CHAPTER 12

MODIFY OTHER SPECIFIC SUBSIDIES

The Administration proposals would repeal various tax subsidies for particular businesses, including the rehabilitation tax credit, the merchant marine capital construction fund provisions, and special rules for book, magazine, and discount coupon income. The research and experimentation credit would be retained, but modified to improve its efficiency. The possessions tax credit would be replaced with a wage credit. Various tax incentives designed to encourage employee stock ownership would be revised to better carry out their purposes.

REPEAL TAX CREDIT FOR QUALIFIED REHABILITATION

General Explanation

Chapter 12.01

Current Law

A special investment tax credit (the "rehabilitation credit") is provided for qualified expenditures incurred in connection with the rehabilitation (but not enlargement) of certain old or historic buildings. The credit rate is equal to (a) 15 percent for qualified expenditures incurred in connection with buildings at least 30 years old but less than 40 years old, (b) 20 percent for qualified expenditures incurred in connection with buildings at least 40 years old, and (c) 25 percent for qualified expenditures incurred in connection with certified historic structures of any age. The regular investment tax credit and the energy investment tax credit do not apply to any portion of an expenditure which qualifies for the rehabilitation credit.

The rehabilitation credit is limited to expenditures incurred in connection with buildings that will not be used for lodging (except in the case of certified historic structures), and is available only if the taxpayer elects to use the straight-line recovery method with respect to the expenditures. A rehabilitation must be substantial to qualify for the credit. In general, this requirement is met if rehabilitation expenditures incurred over a 24-month period exceed the adjusted basis of the property at the beginning of that period. In addition, at least 75 percent of the building's external walls must be retained in place.

The 25 percent credit for rehabilitations of certified historic structures is subject to certain additional requirements. In general, the 25 percent credit is not available unless the rehabilitation is certified by the Secretary of the Interior as being consistent with the historic character of the building or the district in which the building is located. Certified historic structures include only (a) buildings listed in the National Register and (b) buildings located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

In the case of a qualified rehabilitation of a certified historic structure, the basis of the rehabilitated building is reduced by 50 percent of the amount of the credit. The reduction is 100 percent of the credit in the case of other qualified rehabilitations. If a rehabilitation credit is subsequently recaptured, corrective basis adjustments are made (and treated as occurring immediately before the recapture event).

Reasons For Change

As enacted in 1962, the investment tax credit was unavailable for buildings and their structural components. In limiting the credit to tangible personal property, Congress was primarily concerned about the greater average age and lower efficiency of domestic machinery and equipment in comparison with the facilities of major foreign producers.

In 1978, Congress observed a decline in the usefulness of existing, older buildings, primarily in central cities and older neighborhoods, and extended the regular investment tax credit to older buildings for the purpose of promoting stability and economic vitality in deteriorating areas. No special credit was provided for certified historic structures, although the credit was made available for rehabilitation of such structures only if the Secretary of the Interior certified the rehabilitation as appropriate.

In 1981, Congress enacted the Accelerated Cost Recovery System ("ACRS"), and noted that ACRS had the unintended effect of reducing the relative attractiveness of the original (ten percent) credit for rehabilitating older buildings. Accordingly, Congress replaced the original rehabilitation credit with the three-tier credit contained in current law. The three-tier system had the effect of (1) increasing the amount of the credit available for all qualified buildings, (2) further increasing the credit for buildings more than 30 years old, and (3) providing a special increased credit for certified historic structures.

The current rehabilitation tax credit is flawed in several respects. First, the credits are embedded in a complicated matrix of tax rules which, taken as a whole, result in widely varying after-tax returns for investments in different types of assets. There is no evidence that the combined tax benefits granted to rehabilitators of older buildings, when compared to the tax benefits available to constructors or rehabilitators of newer buildings, are an appropriate incentive for investment in older buildings. Moreover, since the amount of the credit for any qualified rehabilitation is generally a function only of (1) the age of the existing structure, and (2) the cost of the rehabilitation, the incentive effects of the credit are not limited to investment in deteriorating areas, as opposed to modernization of older structures in stable areas.

In addition, the 25 percent credit for certified historic structures is effectively administered by an agency without budgetary responsibility for the revenue cost. The Secretary of the Interior is given sole authority to determine whether a structure meets the requirements for the credit, but the subsidy is not included in the Interior Department's budget. Thus, in determining the availability of the credit, the sole reviewing agency has no direct incentive to compare probable costs and benefits.

Proposal

The rehabilitation credit would be repealed.

Effective Date

Repeal would be effective for expenditures incurred on or after January 1, 1986. Expenditures incurred on or after the effective date would be aggregated with expenditures incurred prior to the effective date for purposes of determining whether the earlier expenditures were incurred in connection with a "substantial" rehabilitation.

Analysis

In the absence of investment tax credits for rehabilitation expenditures, the full amount of such expenditures would be recovered through normal cost recovery rules.

REPEAL SPECIAL RULES FOR BOOK, MAGAZINE, AND DISCOUNT COUPON INCOME

General Explanation

Chapter 12.02

Current Law

Magazine, Paperback, and Record Returns. An accrual basis taxpayer that distributes magazines, paperbacks, or sound recordings for resale may elect (irrevocably) to exclude from gross income for the taxable year certain amounts attributable to the sale of such items if the purchaser fails to resell the items and returns them within a specified period after the end of the taxable year (2-1/2 months in the case of magazines, and 4-1/2 months in the case of paperbacks and recordings). The exclusion applies only if, at the time of sale, the taxpayer has a legal obligation to adjust the sales price if the items are not resold, and the exclusion is limited to the amount of price reductions for returns that are actually made within the prescribed periods.

An election to take advantage of this exclusion triggers the application of special transitional adjustment rules designed to prevent the "bunching" of deductions in the first year of the election. In the case of an election relating to magazines, the decrease in income resulting from the bunching of deductions in the first year is spread over a five-year period. In the case of an election relating to paperbacks or records, however, the decrease is placed in a suspense account. Adjustments to this suspense account permit additional exclusions from income in subsequent taxable years only to the extent the taxpayer's adjustments from post-year returns decline over time. In general, the effect of the suspense account is to defer deduction of the transitional adjustment until the taxpayer ceases to be engaged in the trade or business of publishing or distributing paperbacks or records.

Redemptions of Qualified Discount Coupons. An accrual basis taxpayer that issues discount coupons with respect to merchandise marketed by unrelated retailers may irrevocably elect to deduct in the taxable year the cost of redeeming qualified coupons that are returned within six months after the end of the taxable year. A shorter period may be used at the taxpayer's election.

In the case of an election under this provision, the decrease in income resulting from the "bunching" of deductions in the first year is not allowed but is placed in a suspense account. Adjustments to this suspense account permit additional deductions in subsequent taxable years only to the extent the taxpayer's qualified discount coupon redemptions decline over time. If such redemptions do not decline, the suspended amounts may be deducted only when the taxpayer ceases to be engaged in the business.

Reasons for Change

The primary purpose of the special provisions for magazine, paperback, and record returns, and redemptions of qualified discount coupons, is to enable taxpayers to conform their tax accounting to their financial accounting. In both cases, the exclusion or deduction is designed to approximate decreases in adjusted gross income that would have accrued at the end of the taxable year if the amount of the taxpayer's price-adjustment or redemption obligation were known at that time.

On the other hand, there is a general standard for accrual of liabilities in the taxable year -- occurrence of all events sufficient to establish the existence and amount of the liability. The cases covered by the current rules do not satisfy this standard, since the events establishing the taxpayer's liability for the adjustment -- return of magazines, paperbacks, or records, or presentment of coupons -- have not occurred as of the end of the year.

Repeal of these rules would also simplify the tax code and would make it unnecessary to determine the correctness of taxpayers' claims that post-year price adjustments and redemptions are made pursuant to obligations or coupons that were outstanding prior to the end of the taxable year.

Proposal

The elections (a) to exclude from income certain adjustments relating to magazines, paperbacks, and record returns, and (b) to deduct costs of redeeming qualified discount coupons, would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986. Affected taxpayers would be permitted to deduct the balances of their suspense accounts or suspended amounts in the first taxable year in which the proposal is effective.

Analysis

Taxpayers would be adversely affected by repeal of these special accounting rules only to the extent of amounts prematurely deducted in prior years. Under the proposal, affected taxpayers would compute their income on the same basis as others using the accrual method. Adversely affected taxpayers also would gain a compensating benefit from the proposed general reductions in tax rates.

EXTEND AND MODIFY RESEARCH AND EXPERIMENTATION CREDIT

General Explanation

Chapter 12.03

Current Law

A 25 percent nonrefundable tax credit is allowed for the portion of a taxpayer's qualified research expenses which is equal to the lesser of (1) the excess of such expenses in the current year over the average amount of such expenses for the prior three years or (2) 50 percent of qualified research expenses in the current year. Special rules apply to aggregate qualified research expenses of certain related persons to ensure that the credit is available only for real increases in qualified research expenditures.

"Qualified research expenses" generally include only research and development costs in the experimental or laboratory sense. Qualified research expenses that are eligible for the credit include (1) expenses paid or incurred for qualified research conducted directly by the taxpayer, (2) 65 percent of any amounts paid or incurred to another person for qualified research (i.e., "contract research" expenses), and (3) in the case of corporate taxpayers, 65 percent of any amounts contributed to universities and other qualifying organizations for the conduct of basic research.

The credit is available only for research expenses paid or incurred in connection with an ongoing trade or business of the taxpayer. Employee wages are treated as qualified research expenses to the extent paid to an employee for engaging in (1) the actual conduct of qualified research, (2) the immediate supervision of qualified research activities, or (3) the direct support of such activities. Payments for supplies used in the conduct of qualified research and amounts paid for the right to use personal property in the conduct of qualified research also constitute qualified research expenses.

Expenses of (1) research conducted outside the United States, (2) research in the social sciences and humanities, and (3) funded research are specifically excluded from qualified research expenses eligible for the credit.

Credits that are not used in a taxable year may be carried back three years and forward 15 years. The credit will not be available for expenses paid or incurred after December 31, 1985.

Reasons For Change

The existing credit for research and experimentation activities is intended to create an incentive for technological innovation. The benefit to the country from such innovation is unquestioned, and there are reasonable grounds for believing that market rewards to those who take the risks of research and experimentation are not sufficient to support an optimal level of such activity. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

Although the credit for research and experimentation is justified in concept, the existing definition of eligible activities is overly broad. Some taxpayers take the view that the costs of any trial and error procedure are eligible for the credit even though there may be little doubt about the outcome of the procedure.

The definition of qualifying expenses for purposes of the credit should identify clearly those innovative research activities which merit government support. This definition also should incorporate standards that are sufficiently objective to permit taxpayers, in planning their activities, to determine with reasonable certainty whether the credit will be available. A definition that satisfies these two criteria would be more effective in encouraging taxpayers to undertake innovative research and experimental activities.

Proposal

The credit for increases in research and experimentation expenditures would be extended for an additional three years (until December 31, 1988), and the definition of qualified research would be revised to target those research activities likely to result in technological innovations.

Effective Date

The revised definition of qualified research would be effective for expenses paid or incurred after December 31, 1985.

Analysis

The definition of expenses qualifying for the research credit should target private research activities designed to lead to technological innovations in products and production processes. At the same time, the definition must be phrased in terms that permit taxpayers to know with reasonable certainty what research activities qualify for the credit.

A useful definition incorporating both principles is found in the Senate amendment to H.R. 4170 (enacted as the "Tax Reform Act of 1984"). Although the conference committee agreed to defer consideration of the research credit, the Senate definition targets technological innovation and provides taxpayers with relatively objective rules.

The Senate definition focuses on new or technologically improved products and processes and provides that research qualifies for the credit only if it relates to a process of experimentation encompassing the evaluation of alternatives that involve a serious degree of uncertainty as to whether the desired result can be achieved. This requirement is designed to ensure that the credit is available only for research activities intended to lead to technological innovation. In addition, the Senate definition excludes a number of activities, such as reverse engineering and debugging, that, by their nature, will not result in technological innovation.

Further refinements in the Senate definition, such as identifying additional exclusions from the scope of qualifying research, may be appropriate to ensure that the credit does not subsidize private research activities that are not innovative. In addition, the revenue loss resulting from the extension of the credit must be considered in redefining the scope of qualifying expenses.

Other legislative proposals, such as a separate credit for contributions to fund basic university research or an enhanced charitable deduction for contributions of scientific equipment to universities, are typically associated with the research credit. Although the Administration proposal does not address these related issues, they would be considered in the context of legislative efforts to extend the research credit.

REPEAL MERCHANT MARINE CAPITAL CONSTRUCTION FUND PROVISIONS

General Explanation

Chapter 12.04

Current Law

The Merchant Marine Act provides special tax treatment for U.S. citizens and domestic corporations owning or leasing certain vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. The vessel must have been constructed or reconstructed in the United States and must be documented under the laws of the United States.

In general, a taxpayer that qualifies for this treatment receives a deduction for amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. The deductible amount is limited to the portion of the taxable income of the owner or lessee that is attributable to the qualified operation of the vessel covered by the agreement ("eligible agreement vessel"). In addition, nondeductible deposits may be made up to the amount of depreciation on such vessel for the year. Earnings on all amounts in the fund are exempt from Federal income tax liability.

The tax consequences of a withdrawal from such a fund are determined by reference to three accounts. The capital account represents deposits that were not deductible as well as the fund's tax-exempt income (that is, income exempt from tax without regard to the fund's special exemption). The capital gain account represents accumulated net long-term capital gain income of the fund. The ordinary income account represents deductible deposits and accumulated taxable income of the fund (that is, income that would have been taxable if the fund were not exempt).

The tax treatment of a withdrawal depends on whether it is "qualified." A withdrawal is qualified if used to acquire, construct, or reconstruct "qualified agreement vessels," or barges and containers which are part of the complement of such vessels, in accordance with the terms of the applicable agreement, or to repay principal on debt incurred with respect to such acquisition, construction, or reconstruction.

A qualified withdrawal is not currently taxable, and is deemed to come first out of the capital account, then out of the capital gain account, and finally out of the ordinary income account (after the other accounts have been exhausted). Amounts withdrawn from the ordinary income or capital gain accounts reduce the taxpayer's basis in its investment in the qualified vessels (only in part in the case of capital gain account withdrawals). A taxpayer may, however, compute its investment tax credit with respect to a qualified vessel by including at least one-half of its qualified withdrawals in basis. Accordingly, the taxpayer is entitled to at least a partial investment tax credit on investments made with fund withdrawals, even though its basis attributable to withdrawals is zero for purposes of computing depreciation. A qualified withdrawal out of the ordinary income or capital gain account made to retire debt requires a reduction in the basis of vessels, barges, and containers owned by the person maintaining the fund.

Nonqualified withdrawals are deemed to come first out of the ordinary income account, then out of the capital gain account, and finally out of the capital account. A nonqualified withdrawal treated as made out of the ordinary income account must be included in taxable income. To the extent the withdrawal comes out of the capital gain account it is taxed as long-term capital gain; a withdrawal out of the capital account is not taxable. Interest on the tax liability attributable to the withdrawal is payable from the time for payment of tax for the year in which the item was deposited into the fund.

Reasons for Change

The current rules for taxation of merchant marine capital construction funds are a gross departure from generally applicable principles of taxation. The special rules generally exempt from tax earnings on deposits in such funds. Moreover, they permit an eligible taxpayer to expense capital investments made with fund withdrawals as well as claim an investment tax credit on an asset in which it has a zero basis.

The special tax treatment of capital construction funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs.

A national security justification for subsidies of U.S. maritime construction is today unclear. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of oceangoing cargo ships that would be available in any common emergency. Largely for this reason, direct appropriations for maritime construction (the construction differential and operating differential subsidies) are being phased out.

A similar fate is appropriate for the special tax rules applicable to capital construction funds. Even if a capital construction fund subsidy is justified, it would more appropriately be provided in the form of a direct spending or regulatory program that

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is subject to review by the congressional committees and agencies concerned with maritime policy. Basing such a subsidy in the tax laws complicates tax administration and has a differential impact on different taxpayers depending on their other tax attributes. A direct subsidy would be more straightforward and would reflect the costs of the subsidy in the budget of the appropriate agency. Such an approach would also avoid problems of coordination and excessive bureaucracy due to administration of a program by two agencies (the IRS and MARAD).

Similar considerations apply to the allowance of capital construction funds for fishing vessels. To the extent that a subsidy is justified for reasons relating to foreign competition, it would be better provided outside the tax system.

Proposal

The rules providing special tax treatment for capital construction funds would be repealed.

Effective Date

No further tax-free contributions to capital construction funds could be made after 1985, except with respect to qualified agreement vessels that the taxpayer owned on January 1, 1986, or qualified agreement vessels with respect to which the taxpayer had performed (or had caused to be performed) a substantial amount of construction or reconstruction before January 1, 1986. To the extent that fund assets exceeded amounts designated under the agreement to be used with respect to such qualified vessels, earnings on such excess attributable to the period after December 31, 1985, would be subject to tax. Any withdrawals from a fund on or after January 1, 1986, other than with respect to such qualified vessels, would be treated as nonqualified withdrawals, except that no interest charge would apply with respect to such withdrawals. Any amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time.

Analysis

Repeal of the special tax treatment for capital construction funds would promote neutrality by ensuring that capital investments are made only when justified by economic rather than tax considerations.

REPLACE POSSESSIONS TAX CREDIT WITH A WAGE CREDIT

General Explanation

Chapter 12.05

Current Law

Section 936 provides a special credit for certain income of qualifying corporations operating in Puerto Rico and possessions of the United States other than the Virgin Islands. A section 936 corporation is generally subject to tax on its worldwide income in a manner similar to any other U.S. corporation. However, it may claim a tax credit equal to the U.S. tax on business and qualified investment income from the possessions, regardless of whether any tax is paid to the government of the possessions. The effect of this treatment is to exempt from U.S. tax the income from business activities and qualified investments in the possessions and the income from disposition of a possessions business. (Rules having similar effect, but through a different mechanism, apply for the Virgin Islands.) All other income of section 936 corporations is taxed currently, subject to the usual credit for foreign taxes paid on foreign source income. To avoid a double credit against U.S. taxes, no credit is allowed under section 901 for foreign taxes paid on income subject to the section 936 credit, and no deduction is allowed for such taxes.

Any domestic corporation which elects to be a section 936 corporation may receive the section 936 credit if it satisfies two conditions. First, 80 percent or more of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, for tax years beginning after 1984 at least 65 percent of its income for that period must be from the active conduct of a trade or business within a possession (or possessions).

Puerto Rico has complemented the section 936 credit with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from tax certain passive income. The combination of the section 936 credit and the Puerto Rican incentives means that qualifying corporations pay little tax on their Puerto Rican-source income.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") made two changes designed to reduce the revenue cost of section 936 due to (a) the attempted allocation of intangible income to possessions in order to claim exemption for such income, and (b) the exemption of passive income. The problem of intangible income was addressed by adding a very complex set of allocation rules to section 936 for tax years beginning after 1982. The revenue cost of exempting passive income was addressed by increasing the active trade or business percentage requirement from 50 percent in 1982 to 65 percent in 1985.

As a rough corollary to section 936 (and to section 934(b) for Virgin Islands operations), section 957(c) provides that a corporation organized in a possession (including Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands) shall not be considered a controlled foreign corporation (the Subpart F income of which would otherwise be taxed currently to its controlling U.S. shareholders) if 80 percent of its gross income is derived from sources in the possession and 50 percent of its gross income is derived from the active conduct within the possession of certain specified trades or businesses.

Reasons for Change

The stated purpose of section 936 is to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." However, despite the fact that inflation-adjusted tax-exempt income of corporations which have elected the benefits of section 936 has more than doubled since 1972, employment levels (both overall and in the manufacturing sector) have been flat. The credit rewards generating income in the possessions; it provides no direct incentive to generating employment. Even after TEFRA, much of the benefit of the existing credit accrues to income of intangible assets which have been developed in the United States and attributed to a possessions corporation for purposes of determining possession-source income. As an example, for pharmaceutical companies operating in Puerto Rico, profits are frequently 60 percent of their sales.

The existing credit is very costly and inefficient. The average tax benefit per employee for all section 936 corporations was more than $22,000 in 1982, more than 50 percent more than the average wage of possessions corporations' employees of $14,210. Fourteen corporations received tax benefits in excess of $100,000 per employee. Those fourteen companies accounted for 4 percent of the section 936 corporations for which employment data was available and derived 29 percent of the combined tax benefits. (The fourteen companies accounted for 3 percent of all section 936 corporations and 26 percent of the total tax benefits of all such corporations.)

The TEFRA changes were designed to reduce the revenue cost and income distortions associated with this program. However, an examination of available 1983 returns (post-TEFRA), representing companies which claimed 25 percent of the possessions tax credits in 1982, indicates that the credit claimed in 1983 actually increased slightly, rather than declining sharply as had been expected, even though the previously predicted decline in cost had taken expected growth into account. This increase in the possessions credits is particularly disturbing because it took place when there appears to have been a substantial decline in qualified interest income, due to the decline in average interest rates in 1983 and to repatriation of earnings by the companies. In the absence of the decline in interest income, the credits would have increased much more.

Moreover, the TEFRA changes are exceedingly complex. As a result, they will be very difficult for the IRS to administer.

In addition, there remains no direct incentive under current law to increase employment in the possessions; the incentive continues to be to attribute income to the possessions. Even with the TEFRA rules, section 936 fails to provide any incentive to increase employment or economic activity in the possessions beyond the minimum business presence required to qualify for the special income allocation rules introduced by TEFRA.

The exemption from controlled foreign corporation status available to possession-chartered corporations under section 957(c) is similarly poorly targeted to the creation of employment-producing investments in the possessions. That provision permits the exemption of tax-haven income from the Subpart F classification without any significant justification.

Proposal

The current income-based credit would be repealed and replaced by a permanent wage credit. A U.S. corporation could elect a wage credit equal to 60 percent of wages, up to the Federal minimum wage amount, paid to persons employed in the possessions by an establishment engaged in manufacturing, plus 20 percent of such wages paid above the Federal minimum wage amount, subject to an overall wage cap per employee of four times the Federal minimum wage amount. Corporations electing the wage credit would be required to reduce their otherwise allowable deduction for wages paid by the amount of the wage credit claimed. At the present annual minimum wage amount of $6,968, and with a 33 percent corporate tax, the maximum net credit would be $5,602 per employee (67 percent of the maximum gross credit of $8,362).

The wage credit could be used to offset the U.S. tax on any income, without regard to whether such income may have arisen from sources in a possession. The credit would not be refundable, but could be carried forward for 15 years. United States corporations with manufacturing operations in the Virgin Islands would be entitled to elect the wage credit on the same basis as U.S. corporations with operations in any other eligible possession. Thus, the parity that exists under current law between U.S. corporations doing business in the Virgin Islands and those doing business in other possessions would continue.

Corporations electing the wage credit would not be entitled to claim a foreign tax credit for taxes paid to the possessions, but they would be allowed a deduction for such taxes, regardless of whether they otherwise claim a credit for taxes paid to other countries. This rule allowing a deduction for possessions taxes and a foreign tax credit for other foreign taxes compensates for the denial of the foreign tax credit for possessions taxes and is consistent with the approach taken under the proposed per-country limitation on the foreign tax credit. Also, for possessions corporations that elect the wage credit rather than the foreign tax credit for possessions taxes, the introduction of the per-country limitation eliminates any need that might otherwise arise to adopt special rules for possessions-source income to prevent such corporations from using that low-tax income to increase their foreign tax credit limitation on other categories of income.

Dividends paid by corporations electing the wage credit would be subject to the general rules with respect to dividends-received deductions for dividends from U.S. corporations. The electing corporations would be required to be included in the consolidated tax returns filed by affiliated corporations, thereby effectively achieving the equivalent of a 100 percent dividends-received deduction.

Section 957(c) would be repealed, thereby eliminating the deferral of U.S. tax on the Subpart F income of possessions-chartered corporations that fall into the category of controlled foreign corporations.

For purposes of applying the rules of the proposed Capital Cost Recovery System ("CCRS") to property purchased by a domestic corporation on or after January 1, 1986 and used predominantly in a U.S. possession, such property would be treated as foreign property only to the extent such corporation elects to claim the benefits of the income-based credit under section 936, as that section currently applies, during the grandfather period described below.

Effective Date

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. However, corporations which have validly elected possessions corporation status for a taxable year beginning before January 1, 1986 would be entitled to grandfather protection. Such corporations would be allowed to continue to use the existing income-based credit for their first five taxable years beginning on or after January 1, 1986, but only with respect to products which they had validly designated as possessions products for their last taxable year beginning before January 1, 1986. (If they had validly elected possessions corporation status but had not designated a possessions product, they would be allowed to use the income-based credit during the grandfather period only with respect to products which they were "manufacturing" in the same possession during their last taxable year beginning before January 1, 1986, as determined in a manner similar to the significant business presence test transition rules in the proposed section 936(h) regulations issued after TEFRA.) In addition, such corporations could continue to use the income-based credit during the grandfather period with respect to qualified possessions-source investment income from such grandfathered activities and from their existing qualifying passive investments. Existing possessions corporations could elect to claim either the wage credit or the current section 936 credit during the grandfather period, but once they have elected the wage credit they could not return to use of the income-based credit. Related corporations operating in the possessions would not be permitted to make different elections.

Domestic corporations doing business in the Virgin Islands which have validly qualified for the benefits of section 934(b) for their last taxable year beginning before January 1, 1986 would be entitled to elect to use the income-based credit during the five-year grandfather period to achieve exemption of their qualifying Virgin Islands-source income from U.S. taxation under rules similar to those applying to existing possessions corporations.

The repeal of section 957(c) would apply to taxable years of possessions-chartered corporations beginning on or after January 1, 1986 and to taxable years of U.S. shareholders within or with which these taxable years of the possessions-chartered corporations end. For purposes of applying the controlled foreign corporation rules to such corporations, earnings and profits for taxable years beginning before January 1, 1986 and property acquired before January 1, 1986 would be excluded from the operation of the controlled foreign corporation provisions.

Analysis

The current system is complicated, expensive, and inefficient. The rules for determining possessions source income are among the most complex in the tax law. Because section 936 is not targeted toward increasing employment, the average revenue cost per job has exceeded 150 percent of the average total compensation per employee of section 936 corporations, without producing any clearly identifiable and readily measurable improvement in employment levels. Furthermore, the TEFRA changes do not appear to have limited the level of credits claimed to any significant extent.

The Administration recognizes its special obligations toward, and supports the goal of encouraging increased employment and economic growth in, the possessions. The Administration also recognizes a special interest in the economic health of the Caribbean region. Thus, notwithstanding the inefficiency of the present system, a subsidy is maintained for operations in the possessions. The subsidy for the possessions would be restructured as a wage credit, however, for the reasons discussed herein. The Administration is aware of the proposals being developed by interested parties that seek better to benefit Puerto Rico and countries participating in the Caribbean Basin Initiative. It is recognized that there may be other ways to encourage employment in the possessions in a cost-effective way, or that there may be ways to restructure the wage credit to make it more efficient. The Administration looks forward to receiving further comments and suggestions in this regard from the governments of the possessions and other interested persons.

The objective of the proposal is to encourage employment in the possessions in a cost-effective way. The simplest and most direct and efficient way to do so is through a wage subsidy. The proposed credit is permanent, to provide an ongoing incentive to investors.

The proposed wage credit is more generous than it may at first appear. The amount of the credit is 60 percent of the annual Federal minimum wage plus 20 percent of wages above that level up to the ceiling amount of four times the annual Federal minimum wage. The proposed formula for the wage credit primarily offsets the costs of employing a worker at the Federal minimum wage level, but it also gives corporations an incentive to employ more highly skilled, highly paid workers, thereby encouraging the development of a technology-oriented labor force in the possessions. Linking the credit to the minimum wage also provides an element of automatic indexing when that amount is adjusted for inflation. At the current minimum wage level and with a 33 percent corporate rate, the maximum net credit per employee (after reducing the deduction for wages paid by the amount of the credit) is $5,602, that credit would eliminate the tax on $16,975 of taxable income per employee. In 1983 the pre-tax corporate profit per employee in U.S. manufacturing was about $3,600. Even assuming a substantial increase since then as a result of the economic recovery, the availability of a wage credit of the type proposed would have meant a very large increase in the after-tax return on capital. For example, after-tax profits would have much more than doubled in the electronics, instruments, fabricated metals and food industries and would have significantly increased even in the chemical and allied products industries. This result is not surprising, considering the importance of labor costs in manufacturing. For U.S. manufacturing, labor compensation accounts for 70 percent of the value-added on average, somewhat less (about 60 percent) in the manufacture of nondurable goods and somewhat more (nearly 80 percent) in the manufacture of durables. Thus, the proposal should be attractive to a broad class of industries. At the same time, the grandfather protection and the wage credit's extra incentive for highly paid workers should make it attractive to existing companies as well.

Another way in which the proposed credit is generous is that it may be used to offset U.S. tax on any income (including income of affiliated companies filing as a consolidated group). Thus, the benefit is not limited to companies able to generate large profits in the possessions. Even an operation in a possession with a relatively low profit margin would provide tax benefits to a company with other taxable income. This aspect of the proposal will also simplify present law. Any U.S. corporation may elect the credit and may use it to offset U.S. tax on any income; the excessively complex eligibility tests and income allocation rules will no longer be necessary.

Despite the problems inherent in the existing law, the Administration recognizes that the proposed wage credit may be less attractive than the existing income-based credit for certain corporations, primarily those in industries such as pharmaceuticals and electronics which have lower than average employment levels and higher intangible income, and that immediate repeal of the existing credit could cause undesirable short-term economic dislocation in the possessions. The proposed grandfather protection is designed to allow existing firms a generous transitional period to recover their existing investments and restructure their operations. Available data indicate that possessions corporations are able to recover their investments quickly under existing law. For example, in 1982 the ratio of pre-tax operating income to operating assets (including inventories and net accounts receivable as well as property, plant and equipment) was 57 percent for all possessions corporations, this implies that that investments can be fully recovered in about 1 3/4 years. For pharmaceuticals and the electrical and electronic industries, the ratios were 79 and 68 percent, respectively, which imply a recovery periods of about 1 1/4 years for pharmaceuticals and about 1 1/2 years for the electrical and electronic firms. Accordingly, the five-year period should be more than adequate to allow tax-free recovery of investment in existing assets. In addition, a grandfather period of any longer than five years would heighten the need for a re-examination and amendment of the income allocation rules of the existing section 936 to reduce existing abuses during the transition period.

The banking sector of the possessions' economies currently benefits from that aspect of the income-based credit which exempts qualifying possessions-source investment income from tax. Available data indicate, however, that the accumulation of section 936 funds has had little positive impact on real investment in the possessions. The proposal would have little adverse impact on the Puerto Rican banking system, even in the absence of the grandfathering provision, due to the system's high liquidity.

REVISE RULES FOR LEVERAGED ESOPS

General Explanation

Chapter 12.06

Current Law

An employee stock ownership plan ("ESOP") is a qualified retirement plan designed to invest primarily in employer securities. Such plans generally are either "tax credit ESOPs" or "leveraged ESOPs." Both types of plans receive significant tax subsidies.

A corporate employer is entitled to a tax credit for contributions to a tax credit ESOP of cash or employer securities not in excess of 0.5 percent of the compensation paid or accrued with respect to employees participating in the ESOP. The employer also receives a tax credit for the costs of establishing and administering the plan, within certain limits.

In a leveraged ESOP, the plan borrows to purchase employer securities and the corporation obligates itself to contribute amounts sufficient for the ESOP to make payments on the debt. The employer generally may deduct these contributions to the ESOP currently without regard to the limits on employer contributions to other types of qualified plans. A special exception to the prohibited transaction rules applicable to qualified plans permits a sponsoring corporation and its ESOP to engage in this transaction if the loan is primarily for the benefit of participants and certain other requirements are satisfied.

Employees are not taxed on employer contributions to an ESOP or accumulated income of the trust until securities are distributed. A tax credit ESOP must hold employer securities for at least seven years before the securities can be distributed to employees; a leveraged ESOP generally must hold employer securities for at least two years before they can be distributed to employees. Typically, however, in both types of plans, participants do not receive a distribution of securities until they separate from service. When a distribution is made, the participant may "put" the securities to the employer and receive cash, unless the securities are traded on an established exchange.

An ESOP must pass through voting rights on employer securities allocated to the accounts of participants; this requirement, however, is substantially limited if the employer has no registration-required class of securities. An ESOP may pass dividends through to participants on shares allocated to participants' accounts; dividends on unallocated shares are retained by the trust.

Congress provided certain additional incentives for employee ownership through qualified plans in the Tax Reform Act of 1984: (1) banks, insurance companies and other commercial lenders may exclude half of the interest paid or accrued on a loan used by a leveraged ESOP to purchase qualified securities; (2) corporations may deduct dividends actually paid to employees with respect to employer stock held in an ESOP and allocated to participants' accounts; (3) taxpayers are permitted to sell securities in a corporation to an ESOP or eligible worker-owned cooperative, purchase securities in a second corporation and defer recognition of gain on the sale; and (4) an ESOP may assume the estate tax liability of a decedent if the decedent's securities are transferred to the ESOP.

Reasons for Change

Many argue that employees who own stock in their employer are more productive because, as part owners of the business, they have a stake in seeing the enterprise become more profitable. Current law has in many respects embraced this argument, since it contains a variety of provisions aimed at encouraging employee ownership. Despite the intentions behind such provisions, they represent a confused mix of incentives and requirements which fails to encourage direct employee ownership.

Employee ownership of employer securities through a qualified plan defers significant incidents of ownership for employees until distribution of the securities. In most ESOPs, employees must wait until they separate from service before they receive a distribution. Furthermore, since employees are entitled to put nontraded securities to the employer following distribution, employees may never directly own any employer securities despite years of participation in an ESOP.

ESOP participants receive only a small portion of the dividends paid on the employer securities that are eventually distributed to them. This results from the fact that an ESOP may pass through dividends only with respect to shares actually allocated to the participants' accounts. Similarly, voting rights with respect to employer securities are passed through to participants only in limited circumstances and only with respect to shares allocated to participants' accounts.

To the extent the full benefits of owning employer securities are deferred for ESOP participants, the intended incentive for employee ownership is diminished. Indeed, if participation in the ESOP is in lieu of current compensation, such deferral may actually lessen employees' overall incentive to increase productivity.

Finally, ESOPs should be recognized and treated as vehicles to encourage employee ownership rather than as an alternative form of qualified retirement plan. Relying on ESOPs to provide retirement benefits is poor retirement policy. Qualified retirement plans are generally required to invest in a diversified portfolio to insure that anticipated benefits will be available when a participant retires. A retirement benefit entirely dependent on market fluctuations in a single, often unmarketable asset provides an employee little certainty that adequate retirement security will be provided. This concern is particularly acute where employers reduce or eliminate contributions to pension or profit sharing plans because of required contributions to an ESOP. In addition, applying to ESOPs the rules for qualified retirement plans, such as vesting requirements and contribution and distribution limits, unnecessarily restricts the ability of an employer to provide the benefits of owning employer securities to its employees.

Proposal

The tax credit for contributions to an ESOP would be permitted to expire as scheduled and the special deduction limits for contributions to leveraged ESOPs would be repealed. Also, the special exception to the prohibited transaction rules for leveraged ESOPs would be repealed.

An employer with 15 or more employees that borrows funds from an unrelated lender to purchase outstanding "employer securities" with a fair market value equal to the principal amount of the loan would be permitted to deduct principal payments made each year with respect to the indebtedness provided that (1) the employer contributes the securities to an "employee stock ownership trust" and (2) the loan agreement requires either (i) annual principal payments not greater than 20 percent or less than 8.3 percent of the original principal balance or (ii) equal annual payments and a term of ten years or less. In addition, an employer would be precluded from deducting principal payments for any year in excess of 25 percent of eligible employees' aggregate compensation for such year. Nondeductible payments would be deductible in a subsequent year, subject to the same 25 percent limit. For this purpose, "employer securities" would constitute either the stock of the employer or of any related corporation which is traded on an established securities exchange or, if no stock of the employer or of any related corporation is so traded, the securities of the employer or of any related corporation having the greatest voting and dividend rights. The employer would be required to employ an independent fiduciary to value nontraded employer securities.

The employee stock ownership trust generally would be required to distribute annually a portion of the securities held by the trust (in proportion to the scheduled principal repayments for the year) as well as dividends paid during the year on securities held by the trust. Alternatively, the trust agreement could provide that the trust would retain nominal ownership of the employer securities allocated to employees; a trust agreement so providing, would be required to provide employees with all rights of direct ownership in the securities, including the right to dividends paid with respect to the securities, the right to vote and the right to transfer the securities.

In addition, the trust agreement for an employee stock ownership trust would be required to provide that the securities distributed or allocated during a year and dividends on undistributed securities be apportioned among employees on the basis of each employee's compensation for the year not in excess of $50,000. The trust agreement could provide that only employees with at least 1,000 hours of service during the year would receive a distribution or allocation of securities or dividends on unallocated securities. The trust agreement would also be required to provide that employees be able to vote unallocated securities with respect to a corporate matter requiring more than a majority vote of outstanding employer securities; the trustee could grant the right to vote unallocated securities in such cases to employees eligible to receive distributions from the trust in any reasonable manner. In addition, the trustee of the trust holding the employer securities would be subject to the fiduciary responsibility provisions of Title I of ERISA.

Employees would realize no income on the distribution or allocation of securities from an employee stock ownership trust. Employees could freely enter into voting trust arrangements or buy-sell agreements with respect to such securities, but the employer could not impose any restrictions on the exercise of voting rights or transferability of the securities. The employer would be required to grant employees the right to put distributed or allocated securities to the employer at their fair market value three years after receipt or allocation of the securities; the put right would be required to be available during a specified period every year thereafter (through the year following separation from service). Upon sale or disposition of securities, employees would recognize income equal to the full amount of the proceeds from the sale or disposition; the portion of such proceeds not in excess of the employer's principal payments with respect to the stock would be characterized as ordinary income, and the excess would be capital gain.

The current rule allowing deferral of gain on a sale of employer securities to an ESOP or eligible worker-owned cooperative would be retained, but would be revised to permit deferral of gain only on sales of employer securities to an employee stock ownership trust. The exclusion of one-half of the interest paid on a loan used by a leveraged ESOP to purchase employer securities would be retained, but revised to apply to loans to employers in connection with an employee stock ownership trust. The current rule permitting a deduction for dividends paid on stock held in an ESOP would be retained, but revised to require an employer to make an additional nondeductible payment to any employee who receives a dividend with respect to employer securities distributed or allocated to the employee. This additional payment would be an amount equal to the tax saving available to the employer for the taxable year on account of the deductible dividend. The provision permitting an ESOP to assume certain decedents' estate tax liabilities would be repealed.

Effective Date

An employer's deduction for ESOP contributions with respect to securities acquisition loans outstanding on December 31, 1985, and the status of such loans under the prohibited transaction rules would continue to be governed by current law. See Ch. 14.03. The repeal of the rule relating to the assumption of estate tax liability would apply beginning January 1, 1986.

The proposal for an employee stock ownership trust would apply to securities acquisition loans made on or after January 1, 1986. The amendment to the dividends paid deduction would apply to dividends paid on or after January 1, 1986. The amendment of the interest exclusion would apply to loans made on or after January 1, 1986.

Analysis

The proposal is designed to provide a subsidy equivalent to that provided under current law for leveraged ESOPs, but in a manner that will encourage direct ownership by employees. Under current law, an employer is entitled essentially to a current deduction for principal payments on a loan used to acquire employer securities, while an employee is generally not required to include such amounts in income until he or she receives a distribution from the ESOP, usually upon retirement or other separation from service. Under the proposal, the employer would be entitled to claim current deductions for principal payments, but employees, while receiving the employer securities as the loan is repaid, would recognize no income until the securities are sold.

Tax subsidies for employee ownership should encourage direct ownership of employer stock. Direct ownership of employer securities, with the attendant rights and benefits, is far more likely to be an incentive for employee productivity than a speculative benefit to be realized only upon separation from service. Moreover, employees are fully capable of exercising all of the rights of direct stock ownership, including the right to vote and to determine whether to dispose of or hold employer securities.

The tax law should not foster arrangements, such as those existing under current law, which purportedly vest the incidents of ownership of employer securities in employees, but which actually defer and, in certain respects, deprive employees of the rights and responsibilities of stock ownership. For example, if one of the goals of tax incentives for employee ownership is to give employees some voice in the affairs of the employer corporation, employees must be entitled to vote the shares which have been allocated to them. To vest this right in a third party, such as the trustee of an ESOP (who may be an officer of the employer), deprives employees of a valuable right of stock ownership.

Similarly, if an employer chooses to compensate employees by giving employees shares of its stock, employees should receive the benefits of owning the stock currently, including the right to decide whether the employer securities are an appropriate investment, rather than being required, as under current law, to maintain an investment in the employer through the ESOP. If ownership of employer securities is a sound investment, the employees will readily agree to continue that tax deferred investment and work to enhance its value. On the other hand, if the employer stock is a bad investment, employees should enjoy the same freedom to dispose of it as any other rational investor. Employees are poorly served where the tax law overrides their own judgments.

The proposal is also designed to remove the subsidy for employee ownership from the requirements applicable to qualified retirement plans. These requirements are needlessly restrictive in the context of an incentive for employee ownership. Moreover, benefits provided in the form of employer securities should not be viewed as a substitute for plans established to provide a more secure retirement benefit.