief bill is the largest of the four, involving over $25 billion in tax increasing provisions and $21 billion in tax reducing provisions over the 1996 to 2006 time period. Together, the four bills include $52.9 billion in tax increases, $41.5 billion in tax reductions, and represents a net reduction in the budget deficit of $11.4 billion over the period.

The largest tax increase provisions among the four bills are (in billions):

Provision	Amount of Increase
Disallow interest deduction for corporate-owned life insurance	$16.0
Repeal the Possessions Tax Credit	$10.6
Modify the Earned Income Tax Credit	$ 6.7
Repeal the 50% interest income exclusion for loans to Employee Stock Ownership Plans	$ 2.3
Apply math error rules for dependency exemptions	$ 2.2
Reinstate the Airport and Airway Trust Fund excises	$ 1.6

Figure 1
Number of Tax Provisions in the Four New Tax Bills



Source: Tax Foundation.

The largest tax decrease provisions among the four bills are (in billions):

Provision	Amount of Decrease
Provide tax relief related to long-term care insurance	$ 7.8
Increase the self-employed health insurance deduction	$ 6.4
Increase the expensing limitation for small businesses	$ 4.7
Ease the tax treatment of accelerated death benefits	$ 3.0
Allow Medical Savings Accounts for some taxpayers	$ 3.0
Allow a $5,000 adoption tax credit	$ 2.2
Modify treatment of foreign trusts	$ 2.1
Increase the availability of spousal Individual Retirement Accounts	$ 2.1
Repeal the bad debt reserve deduction for thrift institutions	$ 1.9
Extend the Research and Experimentation tax credit	$ 1.8
Extend the employer-provided education assistance exclusion	$ 1.1

The four bills illustrate four basic aspects of tax policy. Foremost of these may be that there remains a strong tendency among policy makers to use the tax code as a tool of social or economic engineering. This tendency is demonstrated by the renewal of the orphan drug credit and the enactment of a $5,000 adoption tax credit. This tendency may ultimately represent the greatest threat to tax reform intended to rid the federal tax system purposes extraneous to raising revenue.

These bills also demonstrate the many ways in which the income tax is an ideal tool for augmenting other policies. For example, the Earned Income Tax Credit is a basic element of the federal income maintenance system. Medical Savings Accounts represent a dramatic shift in federal health care policy. And the repeal of the Section 936 Possessions Tax Credit eliminates a fundamental component of the fiscal relationship between the federal government and U.S. possessions such as Puerto Rico.

Like any complex and heavily used piece of machinery, the federal income tax code requires occasional fine tuning and adjustment. Without such changes, the fundamental complexities of an income tax and the evolution of the economy create unintended tax relief or mis-allocations of national resources. The phase-out of the interest deduction for debt used to purchase Corporate-Owned Life Insurance, for example, is an example of how new economic arrangements require adjustments to the tax code.

Finally, while the Internal Revenue Code and the IRS are asked to do more, often with insufficient resources and an overabundance of congressional meddling, some taxpayers will inevitably be caught in the works. Recognizing this danger, and recognizing the political advantages of standing up to the IRS, the Congress has now made finding new ways to protect the taxpayer part of its regular legislative program. The balance of this report provides an overview of the main features of the four pieces of August tax legislation.

Welfare Reform Legislation

The welfare reform bill represents a major shift in the federal government's approach to assisting those in need, while reducing the federal budget deficit by over $6.9 billion over the next six years. Only the bill's provisions relating to the Earned Income Tax Credit (EITC) affect tax policy. The bill's major, non-tax provisions are presented in Table 1.

Table 1
Non-Tax Provisions of Welfare Reform Bill

- Require welfare recipients to work within two years of receiving benefits.
- Impose a 5-year lifetime limit on welfare benefits, with an exemption for hardship cases.
- Require fathers to pay court-ordered child support and require welfare applicants to assist in establishing the paternity of their children to qualify for full benefits.
- Bar illegal aliens from receiving welfare.
- Require immigrant sponsors to guarantee, by pledging their own income, that those they sponsor do not end up on welfare.
- Bar convicted felons from receiving welfare while in prison.
- Provide an additional $4.5 billion to help States provide child care for parents participating in work and job training programs.
- End the guaranteed federal entitlement to welfare and replace it with a block grant to States that allows them to design their own programs.
- Reduce by 75 percent the number of federal bureaucrats who run the current system.

Source: Tax Foundation compilation of bills.

Earned Income Tax Credit Reform

The EITC is a refundable credit of up to $3,560 annually for a family with two or more children (lesser amounts for single workers and families with one child). A family with two children qualifies for the EITC by having wage income of no more than $28,524. The changes to the EITC, which yield $3.2 billion in savings over six years, include:

- Establishing that the credit could only be claimed by individuals with valid taxpayer identification numbers, thereby excluding illegal aliens from the benefits;
- Modifying the definitions of adjusted gross income (AGI) by disregarding various elements of capital losses that otherwise reduce reported AGI;
- Requiring taxpayers to include previously excluded elements of capital income such as net capital gains; and
- Allowing the IRS to use expedited procedures to correct EITC claims in cases where there is an incorrect or missing taxpayer identification number.

Health Care Reform Legislation

The health care reform bill will induce important changes in the nation's health care system, particularly if the bill's most contentious provision, relating to medical savings accounts (MSAs), works as advertised in instilling greater market discipline in the health care system. The health care reform bill raises $20.4 billion in new revenues while providing about the same amount of tax relief, for a net of $12 million in deficit reduction over the next six years.

The health care reform bill will induce important changes in the nation's health care system, particularly if the bill's most contentious provision, relating to medical savings accounts (MSAs), works as advertised in instilling greater market discipline in the health care system.

Medical Savings Accounts

The theory behind MSAs is to encourage individuals to self-insure themselves and their families for normal and minor medical expenses, while relying on third-party health insurance for major medical expenses. In this way, individuals will evaluate for themselves the value of additional doctor visits, medication, and so forth, associated with normal medical care, while maintaining full insurance protection for more catastrophic-type expenses.

An employer establishes an MSA in the employee's name and offers the employee a high-deductible health insurance plan (parallel arrangements exist for self-employed individuals). Contributions into the account are tax favored and capped, and withdrawals for medical expenses are tax- and penalty-free, as are withdrawals for any reason for individuals over age 65.

As a compromise between MSA advocates and opponents in Congress, the bill limits the number of MSA-based policies that may be issued to 750,000 and restricts availability to employers with fewer than 50 workers. Annual MSA contributions are limited to 65 percent of the catastrophic health insurance deductible for individuals and to 75 percent for families. The maximum deductible for the health insurance plan was set at $4,500 and the maximum out-of-pocket expense was set at $5,500. There is a 15 percent penalty for non-medical related withdrawals.

The MSA program is experimental and temporary. The bill directs the Treasury to monitor the development and use of MSAs. Under the bill, after December 31, 2000, no new MSA policies may be written, though individuals with MSA policies may continue to make tax deferred contributions. The expectation is that the Congress and the President will re-evaluate the program in the year 2000 to determine whether the program should be continued and, if so, whether changes are in order.

Portability

The ability of employees to continue their health care plans after separating from their employer, and the ability of new employees to join a company's health care plan, have long been areas of concern. The bill guarantees that individuals who have had group coverage through an employer would continue to have coverage as long as the premiums have been kept up to date.

The bill also establishes that:

- No business with between two and 50 em-

ployees could be denied coverage for its employees, and

- Employer-based health plans could not deny coverage to employees who are in poor health, have filed a large number of medical claims in the past, show genetic predisposition to serious medical conditions, have been victims of domestic violence, or have disabilities.

Health Insurance Deduction for Self-Employed Workers

The deduction for health insurance premiums paid by self-employed individuals rises from 40 percent in 1997 to 80 percent in 2006.

Long-Term Care

The bill excludes the proceeds of a long-term care insurance contract from income; treats unreimbursed long-term care expenses as medical expenses for purposes of the medical expense itemized deduction calculation; and excludes employer-provided long-term care insurance premiums from taxable income.

Miscellaneous Health Care Provisions

The bill contains many miscellaneous provisions. Some of the more important of these are presented in Table 2.

Table 2
Miscellaneous Tax Provisions in Health Care Reform Bill

- Exclude from income amounts received under a life insurance contract for accelerated death benefits paid to terminally ill and chronically ill individuals.
- Allow penalty-free withdrawals from Individual Retirement Accounts (IRAs) for medical expenses that exceed 7.5 percent of adjusted gross income (AGI).
- Allow self-employed individuals to make penalty-free withdrawals from their IRAs to pay health insurance premiums irrespective of the 7.5 percent AGI floor.
- Exempt from income tax state-sponsored high-risk health insurance pools.
- Allow health organizations that mirror the structure of Blue Cross and Blue Shield to be elegible for comparable tax treatment.

Source: Tax Foundation compilation of laws.

Revenue Raisers

Expatriates provision: The bill shifts the burden of proof to expatriates to show the purpose of their expatriation was not tax avoidance.

COLI: The bill phases out the interest deduction for loans on corporate-owned life insurance (COLI), starting with a 90 percent deduction in 1997 and a complete loss of the deduction beginning in 1999.

Interest Allocation Exception: The bill eliminates the 1986 Tax Reform Act transition rule establishing an interest allocation exception for certain non-financial corporations. Affected companies must now allocate and apportion interest expense for foreign tax credit purposes between U.S. and foreign source income based on the proportion of that taxpayer's total assets in each location.

Minimum Wage and Small Business Tax Relief Legislation

This bill could more accurately be called the Minor Omnibus Tax and Minimum Wage Act of 1996 as it includes tax provisions relating to small businesses, pensions, reforms of the Subchapter S rules, international tax provisions, previously expired provisions, miscellaneous issues, and to revenue raising, all in addition to the minimum wage increase. On balance, the bill offers $21 billion in tax relief over 10 years, offset by $25 billion in tax increases, for a net of $4 billion in deficit reduction.

Minimum Wage Increase

The minimum wage increases from $4.25 an hour to $4.75 effective October 1, 1996, and to $5.15 an hour effective September 1, 1997.

Major Small Business Provisions

Expensing Limits: The bill increases the limit on expensing for small businesses to $25,000, phased in over eight years. The limit in 1996 is $18,500.

Convenience Store Relief: The bill allows owners to use the 15-year depreciation schedule for convenience stores, fast-food stores, and other structures installed at gasoline stations.

The FICA Tax Tip Credit: The bill extends the credit retroactively to off-premises employees.

Subchapter S Reforms

The bill includes important changes to the rules relating to Subchapter S corporations. An S Corporation is a legal form of a business that gives the owners the liability protections of the more common C corporation. For tax purposes, however, the income of an S corporation is subject to a single level of tax at the ownership level, in contrast to the double

level of tax associated with a C corporation. The S corporation reforms generally relax some of the strictures on ownership and activities that previously applied. These reforms are presented in Table 3.

Table 3
Subchapter S Reforms

- Increase the maximum number of shareholders from 35 to 75.
- Allow an S corporation to own 80 percent or more of a C corporation or another S corporation.
- Allow trusts to provide for income to be distributed to individuals to own S corporation stock.
- Allow financial institutions to qualify as an S corporation if the institution does not use a reserve method of accounting for bad debts.
- Allow former S corporations that terminated their S status within five years of the bill's enactment to re-elect S corporation status without the consent of the IRS.

Source: Tax Foundation compilation of laws.

Passive Asset Rules

The bill repeals Section 956A that generally requires a U.S. shareholder of a controlled foreign corporation to include in current income excess passive assets held by the foreign corporation.

Miscellaneous Provisions

Among the bill's more important miscellaneous provisions are:

- A $5,000 non-refundable adoption tax credit, ($6,000 for special-needs children), both of which phase-out for families with adjusted gross income over $75,000;
- Allowing an employee to exclude up to $5,000 in employer provided adoption assistance;
- Making permanent the Federal Unemployment Tax Act exemption for legal alien agricultural workers;
- Repeal of the bad debt reserve deduction for thrift institutions that convert to bank charters;
- Modification of the treatment of foreign grantor trusts; and
- A delay of the effective date for full implementation of the Electronic Federal Tax Payment System until July 1, 1997.

Some other provisions in the bill include:

- Overruling the IRS position that newspaper carriers and distributors are employees;
- Establishing a statutory definition of when a fishing crew should be considered normally to be 10 or fewer individuals; and
- Requiring fishermen to file an information return whenever they purchase more than $600 in fish.

Table 4
Extended Temporary Tax Provisions

- The Research and Experimentation Tax Credit, with a special rule for taxpayers electing an alternative incremental method and another expanding the definition of "start-up" firms.
- A modified Work Opportunity Tax Credit.
- The orphan drug credit, which may now also be carried back 3 years and carried forward 15 years.
- The deduction for contributions of stock to private foundations.
- The Section 29 credit for producing fuels from non-conventional sources.
- The exclusion for employer-provided under-graduate educational expenses (which was extended retroactively from January 1, 1996 through June 30, 1997. The exclusion for graduate expenses was extended through 1996).
- The suspension of the diesel fuel dyeing requirement for recreational boaters.

Source: Tax Foundation compilation of laws.

Expired Provisions

Over the years the Congress has enacted a handful of tax provisions on a provisional basis to study their effectiveness without commiting to making the provisions permanent. At the end of their test period these provisions are added to a list of like provisions known as "extenders." Extenders rarely expire permanently, and just as rarely are they made permanent. Instead, the provisions and the taxpayers who come to rely on them, become caught in a pattern of temporary extensions often followed by temporary expirations. The bill extends some of the provisions once again, this time for 11 months from July 1, 1996 to May 31, 1997. The extended provisions are presented in Table 4.

Pension Provisions

The bill establishes a new, simplified retirement plan called the savings incentive

match plan for employees (SIMPLE). This plan, which can be in either an IRA form or in the form of a 401(k), is available only to businesses with 100 or fewer employees. Under the new plan, an employer could contribute

The taxpayer advocate, created through the Taxpayer Bill of Rights 2, will among other things assist taxpayers in resolving problems with the IRS and write reports to the congressional taxwriting committees proposing administrative and legislative changes to address these problems.

up to $6,000 per year to an IRA for all employees if the contributions were part of a matching plan, with matching up to 3 percent of compensation. The plan must be available to all employees and is otherwise not subject to the non-discrimination rules or top heavy rules applicable to pension plans of large employers.

The bill would allow non-working spouses the same $2,000 deduction into an individual retirement account that is now available to a working spouse. It would repeal five-year averaging for lump sum pension distributions, and would allow self-employed ministers to participate in church pension plans.

Revenue Raisers

Among the bill's revenue raisers are:

- The repeal of the Section 936 Possessions Tax Credit with a set of grandfathering rules for existing credit claimants;
- The repeal of the credit attributable to qualified possessions source investment income;
- Extension of the current law excise tax on luxury automobiles while reducing the rate of tax from 10 percent to 3 percent;
- Reinstatement of the 10% Airport and Airway Trust Fund taxes through December 31, 1996;
- Repeal of the 50 percent interest income exclusion for financial institution loans to employee stock ownership plans;
- Application of the look-through rule for purposes of characterizing subpart F insurance income as unrelated business taxable income; and
- Imposition of a tax on settlements and court awards in non-physical injury cases, including employment discrimination suits, and imposition of a tax on income from punitive damage awards.

Taxpayer Bill of Rights 2 (H.R. 2337)

The first Taxpayer Bill of Rights was enacted in 1988 and was championed by Senator David Pryor (D-AR). T2, as the 1996 version is called, also originated through Senator Pryor's efforts and is substantially the same as the bill that cleared the House Ways and Means Committee in 1995. The total cost of the taxpayer provisions is $138 million over the fiscal years 1996 to 2000. The major provisions of this bill follow.

Taxpayer Advocate

The bill replaces the taxpayer ombudsman with a newly created "taxpayer advocate." The taxpayer advocate will be at the same level in the sense of rank as the IRS chief counsel and will be appointed by the Commissioner. The taxpayer advocate will, among other things:

- Assist taxpayers in resolving problems with the IRS and write reports to the congressional taxwriting committees proposing administrative and legislative changes to address these problems;
- Have expanded authority to rescind taxpayer assistance orders; and
- intervene on behalf of taxpayers who would otherwise suffer a significant hardship as a result of the methods used by the IRS in administering the tax laws.

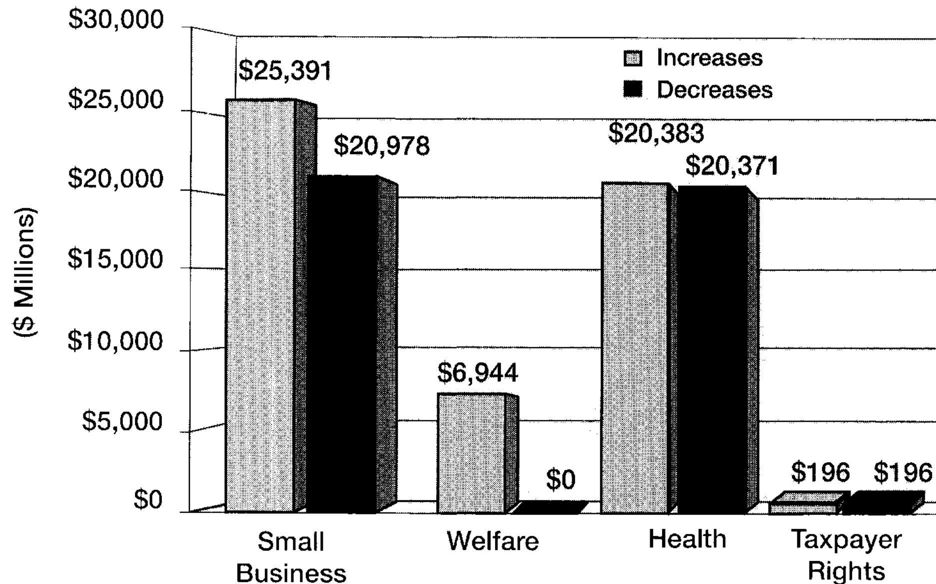
Installment Agreements

The bill requires the IRS notify taxpayers 30 days before it modifies, alters, or terminates an installment agreement unless the Service determines the collection of the tax is in jeopardy. The Service must provide specific reasons for its actions and it must establish procedures for an independent review of installment agreement terminations.

Interest Abatement

The bill expands the interest abatement provisions to permit abatement for "unreasonable" errors or delays caused by IRS personnel performing such acts as the loss of records or changes by the IRS, or caused by changes in IRS personnel due to transfers, training, illness, or leave. The Tax Court will have jurisdiction to review whether the Service abused its discretion in refusing to abate interest owed by a

Figure 2
Projected Tax Revenue Gains and Losses for Each New Tax Bill ($Millions)



Source: Tax Foundation.

taxpayer who meets the net worth requirement.

Joint Returns

The bill requires the General Accounting Office and the Treasury to conduct separate studies analyzing the effects of changing the current standard of "joint and several" liability for spouses to a "proportionate" liability standard.

Liens and Levies

The bill allows the IRS to withdraw without prejudice public notice of a tax lien before payment in full by the indebted taxpayer. The bill also allows the IRS to return levied property to the taxpayer under certain circumstances and, in the case of an erroneous lien, the taxpayer may request the Service notify major credit agencies. The bill increases the levy exemption level for personal property from $1,650 to $2,500. To accelerate the resolution of disputes, the bill allows offers-in-compromise that reduce tax liability by less than $50,000 to be approved without a written opinion from the Office of Chief Counsel.

Information Returns

The bill creates a federal cause of action for a person who has suffered financial loss when another taxpayer has willfully filed a fraudulent information return. The injured party may recover from the fraudulent filer the greater of $5,000 and actual damages, including reasonable attorney's fees. If a taxpayer reasonably disputes the accuracy of an information return, and the taxpayer has cooperated with the IRS, then the IRS bears the burden of proof in establishing corroborating information.

Attorney's Fees

Under prior law, taxpayers could recover attorney's fees incurred in disputes with the IRS when the IRS' position was not substantially justified and when the taxpayer prevails on the merits of the case. The bill shifts the burden of proof by requiring the IRS show that its position was substantially justified. The bill also raises the statutory maximum hourly rate for recoverable attorney's fees from $75 to $110.

Damages for IRS Collections

The bill increases from $100,000 to $1 million the amount of "actual, direct economic" damages that may be recovered by a taxpayer who has suffered from "reckless" IRS collection action.

Summonses

The Service must notify the taxpayer when it issues a summons to a third-party recordkeeper for records pertaining to that taxpayer. It also limits the use of a designated summons to corporations the IRS is examining as part of the Coordinated Examination Program.

Retroactive Regulations

The effective date of any temporary, proposed, or final regulation may not be earlier than the date the regulation is published in the *Federal Register*. In addition, the effective date of a final regulation can be no earlier than the date it was published in the *Federal Register* in temporary or proposed form. A regulation could be effective as of the publication date of a notice that describes the contents of the subsequent regulation. The main exceptions to these rules arise when the IRS issues regulations within 12 months of the enactment of the underlying statutory provision or when the Treasury Secretary determines that retroactive application of a regulation is necessary to prevent tax abuse.

Report of Misconduct

The IRS is required to report annually to the taxwriting committees allegations of IRS employee misconduct.

Private Delivery Systems

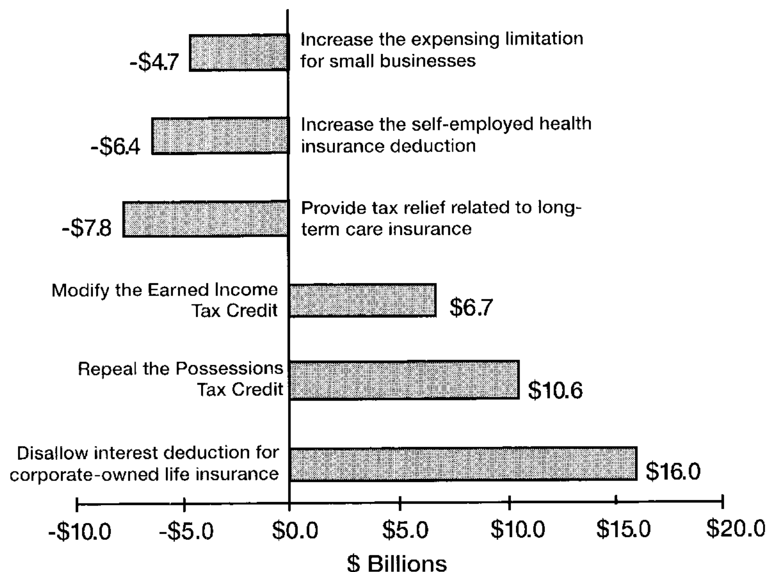
Taxpayers may now legally rely on the postmark when they employ private delivery services to transmit their tax information as long as the private courier service has been so designated by the Treasury Department.

Revenue Offsets

• A penalty exists for failure to pay tax previously applied to delinquent tax filers. The bill extends this penalty to instances where substitute returns are filed by the IRS on behalf of a delinquent taxpayer.

• The bill imposes intermediate sanctions on abusive tax-exempt organizations. These sanctions offer an alternative to the more severe penalty of revoking the organization's tax-exempt status for engaging in behavior that improperly benefits an individual associated with the organization.

Figure 3
Largest Tax Increase and Decrease Provisions in the Four New Tax Laws ($Billions)



Source: Tax Foundation.

SPECIAL REPORT (ISSN 1068-0306) is published at least 10 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4-12 pp. Annual subscription: $25.00 Individual issues $5.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

©1996 Tax Foundation

Editor and Communications Director
Stephen Gold

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005
(202) 783-2760
www.taxfoundation.org
taxfnd@intr.net