

APPENDIX A

EXPIRING PROVISIONS

The following provisions of the Internal Revenue Code are scheduled to expire under current law:

	<u>Administration Proposal</u>
1. Residential and business energy tax credits.	See Ch. 9.01
2. Targeted jobs credit.	Allow to expire as scheduled.
3. Expensing of expenditures to remove architectural barriers to the elderly and handicapped.	Allow to expire as scheduled.
4. Credit for testing orphan drugs.	Allow to expire as scheduled.
5. Special treatment for dividend reinvestment in public utility stock.	Allow to expire as scheduled.
6. Exclusion of employer-provided legal services.	Make permanent, but require a qualified group legal services plan to require the irrevocable establishment of the employee's annual contributions prior to the beginning of the plan year.
7. Exclusion of employer-provided education assistance.	Make permanent, and drop the \$5,000 annual limit of current law on the amount of educational assistance benefits that can be excluded.
8. Exclusion of employer-provided vanpooling.	See Ch. 3.03.

APPENDIX B

EFFECTIVE DATES AND TRANSITION RULES

The Administration proposals are designed to provide for fair and orderly transition to a new tax system. In general, prompt implementation of the proposals is desirable in order to capture their benefits as quickly as possible. Immediate implementation of some proposals, however, would be unfair and disruptive to taxpayers who have made economic commitments based on the current tax structure. Moreover, certain of the proposals would generate substantial windfall gains or losses if implemented immediately. These concerns mandate transition rules that reflect the differing effects of the various proposals.

In those areas where immediate implementation of the proposals would be unfair or disruptive, transition rules are provided to minimize unanticipated effects. These rules include delayed and phased in implementation of reform, as well as a wide variety of grandfather provisions that insulate existing investments. The proposed changes and transition rules for each element of the Administration proposals are summarized in Table B-1. More complete statements are found in each General Explanation.

In general, consistent with Secretary of the Treasury James A. Baker, III's February 27, 1985, testimony before the House Ways and Means Committee, no Administration proposal contains an effective date before January 1, 1986. Even though not effective until 1986, many of the proposals would affect the tax treatment of investments contemplated before 1986. Thus, for example, the new rules for capital cost recovery and repeal of the investment tax credit are proposed to be effective for all property placed in service after 1985, without regard to contractual commitments to acquire such property entered into before 1986. In recognition of the prerogative of the congressional tax-writing committees to design appropriate transition rules, grandfather rules were not specified in this and similar instances. Announcement of a binding contract exception effective as of the date of announcement of the Administration proposals would have encroached on this congressional prerogative; announcement of a binding contract exception to take effect at a future date was considered inappropriate because it would tend to accelerate investments solely for tax reasons.

With respect to life insurance inside build-up and the taxation of deferred annuity investment income, the Administration proposals adopt the rule suggested in the March 15, 1985, statement by House Ways and Means Committee Chairman Dan Rostenkowski and Senate Finance Committee Chairman Bob Packwood. That is, such income would be taxed,

beginning January 1, 1986, only on policies issued after the date of committee action. This rule again defers to the tax-writing committees with respect to the termination date of the grandfather period.

The Treasury Department looks forward to working with the congressional committees to develop any additional transition rules that the committees determine are necessary to implement the Administration proposals in a fair and orderly manner.

Table B-1

PROPOSED CHANGES, EFFECTIVE DATES AND TRANSITION RULES

Proposed Changes

Effective Dates and Transition Rules

I. INDIVIDUAL INCOME TAXES

1. Reduce Marginal Tax Rates

- 1.01 Reduce rates and collapse present 15 tax rates for single taxpayers and 14 tax rates for married taxpayers and heads of households into 3 rates of 15, 25 and 35 percent.

The proposed rates would be effective July 1, 1986. Thus, the rate schedule for taxable years beginning on or after (TYBOA) January 1, 1986, would reflect blended rates; withholding to reflect the rate reduction would change on July 1, 1986.

2. Increase Fairness for Families

- 2.01 Increase ZBAs and personal exemption.
- a. Increase the Zero Bracket Amounts from \$2,480 to \$2,900 for single filers, from \$2,480 to \$3,600 for heads of households, and from \$3,670 to \$4,000 for joint filers (in 1986 dollars).
- b. Increase personal exemption from \$1,080 to \$2,000 (in 1986 dollars).
- 2.02 Fold additional exemptions for the blind and elderly into an expanded credit for the elderly, blind and disabled, and make all taxable disability income eligible for the credit.
- 2.03 Repeal deduction for two-earner married couples.
- 2.04 Increase and index the Earned Income Tax Credit.
- 2.05 Replace child and dependent care credit with a deduction from gross income with the same cap (\$2,400 for one child, \$4,800 for two or more children).

TYBOA 1/1/86.

TYBOA 1/1/86.

TYBOA 1/1/86, with credit applying to workers' compensation and black lung disability payments only as these become taxable (generally, 1/1/87).

TYBOA 1/1/86.

TYBOA 1/1/86.

TYBOA 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

3. Make the System More Neutral and Fair

A. Excluded Sources of Income--Fringe Benefits

3.01 Include a limited amount of employer-provided health insurance in taxable income (\$300 per year for family coverage, \$120 per year for individual coverage).

Applies to employer contributions received in TYBOA 1/1/86.

3.02 Repeal \$5,000 exclusion for employer-provided death benefits.

Applies to benefits paid due to deaths occurring on or after 1/1/86. For collectively bargained plans, applies to years beginning after the earlier of 1/1/89 or the termination of collective bargaining contract.

3.03 Repeal exclusion for employer-provided commuting services.

Allow to expire for TYBOA 1/1/86.

3.04 Establish a uniform nondiscrimination rule for all fringe benefit plans.

Applies to all non-health care fringe benefit plan years beginning on or after 1/1/86 and to health care plan years beginning on or after 1/1/87. For all collectively bargained plans, applies to plan years beginning after termination of collective bargaining contract.

3.05 Repeal exclusion for employee awards.

Applies to awards received in TYBOA 1/1/86.

B. Excluded Sources of Income--Wage Replacement Payments

3.06 Repeal exclusion for unemployment and disability payments.

a. Repeal tax-exempt threshold for unemployment insurance compensation.

Applies to unemployment compensation received in TYBOA 1/1/87.

b. Repeal tax exemption for workers' compensation and black lung disability payments, but make all such income eligible for the expanded credit for the elderly, blind and disabled.

Applies to workers' compensation received in TYBOA 1/1/87 for disabilities occurring on or after 1/1/87, and applies to black lung disability payments received in TYBOA 1/1/87.

Proposed Changes

Effective Dates and Transition Rules

C. Excluded Sources of Income--Other

3.07 Repeal exclusion for scholarships and fellowships in excess of tuition.

Applies to scholarships and fellowships received in TYBOA 1/1/86. However, if binding commitment to grant a scholarship or fellowship in the case of a degree candidate was made before 1/1/86, it would be excluded through 1990.

3.08 Repeal exclusion of prizes and awards.

Applies to prizes and awards received in TYBOA 1/1/86.

D. Preferred Uses of Income

3.09 Repeal itemized deduction for state and local taxes.

TYBOA 1/1/86.

3.10 Accelerate expiration of deduction for charitable contributions for non-itemizers.

TYBOA 1/1/86.

E. Tax Abuses--Mixed Business/Personal Use

3.11 Deny deduction for all entertainment expenses, including club dues and tickets to public events, except for business meals furnished in a clear business setting. For business meals, deny deduction for one-half of cost of meal above \$25 per meal per person.

TYBOA 1/1/86.

3.12 Limit deduction for travel expenses.

a. Establish bright-line rule to separate indefinite and temporary assignments at one year.

TYBOA 1/1/86.

b. Deny deduction for travel as a form of education.

TYBOA 1/1/86.

c. Deny deduction for seminars held aboard cruise ships.

TYBOA 1/1/86.

d. Deny deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above the cost of otherwise available business transportation (with medical exception).

TYBOA 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

F. Tax Abuses--Income Shifting

- 3.13 Tax unearned income of children under 14 at the parent's rate; the child's personal exemption could be used first against such income. TYBOA 1/1/86.
- 3.14 Revise grantor and non-grantor trust taxation.
- a. Revise grantor trust rules to eliminate the shifting of income to lower rate beneficiaries through trusts in which the grantor retains an interest. TYBOA 1/1/86, but if classification of existing irrevocable trust changes from a grantor to a non-grantor trust, may elect to be treated as grantor trust.
- b. During grantor's lifetime, tax trusts at the grantor's tax rates and allow deductions only for non-discretionary distributions and set-asides. After grantor's death, tax all undistributed trust or estate income under a graduated rate schedule. TYBOA 1/1/86, but irrevocable non-grantor trusts created before 1/1/86 can keep fiscal year if elected by 1/1/86, deduct all distributions, and use the tier system.
- 3.15 Revise income taxation of estates. Applies to estates of decedents dying on or after 1/1/86.

4. Reduce Recordkeeping and Complexity

- 4.01 Combine miscellaneous itemized deductions with employee business expenses and itemized state and local taxes (other than income taxes) incurred in an income-producing activity and allow a deduction for such expenses if they exceed 1 percent of adjusted gross income. TYBOA 1/1/86.
- 4.02 Repeal political contribution credit. TYBOA 1/1/86.
- 4.03 Repeal presidential campaign check-off. Effective for tax liability with respect to TYBOA 1/1/86.
- 4.04 Repeal deduction for adoption expenses for children with special needs, and replace with a direct expenditure program. TYBOA 1/1/87, but allow continued deduction for qualified expenses incurred after 1/1/87 by taxpayers who incurred qualified expenses before 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

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| 4.05 | Repeal income averaging. | TYBOA 1/1/86. |
| 4.06 | Simplify penalty provisions. | |
| a. | Simplify information return penalties. | Applies to returns due on or after 1/1/86. |
| b. | Repeal maximum limits on penalties. | Applies to returns due on or after 1/1/86. |
| c. | Replace failure-to-pay penalty with a cost of collection charge. | Applies to returns due on or after 1/1/86. |

5. Simplify the System of Filing

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| 5.01 | Implement a non-filing system, in which IRS would compute taxes for many tax payers. | Unspecified. |
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II. BUSINESS AND CAPITAL INCOME TAXES

6. Revise the Taxation of Corporate Income

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| 6.01 | Reduce corporate income tax rates. | |
| a. | Reduce maximum corporate rate to 33 percent. | Effective 7/1/86. |
| b. | Revise graduated corporate rate structure. | Effective 7/1/86. |
| 6.02 | Reduce double taxation of distributed corporate earnings by allowing a 10 percent dividends-paid deduction. Allow 90 percent intercorporate dividends-received deduction. | Effective 1/1/87. Qualified Dividend Account includes taxable income only for TYBOA 1/1/87. |
| 6.03 | Repeal \$100/\$200 exclusion of dividend income. | TYBOA 1/1/86. |

Proposed Changes

Effective Dates and Transition Rules

7. Revise Taxation of Business Property and Capital Assets

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| 7.01 | Adopt a new capital cost recovery system (CCRS) which indexes depreciation allowances for inflation and adjusts depreciation schedules. | Effective for property placed in service on or after 1/1/86. |
| 7.02 | Repeal investment tax credit. | Effective for property placed in service on or after 1/1/86. |
| 7.03 | Revise tax treatment of capital gains. | |
| a. | Allow individuals a 50 percent exclusion for capital gains; retain 28 percent rate for corporations. | Effective for assets sold on or after 7/1/86. |
| b. | Tax gains on depreciable assets (which will have indexed basis) as ordinary income. Repeal capital gains treatment of livestock and unharvested crops (see 9.04 for changes in treatment of timber, coal and iron ore). | TYBOA 1/1/86, with grandfathering for assets placed in service before 1/1/86. |
| c. | Allow an indexing option as an alternative to the 50 percent exclusion on non-depreciable capital assets beginning 1/1/91. | Effective for assets sold on or after 1/1/91. |
| 7.04 | Allow indexed-FIFO and repeal LIFO conformity requirement. | TYBOA 1/1/87. |
| 7.05 | Retain expensing of the first \$5,000 of depreciable business property but repeal currently scheduled increases in the \$5,000 limit. | No change in current law, except that scheduled increase in \$5,000 level would be eliminated. |
| 7.06 | Repeal rapid amortization rules. | |
| a. | Repeal five-year amortization of trademark expenses, certified pollution control facilities, and rehabilitation of low income housing. Repeal 50 year amortization of qualified railroad grading and tunnel bores. Repeal expensing of certain soil and water conservation and preparation expenditures. Repeal seven-year amortization of reforestation expenditures. | Effective for expenditures paid or incurred on or after 1/1/86. |

Proposed Changes

Effective Dates and Transition Rules

- b. Delete expired rules permitting five-year amortization of qualified child care facilities and railroad rolling stock.
- 7.07 Apply a rate reduction recapture rule to depreciable assets placed in service between 1/1/80 and 12/31/85; the rule specifies an income inclusion that will prevent the benefit which would otherwise occur due to accelerated depreciation deductions taken at high pre-reform tax rates when the associated deferred tax liability is repaid at low post-reform tax rates.
8. Measure Income Properly
- 8.01 Revise accounting rules for production costs of multiperiod production, including all cost-plus contracts.
- 8.02 Recognize gain on pledges of installment obligations when receivables are pledged, with exception for certain short-term receivables.
- 8.03 Limit use of cash method of accounting.
- 8.04 Repeal reserve method for bad debt deductions, and limit deductions to actual loan losses.
- 8.05 Repeal mining and solid waste reclamation and closing cost deduction.
9. Revise Taxation of Energy and Natural Resources
- 9.01 Repeal energy tax credits.
- a. Terminate (or allow to expire) energy investment tax credits.
- Repeal as deadwood.
- 12 percent of the income inclusion would occur in 1986, 12 percent in 1987 and 16 percent in 1988.
- Effective for expenses and interest paid or incurred on or after 1/1/86. Old rules apply to long-term contracts entered into before 1/1/86. Production costs (including interest) attributable to timber planted before 1/1/86 that are not capitalized under present law would be capitalized under 10-year phase in (10 percent of such costs capitalized in 1986, 20 percent in 1987, etc.). Inventory change would begin TYBOA 1/1/86, with income increase due to change spread evenly over up to 6 years. The new rules would not apply to self-constructed assets where substantial construction had begun before 1986.
- Effective for installment notes pledged as security after 1985. As of 1/1/91, applies to installment notes pledged before 1986.
- TYBOA 1/1/86, with income increase due to change spread evenly over up to 6 years.
- TYBOA 1/1/86, with draw down of existing reserves includable in taxable income ratably over 10 years.
- Effective with respect to mining or production activity occurring on or after 1/1/86.
- Credits terminated or allowed to expire on 12/31/85, but affirmative commitment rules would continue to apply.

Proposed Changes

Effective Dates and Transition Rules

- b. Terminate production tax credits. Production tax credits would terminate 12/31/85, but eligible fuel produced from a well drilled, or from facilities completed, before 1/1/86 and sold before 1/1/90 would continue to be eligible for credit.
- c. Repeal excise tax exemptions for alcohol fuel mixtures and alcohol fuels. Excise tax exemptions would terminate 12/31/85.
- d. Terminate alcohol production credit. Alcohol fuels credit would be available for eligible alcohol fuels produced from facilities completed before 1/1/86 and sold before 1/1/93.
- e. Allow excise tax exemption for fuel for certain taxicabs to expire. Qualified taxicab refund would be allowed to expire 9/30/85.
- f. Allow residential energy credit to expire. Residential energy credits would be allowed to expire 12/31/85.
- 9.02 Repeal percentage depletion, except for independent stripper wells, and replace with indexed cost depletion. 5 year phase out beginning with production on or after 1/1/86 (80 percent of current percentage depletion in 1986, 60 percent in 1987, etc.).
- 9.03 Revise minimum tax treatment of intangible drilling costs. Effective for expenditures paid or incurred on or after 1/1/86.
- 9.04 Revise taxation of timber, coal and iron ore.
- a. Repeal capital gains taxation of royalty income received from timber, coal and iron ore. Phase out over three years. For individuals, allow a 30 percent exclusion for all royalty income received in 1986, a 20 percent exclusion in 1987, a 10 percent exclusion in 1988, and tax as ordinary income all royalty income received on or after 1/1/89. For corporations, tax at a 30 percent rate all royalty income received in 1986, a 31 percent rate in 1987, a 32 percent rate in 1988, and tax at a 33 percent rate all royalty income received on or after 1/1/89.
- b. Repeal capital gains taxation of the cutting of timber by the owner of timber or the owner of a contract right to cut timber. Phase out over three years. For individuals, allow a 30 percent exclusion for timber cut in 1986, a 20 percent exclusion in 1987, a 10 percent exclusion in 1988, and tax as ordinary income beginning 1/1/89. For corporations, tax at a 30 percent rate timber cut in 1986, a 31 percent rate in 1987, a 32 percent rate in 1988, and tax at a 33 percent rate all timber cut on or after 1/1/89.

Proposed Changes

Effective Dates and Transition Rules

10. Reform Taxation of Financial Institutions

A. Commercial Banks and Thrift Institutions

10.01 Repeal special rules for bad debt deductions for banks and thrift institutions.

TYBOA 1/1/86, with draw down of existing tax reserves included in taxable income either in the taxable year beginning in 1986 or ratably over 10 years. Thrift reserves accumulated using the percentage of taxable income method would not be brought into taxable income to the extent they exceed the greater of the reserves computed by the percentage of eligible loan or experience methods.

10.02 Disallow 100 percent of interest expense incurred by depository institutions to carry tax-exempt bonds.

Effective for interest allocable to tax-exempt obligations acquired on or after 1/1/86. Permanent grandfathering for bonds acquired prior to 1/1/86. (Current 20-percent disallowance rule would apply for obligations acquired between 1/1/83-12/31/85.)

10.03 Repeal tax exemption of credit unions with gross assets of 5 million dollars or more.

TYBOA 1/1/86.

10.04 Repeal special reorganization rules for financially troubled thrift institutions.

Effective for acquisitions occurring on or after 1/1/91.

10.05 Repeal special rules for carryover of net operating losses of depository institutions.

Effective for net operating losses incurred in TYBOA 1/1/86. Old rules would apply to net operating losses incurred in taxable years before 1/1/86.

B. Life Insurance Companies and Products

10.06 Impose current taxation on inside interest build-up income in life insurance policies.

TYBOA 1/1/86 for inside interest build-up credited to policies issued on or after the date of Committee action.

10.07 Impose current taxation on deferred annuity investment income.

TYBOA 1/1/86 for investment income credited to policies issued on or after the date of Committee action.

10.08 Limit life insurance company reserve deduction to the increase in the policyholder's cash surrender value.

Effective for policies sold on or after 1/1/86.

10.09 Repeal special life insurance company deductions.

TYBOA 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

C. Property and Casualty Insurance Companies

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| 10.10 | Revise treatment of losses by property and casualty insurance companies and allow their policyholders to elect to deduct losses as they occur with insurance proceeds taxable when received. | Effective for unpaid losses incurred in TYBOA 1/1/86 with respect to policies issued on or after 1/1/86. |
| 10.11 | Repeal mutual property and casualty insurance companies' deduction for additions to protection against loss accounts. | TYBOA 1/1/86, with amounts currently in the account includable in taxable income ratably over 5 years. |
| 10.12 | Repeal special tax exemptions, rate reductions, and deductions of small mutual property and casualty insurance companies. | TYBOA 1/1/86, phased in over 5 years. |
| 10.13 | Limit mutual property and casualty insurance companies' deduction for policyholder dividends. | TYBOA 1/1/86. |

11. Reform Treatment of State and Local Government Debt and Investments

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| 11.01 | Repeal tax exemption of non-governmental purpose tax-exempt bonds. | Effective for obligations issued on or after 1/1/86. A transition rule would be provided for certain refundings of outstanding obligations. |
| 11.02 | Tighten restrictions on tax arbitrage and advance refunding for tax-exempt bonds. | Effective for obligations issued on or after 1/1/86. |
| 11.03 | Repeal General Stock Ownership Corporation provisions. | Effective as of 1/1/84, the sunset date for creation of General Stock Ownership Corporations. |

12. Modify Other Specific Subsidies

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| 12.01 | Repeal tax credit for qualified rehabilitation expenditures. | Effective for expenditures incurred on or after 1/1/86. |
| 12.02 | Repeal special rules for returns of magazines and paperback books and for qualified discount coupons. | TYBOA 1/1/86, with balance of suspense account deductible in first year. |
| 12.03 | Extend and modify the incremental research and experimentation credit. | Effective for expenditures incurred on or after 1/1/86. |

Proposed Changes

Effective Dates and Transition Rules

12.04 Repeal special treatment of merchant marine capital construction fund exclusion.

No further tax-free contributions could be made after 12/31/85, except with respect to qualified agreement vessels that the taxpayer owned on 1/1/86, or with respect to which the taxpayer had performed (or had caused to be performed) a substantial amount of construction or reconstruction before 1/1/86. 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 beginning on 1/1/86 would be subject to tax. Any withdrawals from a fund on or after 1/1/86, other than with respect to such qualified vessels, would be treated as nonqualified withdrawals, except that no interest charge would apply. Any amounts remaining in a capital construction fund on 1/1/96 would be treated as withdrawn at that time.

12.05 Repeal possessions tax credit and replace with a wage credit.

Wage credit would replace existing credit for TYBOA 1/1/86. Corporations making an election prior to 1/1/86 may elect prior rules for five years for income on products produced as of that date.

12.06 Revise rules for leveraged employee stock ownership plans (ESOP).

a. Revise limits on deductions for contributions to an ESOP.

Applies to loans incurred on or after 1/1/86; grandfather securities acquisition loans entered into before 1/1/86.

b. Require distribution of ESOP stock as becomes vested.

Applies to stock financed with loans incurred on or after 1/1/86.

c. Revise special treatment of ESOP dividends.

Applies to dividends paid on or after 1/1/86.

d. Allow PAYSOP credit to expire.

Credit expires 12/31/87.

13. Curtail Tax Shelters

13.01 Disallow most current interest deductions (with carry forward) in excess of the sum of mortgage interest on the taxpayer's principal residence, investment income, income from limited partnerships and S corporations, and \$5,000.

TYBOA 1/1/86, but with ten year phase-in for expanded definition of investment interest (10% of newly included interest -- consumer interest, interest expense of S corporation where taxpayer does not participate in management, interest expense of limited partnership where taxpayer is a limited partner -- would be subject to the limitation in TYBOA 1/1/86, 20% in TYBOA 1/1/87, etc.). The current \$10,000 limit would be maintained for taxable years beginning before 1/1/88.

13.02 Extend the at-risk limitations to real estate.

Applies to property acquired on or after 1/1/86.

13.03 Revise the alternative minimum tax for noncorporate taxpayers.

TYBOA 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

- 13.04 Change present corporate add-on minimum tax to a new alternative corporate minimum tax. TYBOA 1/1/86.

14. Revise Treatment of Retirement Savings

- 14.01 Make IRAs of up to \$2,000 each available both to employees and their spouses working in the home. TYBOA 1/1/86.

- 14.02 Unify rules for distributions from tax-favored retirement plans.

- a. Subject all tax-favored retirement plans to uniform minimum distribution rules and apply a 50 percent sanction on difference between the required and actual annual distribution.

Applies generally to TYBOA 1/1/86. Grandfather tax-sheltered annuities with no contributions made on or after 1/1/86.

- b. Repeal capital gain and ten-year averaging for lump sum distributions.

Repeal applies to preretirement lump sum distributions on or after 1/1/86. Repeal applies to retirement lump sum distributions on or after 1/1/86 and is phased-in over six years (5 percent of lump sum received in 1987, 25 percent in 1988, 50 percent in 1989, 75 percent in 1990, and 100 percent in 1991).

- c. Eliminate deferred inclusion of unrealized appreciation on employer securities.

Applies to individual TYBOA 1/1/86, with same six-year phase-out as in (b).

- d. Eliminate special basis recovery rules for qualified plan distributions.

Applies generally to distributions on or after 1/1/86. For distributions made before the annuity starting date, grandfather benefits accrued as of 1/1/86. Grandfather annuity distributions after the annuity starting date for benefits in pay status as of 1/1/86.

- e. Subject early distributions generally to an additional tax of 20 percent, but apply only a 10 percent tax if used for college expenses or first home purchase, or if during a period of unemployment following the termination of unemployment benefits.

Applies to early distributions on or after 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

- 14.03 Modify deduction rules for tax-favored retirement plans.
- a. Replace 15 percent of aggregate compensation limit for profit sharing and stock bonus plans with 15 percent of individual compensation limits; apply 25 percent of aggregate compensation limit to combined defined contribution and defined benefit plans. Applies to employer's TYBOA 1/1/86. For certain "retirement-type" profit sharing and stock bonus plans, a special rule would permit deductions in excess of 15 percent of an individual's compensation where annual contributions of less than 15 percent had been made on behalf of such individuals before 1/1/86.
 - b. Subject excess contributions to an annual 6 percent tax. Applies to excess contributions for employer's TYBOA 1/1/86.
 - c. Repeal special deduction limits for ESOP contributions, and allow PAYSOP tax credit to expire. Applies to employer's TYBOA 1/1/86, with grandfathering for contributions to discharge ESOP loans outstanding on 12/31/85. PAYSOP credit expires 12/31/87.
- 14.04 Modify annual limits on contributions and benefits under tax-favored plans.
- a. Repeal overall plan limit for non-top-heavy plans. Applies to plan limitation years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract.
 - b. Apply a 10 percent tax to annual distributions in excess of 1.25 times the defined benefit dollar limit. Applies to individual TYBOA 1/1/86.
 - c. Include one-half of employee contributions as annual additions to defined contribution plans under the annual contribution limits. Applies to plan limitation years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract.
 - d. Phase in defined benefit dollar limit over ten years of plan participation, rather than merely ten years of service. For limitation years beginning in 1986, the applicable dollar limit is subject to a two years of participation phase-in; for years beginning in 1987, a three years of participation phase-in, etc., until for years beginning on or after 1/1/94, a ten years of participation phase-in rule would apply.
- 14.05 Apply a recapture tax of 10 percent on plan funds reverting to an employer upon plan termination. Applies to asset reversions pursuant to plan terminations occurring on or after 1/1/86.

Proposed Changes

Effective Dates and Transition Rules

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| 14.06 | Revise cash or deferred arrangements by imposing an \$8,000 annual limit and counting contributions against IRA limits, and tighten nondiscrimination rules for cash or deferred arrangements and employer matching contributions. | Applies to plan years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract. |
| 14.07 | Permit use of benefits forfeited by a separated employee to increase benefits of other employees. | Applies to plan years ending on or after 1/1/86. |
| 14.08 | Modify plan loan rules to reduce the \$50,000 loan limit by the highest outstanding loan balance during the prior 12 month period. | Applies to amounts received as loans on or after 1/1/86. |
| 14.09 | Apply objective nondiscriminatory coverage test to all qualified plans; permit 125 percent disparity between prohibited group coverage and coverage of other employees. | Applies to plan years beginning on or after 1/1/87. For collectively bargained plans, applies to year beginning after termination of collective bargaining contract. |
| 14.10 | Unify rules for unfunded deferred compensation for employees of public sector employers, and employees of tax-exempt employers. | Applies to individual TYBOA 1/1/86. |

15. Reform International Taxation

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| 15.01 | Reform foreign tax credit. | |
| a. | Change foreign tax credit limitation to a separate per country limitation. | TYBOA 1/1/86. Five-year carryforward of prior excess credits without per country limitation. |
| b. | Modify the calculation of the deemed-paid credit. | TYBOA 1/1/86. Changes do not apply to dividends paid out of earnings and profits of taxable years beginning prior to 1/1/86. |
| 15.02 | Modify sourcing rules for income and deductions. | |
| a. | Modify rules defining sources of income derived from sales of inventory-type property, manufactured goods, and intangible property. | TYBOA 1/1/86. Transitional rules would be provided for sales made under unrelated party contracts executed before 1/1/86. |

Proposed Changes

Effective Dates and Transition Rules

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|-------|--|---|
| b. | Repeal special sourcing rules for interest and dividend income of 80-20 corporations. | TYBOA 1/1/86, with modification of source rule for interest income received from 80-20 corporations effective only for interest on debt obligations incurred after 1/1/86. |
| c. | Repeal special source rules for income derived from U.S. built vessels and aircraft. | TYBOA 1/1/86, but old rules apply to income derived from vessels or aircraft owned by the taxpayer on 1/1/86 and leased before 1/1/86. |
| d. | Allocate interest expense on a combined group basis, rather than a separate company basis. | TYBOA 1/1/86. |
| e. | Disregard tax-exempt income in allocating interest expense. | TYBOA 1/1/86 for tax-exempt income derived from assets acquired on or after 1/1/86. |
| 15.03 | Replace second dividend tax with a branch profits tax and the second tax on interest with a branch interest tax. | TYBOA 1/1/86. |
| 15.04 | Revise taxation of foreign exchange gains and losses. | Effective for transactions entered into after 1/1/86, with grandfathering of certain transactions that are open as of 1/1/86. Translation rules effective for TYBOA 1/1/86. |
| 15.05 | Reform the mirror system of taxation for the United States possessions. | TYBOA 1/1/86; certain provisions would remain in effect until necessary changes are made in territorial laws. |

APPENDIX C

Fundamental Tax Reform
Change in Receipts by Source

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS 1/					
A. Rate Reduction					
Rate schedules (see Note B at end of table).....	-11.1	-49.5	-60.6	-66.7	-72.7
B. Fairness for Families					
Increase the Zero Bracket Amount 2/.....	-4.4	-6.2	-6.6	-7.1	-7.6
Repeal the additional exemption for the blind and elderly; increase the taxpayer and dependent exemption to \$2000.....	-18.8	-39.1	-42.1	-45.1	-48.0
Expand the credit for the elderly and the disabled.....	-.2	-1.1	-1.1	-1.2	-1.3
Repeal second earner deduction.....	1.6	7.1	7.7	8.3	9.0
Expand and index earned income tax credit 3/.....	-.*	-1.4	-1.6	-1.7	-1.9
Replace child and dependent care credit with a deduction from gross income.....	-.*	-.3	-.3	-.3	-.3
Fairness to Families, subtotal.....	-21.8	-40.9	-44.0	-47.1	-50.1
C. Fair and Neutral Taxation					
Excluded Sources of Income:					
Include a portion of employer provided health insurance in taxable income (\$10/individual;\$25/family per month).....	2.4	3.5	3.7	3.8	4.0
Repeal exclusion of employer provided death benefits.....	*	*	*	*	.1
Repeal exclusion of employee awards.....	*	*	*	*	*
Repeal tax exempt threshold for unemployment compensation...	--	.4	1.2	1.1	1.1
Repeal exclusion of workers' compensation and black lung benefits (net of credit).....	--	.2	1.3	1.5	1.8
Limit exclusion of scholarships and fellowships.....	*	.1	.2	.2	.2
Repeal exclusion of prizes and awards.....	*	*	*	*	*
Extend exemption of contributions to group legal plans.....	-1	-1	-2	-2	-3
Extend exemption of contributions for educational assistance Discrimination rules for employee benefits other than retirement benefits.....	-1	-1	-2	-2	-2
Excluded Sources of Income, subtotal.....	2.3	4.0	6.1	6.5	6.9
Preferred Uses of Income:					
Repeal deduction for state and local taxes.....	4.5	33.3	34.1	37.0	40.0
Accelerate expiration of charitable contributions deduction for non-itemizers.....	.4	2.7	--	--	--
Preferred Uses of Income, subtotal.....	5.0	36.0	34.1	37.0	40.0
D. Tax Abuses					
Restrict entertainment expense deductions and limit deductions for business meals (50% over \$25 per meal)					
Individual.....	.3	.6	.7	.8	.9
Corporate.....	.3	.6	.8	.9	1.0
Limit temporary assignments to 1 year					
Individual.....	*	*	*	*	*

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Deny deduction for education travel					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Deny deduction for cruise ship seminars					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Limit deduction for luxury water travel					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Tighten grantor trust rules					
Individual.....	*	*	*	*	*
Revise taxation of trusts and estates					
Individual.....	.2	.5	.6	.7	.8
Tax unearned income of children under 14 at parent's rate					
Individual.....	.1	.4	.5	.5	.6
Tax abuses, subtotal:					
Individual.....	.6	1.6	1.8	2.1	2.3
Corporate.....	.3	.6	.8	.9	1.0
E. Further Simplification					
Implement return-free system.....	--	--	--	--	--
Revise the alternative minimum tax.....	.1	.3	.3	.3	.3
Move miscellaneous deductions above the line and combine with employee business expense subject to a 1% of AGI floor	.2	1.5	1.7	1.8	1.9
Repeal political contribution credit.....	*	.3	.3	.3	.4
Repeal presidential campaign checkoff.....	--	--	--	--	--
Repeal deduction for special needs adoption expenses.....	--	4/	4/	4/	4/
Repeal income averaging.....	1.0	3.9	4.3	4.6	4.9
Simplification, subtotal.....	1.3	6.0	6.6	7.0	7.6
BASIC TAXATION OF CAPITAL AND BUSINESS INCOME					
A. Revise Corporate Tax Rates					
Reduce maximum corporate rate to 33%					
Corporate.....	-9.8	-26.9	-36.1	-39.2	-42.0
Revise graduated corporate rate structure					
Corporate.....	-.2	-.4	-.4	-.5	-.5
Revise corporate minimum tax					
Corporate.....	--	.7	.7	.7	.8
Reduce corporate tax rates, subtotal:					
Corporate.....	-10.0	-26.7	-35.9	-39.0	-41.8
B. Taxing Real Economic Income					
Capital gains					
Individual- (50% exclusion rate).....	.6	2.9	4.6	5.0	5.4
Corporate.....	--	-*	-*	-*	-*

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Adjust depreciation schedules and index for inflation					
Individual.....	.1	.3	1.3	3.6	5.8
Corporate.....	.3	-.7	2.3	8.7	15.4
Repeal investment tax credit					
Individual.....	1.7	4.8	5.6	6.4	7.2
Corporate.....	14.0	25.6	29.4	33.3	37.4
Allow expensing of first \$5,000 of depreciable business property, repeal scheduled increases					
Individual.....	--	--	.1	.3	.3
Corporate.....	--	--	.2	.3	.4
Allow indexed FIFO, repeal conformity					
Individual.....	--	-.1	-.2	-.2	-.2
Corporate.....	--	-2.4	-4.5	-4.5	-4.5
Taxing real economic income, subtotal:					
Individual.....	2.4	7.9	11.4	15.0	18.5
Corporate.....	14.3	22.5	27.4	37.8	48.7
C. Recapture of Rate Differential on Accelerated Depreciation					
Individual.....	*	.3	.3	.5	--
Corporate.....	7.6	19.4	20.4	9.1	--
D. Retirement Saving					
Increase spousal IRA limit to \$2,000					
Individual.....	-.3	-.8	-.9	-1.0	-1.1
Uniform distribution requirements					
Individual.....	*	*	*	*	*
Excise.....	--	*	*	*	*
Tax on pre-retirement distributions, uniform basis recovery rules					
Individual.....	-.1	-.2	.1	.5	.9
Tax on qualified plan reversions					
Corporate.....	*	*	*	*	*
Repeal 10 year averaging of lump sum distributions					
Individual.....	.5	.7	.6	.6	.7
Repeal 3 year basis recovery rule for contributory plans					
Individual.....	.8	2.1	2.8	2.8	2.8
Eliminate deferral of appreciation on employer retirement securities					
Individual.....	--	*	*	*	.1
Simplify contribution deduction limits					
Individual.....	*	.1	.1	.1	.1
Excise tax on excess retirement contributions					
Individual.....	*	*	*	*	*
Excise.....	--	*	*	*	*
Repeal combined plan limit for non-topheavy plans					
Individual.....	-.1	-.3	-.3	-.3	-.4
Tax on retirement distributions in excess of ceiling					
Individual.....	*	*	*	*	*

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Modify rules for deductions of ESOP contributions, allow PAYSOP credit to expire					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Modify cash and deferred arrangements (CODAs)					
Individual.....	1.1	1.8	2.1	2.4	2.8
Modify CODA and non-CODA discrimination rules					
Individual.....	--	*	*	*	*
Retirement saving, subtotal:					
Individual.....	1.9	3.4	4.5	5.0	5.8
Corporate.....	*	*	*	*	*
Excise.....	--	*	*	*	*
E. Neutrality Toward the Form of Business Organization					
10% dividends paid deduction, 90% intercorporate dividends received deduction					
Individual.....	--	-.2	-.3	.6	1.3
Corporate.....	--	-3.4	-6.2	-7.2	-8.0
Repeal \$100/\$200 dividend exclusion					
Individual.....	.2	.6	.6	.6	.7
Neutrality toward business organization, subtotal:					
Individual.....	.2	.4	.3	1.2	1.9
Corporate.....	--	-3.4	-6.2	-7.2	-8.0
INDUSTRY SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES					
A. Other General Issues of Income Measurement					
Match expense and income from multiperiod production: completed contracts					
Individual.....	.1	.3	.7	1.0	1.1
Corporate.....	.5	1.9	3.6	4.8	4.4
Match expense and income from multiperiod production: other					
Individual.....	*	.2	.3	.3	.3
Corporate.....	1.8	3.2	4.6	6.6	8.3
Restrict use of cash accounting method					
Individual.....	.1	.2	.3	.3	.3
Corporate.....	.4	.7	.8	.8	.8
Limit bad debt deductions to actual loss					
Individual.....	*	.1	.1	.1	.1
Corporate.....	.7	1.1	1.2	1.2	1.3
Treat pledges of installment obligations as payments					
Individual.....	*	.1	.2	.3	.4
Corporate.....	*	.1	.1	.2	.3
Income measurement, subtotal:					
Individual.....	.2	.9	1.5	1.9	2.1
Corporate.....	3.3	6.9	10.3	13.6	15.0

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(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
B. Subsidies for Specific Industries					
Energy Subsidies:					
Repeal business energy credits, limit gasahol exemption					
Individual.....	-.*	-.1	-.1	-.1	-.1
Corporate.....	-.2	-.3	-.3	-.3	-.3
Excise.....	.2	.3	.3	.4	.4
Phase out percentage depletion except for stripper wells					
Individual.....	.1	.2	.4	.6	.8
Corporate.....	.1	.2	.3	.6	.9
Index basis of certain depletable assets					
Individual.....	--	-.*	-.*	-.*	-.*
Corporate.....	--	-.*	-.1	-.1	-.2
Repeal special treatment of royalty income					
Individual.....	*	*	.1	.1	.2
Corporate.....	*	*	*	*	*
Repeal of capital gains treatment for timber income					
Individual.....	*	*	*	*	*
Corporate.....	*	.1	.1	.2	.2
Repeal special rules for mining reclamation reserves					
Individual.....	*	*	*	*	*
Corporate.....	*	.1	.1	.1	.1
Energy, subtotal:					
Individual.....	*	.2	.5	.7	.9
Corporate.....	-.*	.1	.2	.4	.7
Excise.....	.2	.3	.3	.4	.4
Financial Institutions:					
Repeal depository institution's bad debt reserve deductions					
Corporate.....	.7	1.3	1.1	.9	1.1
Disallow interest incurred to carry tax exempts 5/					
Individual.....	-.*	-.2	-.4	-.6	-.8
Corporate.....	.1	.2	.4	.6	.9
Repeal tax exemption of large credit unions					
Corporate.....	.2	.3	.4	.4	.4
Repeal special carryover rules for depository institutions					
Corporate.....	*	*	*	*	*
Repeal special reorganization rules for troubled thrifts					
Corporate.....	--	--	--	--	--
Limit life insurance reserve deductions					
Corporate.....	.4	.7	.7	.8	.8
Repeal special percentage of taxable income deduction for life insurance companies and repeal exemption of certain small life insurance companies					
Corporate.....	.5	.9	1.0	1.0	1.1
Limit P&C reserves					
Individual.....	-.1	-.3	-.1	-.1	-.1
Corporate.....	.1	.4	1.0	1.7	2.4

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Repeal P&C insurance company deduction for addition to protection against loss accounts					
Corporate.....	.1	.1	.1	.1	.1
Limit deductibility of P&C dividends					
Corporate.....	.1	.1	.1	.1	.1
Repeal special tax exemption, rate reductions, and deductions of small mutual P&C companies					
Corporate.....	*	*	*	*	*
Financial institutions, subtotal:					
Individual.....	-.2	-.5	-.5	-.7	-.9
Corporate.....	2.1	4.2	4.9	5.7	6.9
Insurance Investment Income:					
Repeal exclusion of inside buildup					
Individual.....	--	--	--	*	.2
Repeal exclusion of current annuity income					
Individual.....	*	.1	.2	.3	.4
Insurance investment income, subtotal:					
Individual.....	*	.1	.2	.4	.6
State and Local Government Debt and Investments:					
Repeal exemption for nongovernmental bonds					
Individual.....	.4	1.8	3.5	4.7	5.5
Corporate.....	-.1	-.3	-.6	-.9	-1.0
Tighten restrictions on tax exempt bond arbitrage					
Individual.....	.1	.2	.2	.2	.2
Corporate.....	*	*	*	*	*
State and local government, subtotal:					
Individual.....	.5	2.0	3.7	4.8	5.7
Corporate.....	*	-.3	-.6	-.8	-1.0
Special Expensing and Amortization Rules:					
Repeal expensing of conservation expenditures and farmers fertilizer and field clearing					
Individual.....	.4	.9	.1	.1	.1
Corporate.....	.4	.3	.1	.1	.1
Repeal 5 year amortization of expenditures for rehabilitation of low income rental housing					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Repeal 5 year amortization of pollution control					
Corporate.....	*	*	*	*	*
Repeal 50 year amortization of railroad tunnels and bores					
Corporate.....	*	*	*	*	*
Repeal 5 year amortization of trademark expenses					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Repeal 84 month amortization, 10% credit for reforestation					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Special expensing and amortization, subtotal:					
Individual.....	.4	.9	.1	.1	.2
Corporate.....	.4	.3	.1	.1	.1
Other Specific Subsidies:					
Repeal rehabilitation tax credits					
Individual.....	.1	.3	.9	1.6	2.1
Corporate.....	*	.1	.3	.5	.6
Repeal special rules for returns of magazines etc and qualified discount coupons					
Corporate.....	.2	.1	*	*	*
Repeal exclusion of Merchant Marine Capital Construction Fund					
Corporate.....	*	.1	.1	.1	.1
Extend credit for research and experimentation					
Individual.....	-.*	-.*	-.*	-.*	-.*
Corporate.....	-.6	-1.2	-1.5	-1.7	-1.9
Require employers to make nondeductible payments to employees who receive ESOP dividends					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Other subsidies, subtotal:					
Individual.....	.1	.3	.9	1.6	2.1
Corporate.....	-.3	-.9	-1.0	-1.1	-1.2
C. Further Curtailment of Tax Shelters					
Repeal deduction for nonbusiness interest other than principal home mortgages (\$5,000 limitation)					
Individual.....	*	.2	.4	1.0	1.5
Limit artificial losses (at risk rules)					
Individual.....	.1	.2	.3	.4	.5
Corporate.....	-.1	-.2	-.3	-.3	-.4
Tax shelters, subtotal:					
Individual.....	.1	.4	.7	1.4	1.9
Corporate.....	-.1	-.2	-.3	-.3	-.4
D. International Issues					
Use per country limitation for foreign tax credit					
Corporate.....	.9	2.5	3.0	3.3	3.6
Modify rules concerning source of income and allocation of deductions					
Corporate.....	.4	.9	1.1	1.2	1.3

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Replace secondary dividend rule with branch profit tax					
Corporate.....	*	*	*	*	*
Possessions tax credit					
Corporate.....	-.0	-.*	*	.1	.2
Treat foreign exchange gains or losses as adjustments in interest					
Corporate.....	*	*	*	*	*
Rationalize tax treatment of U.S. territories					
Corporate.....	*	*	*	*	*
International Issues, subtotal:					
Corporate.....	1.3	3.4	4.1	4.6	5.1
E. Other Related Tax Issues					
Penalties:					
Simplify information return penalties					
Individual.....	--	--	--	--	--
Corporate.....	--	--	--	--	--
Repeal maximum limits for penalties					
Individual.....	*	*	*	*	*
Corporate.....	*	*	*	*	*
Estate and gift.....	*	*	*	*	*
Excise.....	*	*	*	*	*
Change failure-to-pay penalty to cost-of-collection charge					
Individual.....	.3	.3	.3	.3	.3
Corporate.....	*	*	*	*	*
Estate and gift.....	*	*	*	*	*
Excise.....	*	*	*	*	*
Penalties, subtotal:					
Individual.....	.3	.3	.3	.3	.3
Corporate.....	*	*	*	*	*
Estate and gift.....	*	*	*	*	*
Excise.....	*	*	*	*	*

(\$billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Total Change in Receipts:					
Individual.....	-17.9	-26.0	-32.0	-29.0	-26.9
Corporate.....	18.9	26.1	24.3	23.9	25.2
Estate and gift.....	*	*	*	*	*
Excise.....	.2	.3	.4	.4	.4
Total.....	1.2	.4	-7.3	-4.6	-1.2
Current Service April Update Receipts:					
Individual.....	358.9	395.9	436.1	479.2	517.8
Corporate.....	76.9	90.3	100.3	106.2	110.8
Estate and gift.....	5.3	5.0	4.7	4.7	5.1
Excise.....	34.3	34.3	32.9	32.3	32.6
Total.....	475.5	525.5	574.1	622.4	666.2
Unified Budget Receipts - Tax Reform:					
Individual.....	341.0	369.9	404.2	450.3	490.9
Corporate.....	95.8	116.4	124.6	130.2	136.0
Estate and gift.....	5.4	5.0	4.7	4.7	5.1
Excise.....	34.5	34.6	33.2	32.6	33.0
Total.....	476.7	525.9	566.7	617.8	665.0

Office of the Secretary of the Treasury
Office of Tax Analysis

May 24, 1985

- * - negligible Detail may not add to total due to rounding.
- 1/ Individual unless otherwise noted.
- 2/ Zero Bracket Amounts are increased to (in 1986 dollars): \$2,900 for single filers, \$3,600 for heads of households, and \$4,000 for joint filers.
- 3/ Includes outlays associated with the refundable portion of the credit.
- 4/ The effect of the repeal of these provisions is assumed to be offset by increased expenditures. The receipts generated by these provisions are not shown in this table.
- 5/ The proposal would effectively eliminate the use of deposits by banks for leveraged holdings of tax exempt bonds. These bonds would then be held primarily by individuals.

Note A: The estimates are based on the April Update of the 1986 Budget. The effects of the reduced corporate and individual rates are estimated assuming all other provisions are enacted. The revenue effects of all other provisions reflect current law tax rates. These estimates do not include the revenue impact of delaying the date of announcement.

Note B: The individual rate schedule estimate assumes that the relationship between collections and tax liability is unchanged from current law. The 1986 level revenue effect may be significantly altered depending on the prescribed changes in the withholding tables and the estimated tax rules.