REV-20 IMPOSE A MINIMUM TAX ON FOREIGN-OWNED BUSINESSES

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	0.2	0.3	0.4	0.5	0.5	1.9

SOURCE: Joint Committee on Taxation.

Foreign-owned companies must pay tax on the income they earn from business activities within the United States. Treaties with other countries generally stipulate that the United States will not tax the income of foreign-owned businesses more heavily than the income of U.S.-owned businesses.

When foreign multinational corporations operating in the United States import materials and services from affiliated companies abroad, the "transfer price" of imports affects the amount of income that is subject to U.S. tax. (The transfer price is the price charged for goods sold between affiliated companies.) By raising the transfer price of imports, foreign-owned companies can shift income out of the United States to their foreign affiliates and reduce their U.S. tax liability. U.S. tax law requires companies to base the transfer prices of many goods and most services on comparable transactions between unaffiliated companies. But such prices are often difficult for companies to determine and even more difficult for the Internal Revenue Service to enforce, especially when comparable goods and services are not routinely traded between unaffiliated companies.

Foreign-owned multinational corporations may be manipulating transfer prices to shift income overseas and avoid U.S. tax. Circumstantial evidence has indicated that this kind of tax avoidance has occurred. For example, studies have found that the reported profit rates (as a percentage of assets and as a percentage of sales) of foreign-owned multinational corporations operating in the United States are generally lower than the profit rates of U.S.-owned corporations in the same industry. However, other plausible explanations exist for the low profit rates. For example, foreign-owned companies may have newer plants and equipment than U.S.-owned companies in the same industry. Because accelerated depreciation methods allow companies to claim larger annual deductions on newer equipment than on older equipment, foreign-owned companies would have higher reported depreciation costs and lower reported profit rates as a percentage of sales. Moreover, because the absence of an inflation adjustment for the book value of plant and equipment undervalues older assets relative to newer assets, U.S.-owned companies with older assets would tend to have higher profit rates as a percentage of reported book value than foreign-owned companies with newer assets.

To discourage foreign companies from manipulating transfer prices to avoid U.S. tax, a minimum tax could be levied on foreign-owned businesses that have a sizable amount of trade with affiliated companies overseas. One legislative provision, introduced in 1992, would have imposed a minimum tax on all companies that are at least 25 percent foreign owned and have transactions with foreign affiliates in excess of either 10 percent of their gross income or $2 million annually. Under the proposal, the foreign-owned company would compute its taxable income under the current income tax rules, but its taxable income would be subject to a floor. The floor would equal 75 percent of its gross business receipts multiplied by the average profit margin on gross receipts for U.S. companies in the same industry. If the foreign-owned company's operations spanned several industries, the floor would be based on the profit margins in each industry weighted by the share of the company's gross receipts in that industry. The Internal Revenue Service could waive the minimum tax after examining a company's method of computing transfer prices and finding it acceptable.

The formula approach under the minimum tax provides a simple way to ensure that foreign-owned companies conducting business in the United States pay an acceptable amount of U.S. tax. The simplicity of the approach may offer some advantage over the cumbersome rules for arm's-length pricing, which are extremely difficult to enforce. The formula approach, however, provides a very crude estimate of taxable profit.

The minimum tax would discriminate against foreign-owned companies, possibly in violation of U.S. treaties, by taxing their income more heavily than the income of their domestic competitors. The minimum tax would be especially onerous on foreign-owned companies starting new businesses in the United States because new businesses are seldom profitable initially. Under the minimum tax, such businesses would still owe a sizable amount of income tax based on their gross receipts.

Other countries would be likely to treat the minimum tax as a protectionist measure and retaliate with similar taxes on U.S.-owned companies conducting business within their borders. If so, the minimum tax would stifle international trade and reduce economic welfare throughout the world. Imposing the minimum tax on foreign-owned companies, which is one of many possible formulary approaches, would raise almost $2 billion from 1996 through 2000.

REV-21 TAX CAPITAL GAINS FROM HOME SALES

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Tax 30 Percent of Gain	3.6	5.5	5.4	5.6	5.8	25.9
Tax Lifetime Gains in Excess of $125,000	0.2	0.4	0.4	0.4	0.4	1.8

SOURCE: Joint Committee on Taxation.

When homeowners sell their home, they realize a capital gain or loss equal to the difference between the selling price and their basis. Their basis is the initial cost of the home plus the cost of home improvements.

Although capital gains on most assets are taxable when the assets are sold, capital gains on home sales generally escape taxation. A taxpayer can defer the capital gain from the sale of a principal residence if she or he purchases another home of at least equal value within two years. When a homeowner dies, the accrued gain on the current home plus any gain on previous homes escapes tax permanently. Further, the tax law allows taxpayers age 55 and older to exclude up to $125,000 of gain from one home sale even if they do not purchase another home of equal or greater value within two years. Replacing the above provisions with a rule that includes 30 percent of capital gains from home sales in taxable income would raise $25.9 billion in 1996 through 2000. Alternatively, including all lifetime gains in excess of $125,000 in taxable income when realized would raise $1.8 billion over the same period.

The preferential treatment of capital gains from home sales is only one of the ways in which the tax code strongly favors owner-occupied homes over other investments (for a discussion of other ways, see REV-04). All of these tax preferences divert savings from business investment to housing. One way to make the tax treatment of housing more like that of other assets would be to replace the capital gains deferral and exclusion provisions with a low tax rate on gains from home sales. Including 30 percent of the gain from home sales in taxable income would make the tax rate on such gains range from 4.5 percent for taxpayers facing a 15 percent marginal tax rate to 11.9 percent for those in the 39.6 percent tax bracket.

A tax on gains from home sales would discourage home sales in the same way that current law discourages taxpayers from selling other capital assets. In the case of home sales, that might discourage workers from relocating to take advantage of better job opportunities. The tax might also deter some homeowners (especially older taxpayers with large accrued gains) from changing homes as family requirements change.

Another option would allow all taxpayers to exempt the first $125,000 of gains on all home sales from tax, while fully taxing the excess over that amount at the time of sale. This option would protect the mobility of most homeowners. Taxpayers who realize a gain of less than $125,000 on their first home could apply the unused portion to future home sales. That exclusion would increase the mobility of homeowners under age 55 relative to current law because they could move to homes of lesser value without incurring a tax as long as the gain on the home they sold was less than $125,000. Although this proposal would increase mobility for most homeowners, it would reduce it for those under age 55 whose gains from home sales exceed $125,000. Those taxpayers could no longer defer additional gain by purchasing a more expensive home.

Taxing gains on home sales without the rollover and exclusion that current law allows would increase the need for taxpayers to keep records of home improvements. They would need to maintain such records to establish the tax basis of a home upon sale. Currently, many taxpayers do not keep such records because the probability of any future tax on gains from a home sale is low and the expected present value of such a tax is small. Allowing a lifetime exemption of $125,000 would complicate recordkeeping, especially when people buy and sell successive homes with different spouses.

Much of the capital gain on home sales results from inflation. Inflationary gains are not income and therefore ideally would not be subject to income taxation. Taxing inflationary gains may, however, be an appropriate way to offset the tax benefit homeowners enjoy from inflation by being able to deduct fully their mortgage interest payments, which include an inflation premium.

Including gains from the sale of a home in taxable income would also be inequitable if losses from home sales were not deductible. H.R. 9, a bill introduced in 1995 based on a proposal in the Contract with America, would allow the deductibility of losses on the sale of a home.

Any reduction in the tax benefit from home ownership would lower the value of existing housing relative to other assets such as corporate equity. Middle-income taxpayers would feel the loss in value most because homes are their principal asset.

As a way of reducing the tax benefit to home ownership, the primary alternative to taxing gains on sale is to limit the mortgage interest deduction (see REV-04). Limiting the mortgage interest deduction has the advantages of not hindering mobility or complicating recordkeeping. Taxing gains on sale, however, has the advantage of preserving the greatest tax break for first-time homebuyers.

REV-22 TAX CAPITAL GAINS HELD UNTIL DEATH

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Include Gains in the Last Income Tax Return of the Deceased[a]	b	8.7	9.1	9.6	10.1	37.5
Enact a Supplemental 10 Percent Estate Tax	b	0.8	0.9	1.0	1.1	3.8
Enact a Carryover Basis	b	0.9	1.8	2.9	4.0	9.6

SOURCE: Joint Committee on Taxation.

a. Estimate is net of reduced estate tax revenues.

b. Less than $50 million.

A capital gain or loss is the difference between the current value of an asset and the owner's basis. The owner's basis is the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. When an asset is sold, the tax law normally requires that the owner include any realized gain in taxable income. The owner can deduct any realized loss against realized gains, and when the owner does not have gains in excess of losses, he or she can deduct up to $3,000 of the loss against other income.

An exception occurs when an owner holds an asset until death. In that case, the tax law allows the beneficiary to "step up" the basis to the asset's value as of the date of the decedent's death. When the beneficiary subsequently sells the asset, he or she pays tax on the gain that accrued after the decedent's death. The gain that accrued before the decedent's death is permanently excluded from taxable income. The estate of the decedent may pay taxes under the separate estate tax, but that tax applies equally to assets on which the decedent previously paid income tax and to assets with accrued capital gains that had escaped income taxation.

There are three ways to tax gains held at death: the law could require that gains held at death be included as income on the final income tax return of the decedent, the estate of the decedent could be subject to a supplemental tax rate on accrued gains, or the law could require that beneficiaries assume the decedent's basis in the asset they inherit. Under the last method of carryover basis, the beneficiaries would include the decedent's unrealized gain in their taxable income when they sell the asset.

Tax Gains on Final Return of the Decedent. Taxing accrued but unrealized gains on the final income tax return of the decedent would raise $37.5 billion from 1996 through 2000. This option would exclude gains on assets that a spouse inherits. Instead, the spouse would assume the basis of the decedent and pay tax on the full gain only if the spouse sold the asset. Any gains on assets that the decedent leaves to charity would also be exempt. The option would include gains on other assets in taxable income. It would also allow three additional modifications. First, to ease the problem of documenting the basis, the option would allow the estate to use an alternative basis equal to one-half of the asset's current value in computing the gain to be included on the final tax return. Second, the estate could claim the existing $125,000 exclusion on the gain from the sale of a principal residence if the decedent had not already claimed it. Third, the estate could exclude an additional $75,000 of any remaining gains. With all of those provisions, about one-tenth of the people who hold accrued gains when they die would pay taxes on those gains. Finally, taxes paid on gains realized at death would be deductible under the estate tax.

Tax Gains Under the Estate Tax. An additional estate tax on accrued gains of 10 percent would raise $3.8 billion from 1996 through 2000. This option would apply a flat 10 percent rate to the same tax base as in the previous option. In addition, however, taxpayers could offset the additional tax with any unused credits under the estate tax. Because of those credits, few people would owe additional tax under this option. Only about 1 percent of estates currently pay the estate tax and the fraction paying the additional tax on gains would be about the same.

Tax Gains Upon Realization by Heirs (Carryover Basis). A third option would carry over the decedent's basis in assets left to the heirs and tax the gains of the decedent when the heirs sell their assets. This option would raise $9.6 billion from 1996 through 2000. The option would also allow heirs to set the basis of inherited assets at one-half of their current value. In addition, if the estate of the decedent paid any estate tax, shares of that tax would be added to the basis of all the estate's assets in proportion to their shares of the estate's value. Carryover basis would make most gains held at death taxable, but the timing of the tax payments would depend on when the heirs sold the inherited assets.

Gains held until death have always been exempt from income tax. The Congress enacted a carryover basis in the Tax Reform Act of 1976 but postponed it in 1978 and repealed it in 1980. Hence, it never took effect.

Taxing accrued gains at death, on either the last income tax return or the estate tax, would reduce the incentive for investors to hold assets until death in order to avoid tax. Current law encourages taxpayers to hold on to assets longer than they otherwise would. That "lock-in" effect distorts their investment portfolios and may hinder the flow of capital to activities with higher rates of return. Reducing the lock-in effect is one of the advantages of reducing the income tax on realized capital gains. Taxing gains at death would also reduce the lock-in effect, but, unlike a lower capital gains tax rate, it would reduce the preferential treatment of capital gains over ordinary income.

Using a carryover basis would not achieve the same unambiguous reduction of the lock-in effect that the other two options would achieve. Using a carryover basis lessens the incentive for the original owner to hold on to an asset until death. But an heir receiving an asset with a carryover basis has a stronger incentive to hold on to the asset than under current law.

A disadvantage of taxing gains at death is that the tax might force the family of the decedent to sell assets to pay the tax, although two of the three options minimize this problem. Forced sales of illiquid assets at an inopportune time can reduce their value substantially. Forcing heirs to sell a family farm or business would impose a particular hardship on families wanting to continue the enterprise. Forced sales would not occur if a carryover basis was used because heirs could defer the tax on unrealized gains until they sold the assets. In addition, taxing gains held at death through the estate tax would also reduce forced sales because the estate tax permits heirs who continue to operate a family farm or business to defer payment for five years and then spread payment over the next 10 years. Estates would receive no deferral, however, if gains were taxed on the final income tax return of the deceased. If this option was instead structured to allow the estate to value a family farm or business on its current use instead of by its market value, as is currently allowed under the estate tax, then the option would allow a deferral and would raise less revenue than cited.

Taxpayers and the Internal Revenue Service often have difficulty determining the basis of assets of closely held businesses, personal property, and assets for which the taxpayer did not keep adequate records. The difficulty in determining the amount of the basis was one of the main arguments that influenced the Congress to delay implementing carryover basis in 1978 and then to repeal it in 1980. Because people currently planning to hold assets until death might not have kept adequate records, documenting the basis would be particularly difficult immediately after passage of a law to tax gains held until death. Once a tax on gains held at death had taken effect, however, people would have a reason to keep better records. In the interim, allowing estates and heirs to set the basis at one-half of the market value at the time of death would ease compliance. Finally, if gains held at death were taxable under the estate tax instead of the income tax, most taxpayers would be exempt because of the high estate tax credit (see REV-23).

REV-23 INCREASE ESTATE AND GIFT TAXES

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Reduce the Unified Credit	a	3.5	4.1	4.8	5.5	17.9
Convert the Credit for State Death Taxes into a Deduction	a	1.9	2.0	2.2	2.3	8.4
Include Life Insurance Proceeds in the Base	a	0.3	0.3	0.3	0.3	1.2

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on transfers at death. The estate and gift taxes together constitute a unified tax: one progressive tax is imposed on cumulative transfers during life and at death. Generous credits built into the system, however, exempt most estates from taxation; about 27,000 estates paid tax in 1993.

The estate and gift tax rates in 1996 will range from 18 percent on the first $10,000 of transfers to 55 percent on transfers of more than $3 million, but a unified credit of $192,800 effectively exempts the first $600,000 from taxation. As a result of the credit, taxable estates face an initial tax rate of 37 percent on the first $150,000 of transfers in excess of $600,000. An additional 5 percent surcharge applies to estates between $10 million and $21.04 million. The 5 percent surcharge phases out the benefit of graduated rates for those larger estates. In addition, current law phases out the unified credit for estates above $10 million. Another credit allows taxpayers to subtract a portion of state death taxes from federal estate tax liability.

In the Omnibus Budget Reconciliation Act of 1993, the Congress made permanent the top two estate tax rates that had been scheduled to decline to 50 percent after 1992. Those are the 53 percent rate that applies to estates of between $2.5 million and $3 million and the 55 percent rate that applies to estates of more than $3 million. The Congress could raise the estate and gift tax, without raising rates, by reducing allowable credits or by including proceeds of life insurance policies in the tax base.

Reduce the Unified Credit. Lowering the unified credit from $192,800 to $87,800 would raise $17.9 billion from 1996 through 2000 and make an additional 80,000 estates subject to tax. That lower credit is equivalent to an exemption of only the first $300,000 of transfers, instead of the current $600,000.

The estate and gift tax reduces the extent to which concentrations of wealth can be perpetuated, which may provide more equal opportunity for members of each new generation. The tax may also slow economic growth, however, by discouraging the accumulation of large estates.

The estate and gift tax provides the only tax on the unrealized capital gains held until death by people with the highest-valued estates. The estate and gift tax, however, taxes those unrealized gains at the same rate as other accumulated wealth that has already been taxed as income when earned (see REV-22).

Reducing the unified credit would extend the tax to more estates with small businesses, family farms, and large homes. The necessity of paying the tax would put pressure on heirs to sell those assets when they might prefer to retain them in the family or when the value of the assets was temporarily depressed. The estate tax has provisions for spreading payment over 15 years for small businesses and family farms, but even this burden could be prohibitive for retaining some family assets. Reducing forced liquidation of assets was one concern of the Congress when it voted in 1981 to raise the credit from $47,000 to $192,800. Furthermore, H.R. 9, a bill introduced in 1995 based on a proposal in the Contract with America, would raise the unified credit to $248,300 by 1998 and index it to inflation thereafter. Such a change would be equivalent to an exemption of the first $750,000 of transfers, instead of the current $600,000.

Convert the Credit for State Death Taxes into a Deduction. Currently, state death taxes reduce federal tax liability by a credit that ranges from 0.8 percent on transfers of $40,000 to 16 percent on transfers of more than $10 million. When implemented in 1926, the credit sometimes virtually eliminated federal tax liability because the top marginal rate on estate and gifts taxes was 20 percent. The credit acts as a state revenue-sharing system for estates taxed up to the 16 percent exclusion level. Consequently, a majority of states have adopted death tax systems that simply redistribute estate tax revenues from the federal to state governments. That shift is accomplished by imposing state taxes that exactly match the amount of the federal credit. Changing the state death tax credit to a deduction would raise $8.4 billion from 1996 through 2000 and would correspond to the itemized deduction that taxpayers receive for state and local income and property taxes.

An alternative change that yields about the same revenue is to reduce the amount of state tax credited by half so that the maximum credit is 50 percent of the amount paid to states. The two alternatives are not equivalent for estates of different sizes: the value of the deduction increases as the marginal tax rate rises, whereas the value of the credit is not affected by the marginal tax rate.

Include Life Insurance Proceeds in the Base of the Estate and Gift Tax. Life insurance is an alternative way of transferring wealth to descendants, but is currently exempt from the estate tax if the policyholder is someone other than the person who died. Making life insurance proceeds subject to estate and gift tax would raise $1.2 billion from 1996 through 2000.

REV-24 AMORTIZE A PORTION OF ADVERTISING COSTS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	3.5	6.2	4.7	3.1	1.8	19.3

SOURCE: Joint Committee on Taxation.

The income tax law allows taxpayers to deduct the ordinary costs of doing business. When a taxpayer purchases a durable asset for use in business, however, the expense may not normally be deducted immediately. Taxpayers must spread out (amortize) deductions over a number of years as the asset depreciates in value. That requirement is intended to match the timing of the deductions for depreciation with the timing of income earned from using the asset in business.

The rate at which such deductions are allowed, the "depreciation schedule," is normally faster than the rate at which an asset actually depreciates. For example, when a machine is expected to last 10 years, the depreciation schedule might allow the original cost to be deducted over five years. The sooner the deductions, the lower the effective rate at which income earned from using the asset is taxed. In the extreme, if the initial cost of a durable asset is deducted immediately, the net income from the asset would effectively not be taxed at all.

Currently, businesses may deduct advertising expenses in the year they are incurred. The benefits of advertising, however, may extend beyond the current year because advertising can create brand recognition or otherwise increase the demand for a business's products or services in later years. If advertising creates a durable asset, the immediate deduction allowed by current law provides it with a preference relative to investment in other durable assets.

Under this option, businesses could deduct 80 percent of all advertising expenses immediately, but would have to amortize the remaining 20 percent equally (using a "straight line" method) over four years. The option is intended to improve the match between the deductions and the income created from advertising. This option would raise about $19 billion from 1996 through 2000. After peaking at $6.2 billion in 1997, the estimated revenue gain would diminish to $1.8 billion by 2000 because the option represents an acceleration of tax revenue that would otherwise be paid in later years.

Because advertising can be difficult to define, this option would require complex rules to distinguish advertising costs from other ordinary business costs. Some marketing costs, such as those of notifying customers about price changes, redesigning a product package, or changing store displays, might or might not fit within the definition of advertising. If advertising was defined too narrowly, the depreciation requirement would be easy to avoid and difficult to administer. If advertising was defined too broadly, however, it would place an unintended burden on some forms of marketing.

The option would increase the after-tax cost of advertising and discourage its use. However, advertising also fulfills important economic functions by supplying information about products to prospective buyers. Advertising often provides information about prices, making it easier for buyers to find the lowest price, which can make markets more competitive. Advertising can also provide valuable information about the quality and other characteristics of products, making it easier for buyers to make good purchasing decisions.

Available research provides conflicting evidence about the durability of advertising. The actual rate at which advertising depreciates is unknown and probably differs for different types of advertising. The correct depreciation schedules would therefore be very difficult to construct, making the schedule chosen under this option somewhat arbitrary. If the depreciation period was too long under the option, advertising would be overtaxed relative to other economic activities, which would discourage economically important forms of advertising.

REV-25 ELIMINATE PRIVATE-PURPOSE, TAX-EXEMPT BONDS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Eliminate All Private-Purpose, Tax-Exempt Bonds	0.2	0.8	1.4	1.9	2.4	6.7
Raise the Cap and Extend Limits on Volume to New Issues of All Private-Purpose Bonds	0.1	0.3	0.5	0.7	0.9	2.5

SOURCE: Joint Committee on Taxation.

The tax law permits state and local governments to issue bonds that are exempt from federal taxation. For the most part, the bonds' proceeds have financed public investments such as schools, highways, and water and sewer systems. Beginning in the 1960s, however, state and local governments began to issue a growing dollar volume of tax-exempt bonds to finance quasi-public facilities, such as ports and airports, and private-sector projects, such as housing and shopping centers. Those bonds eventually became known as "private-purpose" bonds because the ultimate users of the tax-exempt-financed facilities were private, nongovernmental entities.

Private-purpose, tax-exempt bonds include mortgage bonds for rental housing and single-family (in some cases two-family) homes; bonds for exempt facilities, such as airports, docks, wharves, mass transit, and solid waste disposal; small-issue bonds for manufacturing facilities and agricultural land and property for first-time farmers; student loan bonds, which state authorities issue to increase the funds available for guaranteed student loans; and bonds for nonprofit institutions, such as hospitals and universities.

Although private-purpose bonds provide subsidies for activities that may merit federal support, tax-exempt financing is not the most efficient way to provide assistance. With a direct subsidy, the benefit would go entirely to the borrower; with tax-exempt financing, the borrower of funds shares the benefit with the investor in tax-exempt bonds. In addition, because tax-exempt financing is not a budget outlay, the Congress may not routinely review it as part of the annual budget process.

The Congress has placed restrictions on tax-exempt financing several times, beginning in 1968. During the 1980s, those restrictions included limiting the volume of new issues of tax-exempt bonds for some activities and eliminating or setting expiration dates on the use of tax-exempt bonds for other facilities. The Congress, however, frequently postponed some of the expiration dates. In the Omnibus Budget Reconciliation Act of 1993, the Congress permanently extended the use of mortgage bonds for single-family (and some two-family) homes and the use of small issues for manufacturing facilities and agricultural land and property for first-time farmers.

The Tax Reform Act of 1986 included interest earned on newly issued private-purpose bonds in the base for the alternative minimum tax and placed a single state-by-state limit on the volume of new issues of exempt facility bonds, small issues, student loan bonds, and housing and redevelopment bonds. The state volume limits are the greater of $50 per resident or $150 million a year. Bonds for publicly owned airports, ports, and solid waste disposal facilities and bonds for nonprofit 501(c)(3) organizations (primarily hospitals and educational institutions) are exempt from the limits on issues of new bonds. Large private universities and certain other nonprofit institutions may not issue tax-exempt bonds if they already have more than $150 million in tax-exempt debt outstanding.

If the Congress eliminated tax exemption for all new issues of private-purpose bonds, the revenue gain would be about $6.7 billion in 1996 through 2000. That amount assumes that at least some construction of airports and sewage and solid waste facilities would qualify for tax-exempt financing as governmental in nature. Eliminating the tax exemption would eventually raise the cost of the services provided by nonprofit hospitals and other facilities that currently qualify for tax-exempt financing, but the cost increase would be small and gradual.

Including all bonds for private nonprofit and quasi-public facilities in a single state volume limit--while raising the limits beginning in 1996 to, say, $75 per capita or $200 million a year--would increase revenues by $2.5 billion in 1996 through 2000. Those changes would curb the growth of all private-purpose bonds without sharply reducing their use. The curb would primarily affect bond issues for nonprofit hospitals, which are not included in the current cap. The proposal would also apply to bonds for airport facilities, such as departure gates, which are for the exclusive private use of airlines under long-term leases, but would continue to allow unlimited tax-exempt financing of public airport facilities, such as runways and control towers.

REV-26 REDUCE TAX CREDITS FOR REHABILITATING OLDER BUILDINGS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Repeal Credit for Nonhistoric Structures and Reduce Credit for Historic Structures to 15 Percent	a	a	0.1	0.1	0.1	0.4
Repeal Both Credits	0.1	0.1	0.2	0.2	0.2	0.8

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

The Congress enacted tax credits for rehabilitation to promote the preservation of historic buildings, encourage businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit rate is 10 percent for expenditures on commercial buildings built before 1936, and 20 percent for commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance.

The credits favor commercial use over most rental housing and may therefore divert capital from more productive uses. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings.

Rehabilitation may have social benefits to the extent that it discourages the destruction of historically noteworthy buildings. The government could promote that objective at a lower cost, however, by permitting a credit only for the renovation of certified historic buildings and lowering the credit rate. Some surveys have indicated that a 15 percent credit would be sufficient to cover the extra costs of both obtaining certification and undertaking rehabilitation of historic quality. Reducing the credit for historic structures to 15 percent and repealing the credit for nonhistoric structures would increase revenues over the 1996-2000 period by about $0.4 billion. Repealing both credits would raise about $0.8 billion over the same period.

REV-27 DISALLOW INTEREST DEDUCTIONS FOR CORPORATE-OWNED LIFE INSURANCE LOANS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	0.4	0.5	0.6	0.6	0.7	2.8

SOURCE: Joint Committee on Taxation.

Corporations purchase life insurance policies in part as protection against the financial loss from the death of their more important employees. Those purchases provide a tax benefit when corporations take out a loan with the cash value of the policy as collateral and deduct the interest expense from taxable income. This option would disallow the deduction for interest that corporations pay on loans secured by the cash value of life insurance policies. It would raise about $2.8 billion over the 1996-2000 period.

The tax code makes the tax benefit available by allowing the investment income ("inside buildup") within a life insurance policy to be generally exempt from the corporate income tax, while allowing a corporation to deduct a significant share of the associated loan's interest expense from taxable income. Such asymmetric treatment provides a tax arbitrage opportunity in that corporations can generate interest deductions that they can use to shelter other taxable income. Individuals cannot use that tax benefit because the tax code does not allow them to deduct those interest payments. Corporations that pay the alternative minimum tax receive only a limited opportunity for tax arbitrage because merely a part of their inside buildup is exempt from income tax. Those corporations, therefore, tend not to purchase such insurance policies for tax purposes.

The Congress enacted restrictions on this tax benefit in the Tax Reform Act of 1986, but the restrictions have not been particularly effective. In that act, the Congress restricted the size of a loan that qualifies for the interest deduction to $50,000 per insured employee. Since that time, corporations have spread smaller policies over a larger group of employees.

This tax option would broaden the restrictions enacted in 1986 by denying the deduction by corporations for interest from all life insurance policy loans, regardless of loan size. The Bush Administration proposed this option in its budget for fiscal year 1993, and the Reagan Administration proposed it in 1984. If the Congress was to tax all investment income from cash-value life insurance as it accrued (the option depicted in REV-16), then restricting the interest deductibility of policy loans would be unnecessary.