

104TH CONGRESS
1ST SESSION

H. R. 2692

To amend the Internal Revenue Code of 1986 to provide for deductible contributions to medical finance accounts and to reform the earned income credit.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 30, 1995

Mr. ROYCE introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to provide for deductible contributions to medical finance accounts and to reform the earned income credit.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **TITLE I—MEDICAL FINANCE**
4 **ACCOUNTS**

5 **SEC. 101. MEDICAL FINANCE ACCOUNTS.**

6 (a) IN GENERAL.—Part VII of subchapter B of chap-
7 ter 1 of the Internal Revenue Code of 1986 (relating to
8 additional itemized deductions for individuals) is amended

1 by redesignating section 220 as section 221 and by insert-
2 ing after section 219 the following new section:

3 **“SEC. 220. MEDICAL FINANCE ACCOUNTS.**

4 “(a) DEDUCTION ALLOWED.—In the case of an indi-
5 vidual, there shall be allowed as a deduction for the tax-
6 able year an amount equal to the aggregate amount paid
7 in cash by such individual during such taxable year to a
8 medical finance account of such individual.

9 “(b) LIMITATIONS.—

10 “(1) IN GENERAL.—Except as otherwise pro-
11 vided in this subsection, the amount allowable as a
12 deduction under subsection (a) to an individual for
13 any taxable year shall not exceed the greater of—

14 “(A) \$3,000 or, in the case of an individ-
15 ual who is married, has a dependent (as defined
16 in section 152), or is a dependent (as so de-
17 fined) for the taxable year, the amount deter-
18 mined under paragraph (3),

19 “(B) in the case of an individual who is
20 covered by a catastrophic health plan, the de-
21 ductible under such plan, or

22 “(C) the excess of—

23 “(i) the limitation under this para-
24 graph (determined without regard to this

1 subparagraph) for the taxable year and
2 each of the preceding 4 taxable years, over
3 “(ii) the sum of the amounts allowed
4 as a deduction under this section for each
5 of such 4 taxable years.

6 For purposes of subparagraph (C), any of such pre-
7 ceding 4 taxable years during which the individual
8 did not have a medical finance account shall not be
9 taken into account, and any taxable year beginning
10 before January 1, 1996, shall not be taken into ac-
11 count.

12 “(2) COORDINATION WITH EXCLUSION FOR EM-
13 PLOYER CONTRIBUTIONS.—The limitation which
14 would (but for this paragraph) apply under this sub-
15 section to any individual for any taxable year shall
16 be reduced (but not below zero) by the amount
17 which would (but for section 106(b)) be includible in
18 such individual’s gross income for such taxable year.

19 “(3) SPECIAL RULES FOR MARRIED INDIVID-
20 UALS AND FAMILIES.—For purposes of paragraph
21 (1)(A)—

22 “(A) IN GENERAL.—Subject to subpara-
23 graphs (B) and (C), the amount determined
24 under this paragraph, with respect to an indi-
25 vidual who is married or has a dependent (as

1 defined in section 152) for the taxable year, is
2 \$5,000.

3 “(B) TREATMENT OF FAMILY AS ONE IN-
4 DIVIDUAL.—For purposes of subparagraph (A),
5 an individual, the spouse (if any) of such indi-
6 vidual, and all dependents of such individual or
7 such spouse shall be treated as 1 individual.

8 “(C) DIVISION OF AMOUNTS BETWEEN
9 FAMILY MEMBERS.—Individuals who are mar-
10 ried to each other may allocate the amount ap-
11 plicable under subparagraph (A) between them
12 in any proportion on which they agree. If there
13 is no such agreement, such amount shall be al-
14 located equally between such individuals. Any
15 individual may allocate to any dependent (as
16 defined in section 152) of such individual any
17 portion of the amount otherwise allocable to
18 such individual under this paragraph.

19 “(4) SPECIAL RULE IF ONE DEDUCTIBLE AP-
20 PLIES TO FAMILY.—For purposes of paragraph
21 (1)(B), rules similar to the rules of subparagraphs
22 (B) and (C) of paragraph (3) shall apply with re-
23 spect to any catastrophic health plan which applies
24 one deductible to—

25 “(A) an individual, and

1 “(B)(i) the spouse (if any) of such individ-
2 ual, or

3 “(ii) any dependent of such individual or
4 such spouse.

5 “(c) MEDICAL FINANCE ACCOUNT.—For purposes of
6 this section—

7 “(1) MEDICAL FINANCE ACCOUNT.—The term
8 ‘medical finance account’ means a trust created or
9 organized in the United States exclusively for the
10 purpose of paying the qualified medical expenses of
11 the account holder, but only if the written governing
12 instrument creating the trust meets the following re-
13 quirements:

14 “(A) Except in the case of a rollover con-
15 tribution described in subsection (f)(3), con-
16 tributions will be accepted—

17 “(i) only in cash, and

18 “(ii) only to the extent not in excess
19 of the limitation under subsection (b) (de-
20 termined without regard to paragraph (2)
21 thereof).

22 “(B) The trustee is a bank (as defined in
23 section 408(n)), an insurance company (as de-
24 fined in section 816), or another person who
25 demonstrates to the satisfaction of the Sec-

1 retary that the manner in which such person
2 will administer the trust will be consistent with
3 the requirements of this section.

4 “(C) No part of the trust assets will be in-
5 vested in life insurance contracts.

6 “(D) The assets of the trust will not be
7 commingled with other property except in a
8 common trust fund or common investment
9 fund.

10 “(E) The interest of an individual in the
11 balance in his account is nonforfeitable.

12 “(2) QUALIFIED MEDICAL EXPENSES.—The
13 term ‘qualified medical expenses’ means, with re-
14 spect to an account holder, amounts paid by such
15 holder for medical care (as defined in section
16 213(d)), or long-term care, for—

17 “(A) such individual, the spouse of such
18 individual, and any dependent (as defined in
19 section 152) of such individual, or

20 “(B) any member of the family of such in-
21 dividual or spouse who has attained age 65,
22 but only to the extent such amounts are not com-
23 pensated for by insurance or otherwise, and

1 “(3) ACCOUNT HOLDER.—The term ‘account
2 holder’ means the individual on whose behalf the
3 medical finance account was established.

4 “(4) CERTAIN RULES TO APPLY.—Rules similar
5 to the following rules shall apply for purposes of this
6 section:

7 “(A) Section 219(d)(2) (relating to no de-
8 duction for rollovers).

9 “(B) Section 219(f)(3) (relating to time
10 when contributions deemed made).

11 “(C) Except as provided in section 106(b),
12 section 219(f)(5) (relating to employer pay-
13 ments).

14 “(D) Section 408(h) (relating to custodial
15 accounts).

16 “(d) TAX TREATMENT OF ACCOUNTS.—

17 “(1) IN GENERAL.—A medical finance account
18 is exempt from taxation under this subtitle, unless
19 such account has ceased to be a medical finance ac-
20 count by reason of the rules referred to in paragraph
21 (2). Notwithstanding the preceding sentence, any
22 such account is subject to the taxes imposed by sec-
23 tion 511 (relating to imposition of tax on unrelated
24 business income of charitable, etc., organizations).

1 “(2) ACCOUNT ASSETS TREATED AS DISTRIB-
2 UTED IN THE CASE OF PROHIBITED TRANSACTIONS
3 OR ACCOUNT PLEDGED AS SECURITY FOR LOAN.—
4 Rules similar to the rules of paragraphs (2) and (4)
5 of section 408(e) shall apply to medical finance ac-
6 counts, and any amount treated as distributed under
7 such rules shall be treated as not used to pay quali-
8 fied medical expenses.

9 “(e) TAX TREATMENT OF DISTRIBUTIONS.—

10 “(1) INCLUSION OF AMOUNTS NOT USED FOR
11 QUALIFIED MEDICAL EXPENSES.—Any amount paid
12 or distributed out of a medical finance account shall
13 be included in the gross income of the account hold-
14 er unless such amount is used exclusively to pay the
15 qualified medical expenses of such holder.

16 “(2) PENALTY FOR AMOUNTS NOT USED FOR
17 QUALIFIED MEDICAL EXPENSES.—

18 “(A) IN GENERAL.—The tax imposed by
19 this chapter for any taxable year in which any
20 amount is included in gross income by reason
21 of paragraph (1) shall be increased by 10 per-
22 cent of such amount.

23 “(B) EXCEPTIONS.—Subparagraph (A)
24 shall not apply with respect to any amount paid

1 or distributed on or after the date the account
2 holder—

3 “(i) becomes disabled within the
4 meaning of section 72(m)(7), or

5 “(ii) dies.

6 “(3) EXCESS CONTRIBUTIONS RETURNED BE-
7 FORE DUE DATE OF RETURN.—Paragraph (1) shall
8 not apply to the distribution of any contribution paid
9 during a taxable year to a medical finance account
10 to the extent that such contribution exceeds the limi-
11 tation under subsection (b) (determined without re-
12 gard to paragraph (3) thereof) if—

13 “(A) such distribution is received by the
14 account holder on or before the last day pre-
15 scribed by law (including extensions of time) for
16 filing such individual’s return for such taxable
17 year, and

18 “(B) such distribution is accompanied by
19 the amount of net income attributable to such
20 excess contribution.

21 Any net income described in subparagraph (B) shall
22 be included in the gross income of the account hold-
23 er for the taxable year in which it is received.

24 “(4) ROLLOVERS AND TRANSFERS AT
25 DEATH.—Paragraph (1) shall not apply to any

1 amount paid or distributed out of a medical finance
2 account if the entire amount received (including
3 money and any other property) is paid into another
4 medical finance account for the benefit of—

5 “(A) such holder,

6 “(B) the spouse of such holder,

7 “(C) any dependent of such holder who has
8 attained age 21 as of the date of the payment
9 or distribution, or

10 “(D) in the case of a payment or distribu-
11 tion made by reason of the death of such hold-
12 er, the beneficiary designated by such holder,
13 not later than the 60th day after the date of such
14 payment or distribution.

15 “(5) COORDINATION WITH MEDICAL EXPENSE
16 DEDUCTION.—For purposes of section 213, any pay-
17 ment or distribution out of a medical finance ac-
18 count for qualified medical expenses shall not be
19 treated as an expense paid for medical care.

20 “(6) TRANSFER OF ACCOUNT INCIDENT TO DI-
21 VORCE.—The transfer of an individual’s interest in
22 a medical finance account to his spouse or former
23 spouse under a divorce or separation instrument de-
24 scribed in subparagraph (A) of section 71(b)(2) is
25 not to be considered a taxable transfer made by such

1 individual notwithstanding any other provision of
2 this subtitle, and such interest at the time of the
3 transfer is to be treated as a medical finance ac-
4 count of such spouse, and not of such individual.
5 Thereafter such account for purposes of this subtitle
6 is to be treated as maintained for the benefit of such
7 spouse.

8 “(f) REPORTS.—The trustee of a medical finance ac-
9 count shall make such reports regarding such account to
10 the Secretary and to the account holder with respect to
11 contributions, distributions, and such other matters as the
12 Secretary may require under regulations. The reports re-
13 quired by this subsection shall be filed at such time and
14 in such manner and furnished to such individuals at such
15 time and in such manner as may be required by those reg-
16 ulations.”

17 (b) DEDUCTION ALLOWED WHETHER OR NOT INDI-
18 VIDUAL ITEMIZES OTHER DEDUCTIONS.—Subsection (a)
19 of section 62 of such Code is amended by inserting after
20 paragraph (15) the following new paragraph:

21 “(16) MEDICAL FINANCE ACCOUNTS.—The de-
22 duction allowed by section 220.”

23 (c) EXCLUSIONS FOR EMPLOYER CONTRIBUTIONS
24 TO MEDICAL FINANCE ACCOUNTS.—

1 (1) EXCLUSION FROM INCOME TAX.—The text
2 of section 106 of such Code (relating to contribu-
3 tions by employer to accident and health plans) is
4 amended to read as follows:

5 “(a) GENERAL RULE.—Gross income of an employee
6 does not include employer-provided coverage under an ac-
7 cident or health plan.

8 “(b) CONTRIBUTIONS TO MEDICAL FINANCE AC-
9 COUNTS.—

10 “(1) IN GENERAL.—In the case of an employee,
11 gross income does not include amounts contributed
12 by such employee’s employer to any medical finance
13 account (as defined in section 220(e)) of such em-
14 ployee.

15 “(2) NO CONSTRUCTIVE RECEIPT.—No amount
16 shall be included in the gross income of any em-
17 ployee solely because the employee may choose be-
18 tween the contributions referred to in paragraph (1)
19 and employer contributions to another health plan of
20 the employer.

21 “(3) COORDINATION WITH DEDUCTION LIMITA-
22 TION.—The amount excluded from the gross income
23 of an employee under this subsection for any taxable
24 year shall not exceed the limitation under section
25 220(b)(1) (determined without regard to this sub-

1 section) which is applicable to such employee for
2 such taxable year.”

3 (2) EXCLUSION FROM EMPLOYMENT TAXES.—

4 (A) SOCIAL SECURITY TAXES.—

5 (i) Subsection (a) of section 3121 of
6 such Code is amended by striking “or” at
7 the end of paragraph (20), by striking the
8 period at the end of paragraph (21) and
9 inserting “; or”, and by inserting after
10 paragraph (21) the following new para-
11 graph:

12 “(22) any payment made to or for the benefit
13 of an employee if at the time of such payment it is
14 reasonable to believe that the employee will be able
15 to exclude such payment from income under section
16 106(b).”

17 (ii) Subsection (a) of section 209 of
18 the Social Security Act is amended by
19 striking “or” at the end of paragraph (17),
20 by striking the period at the end of para-
21 graph (18) and inserting “; or”, and by in-
22 serting after paragraph (18) the following
23 new paragraph:

24 “(19) any payment made to or for the benefit
25 of an employee if at the time of such payment it is

1 reasonable to believe that the employee will be able
2 to exclude such payment from income under section
3 106(b) of the Internal Revenue Code of 1986.”

4 (B) RAILROAD RETIREMENT TAX.—Sub-
5 section (e) of section 3231 of such Code is
6 amended by adding at the end the following
7 new paragraph:

8 “(10) MEDICAL FINANCE ACCOUNT CONTRIBU-
9 TIONS.—The term ‘compensation’ shall not include
10 any payment made to or for the benefit of an em-
11 ployee if at the time of such payment it is reason-
12 able to believe that the employee will be able to ex-
13 clude such payment from income under section
14 106(b).”

15 (C) UNEMPLOYMENT TAX.—Subsection (b)
16 of section 3306 of such Code is amended by
17 striking “or” at the end of paragraph (15), by
18 striking the period at the end of paragraph (16)
19 and inserting “; or”, and by inserting after
20 paragraph (16) the following new paragraph:

21 “(17) any payment made to or for the benefit
22 of an employee if at the time of such payment it is
23 reasonable to believe that the employee will be able
24 to exclude such payment from income under section
25 106(b).”

1 (D) WITHHOLDING TAX.—Subsection (a)
2 of section 3401 of such Code is amended by
3 striking “or” at the end of paragraph (19), by
4 striking the period at the end of paragraph (20)
5 and inserting “; or”, and by inserting after
6 paragraph (20) the following new paragraph:

7 “(21) any payment made to or for the benefit
8 of an employee if at the time of such payment it is
9 reasonable to believe that the employee will be able
10 to exclude such payment from income under section
11 106(b).”

12 (d) EXCLUSION OF MEDICAL FINANCE ACCOUNTS
13 FROM ESTATE TAX.—Part IV of subchapter A of chapter
14 11 of such Code is amended by adding at the end the fol-
15 lowing new section:

16 **“SEC. 2057. MEDICAL FINANCE ACCOUNTS.**

17 “For purposes of the tax imposed by section 2001,
18 the value of the taxable estate shall be determined by de-
19 ducting from the value of the gross estate an amount
20 equal to the value of any medical finance account (as de-
21 fined in section 220(c)) included in the gross estate.”

22 (e) TAX ON EXCESS CONTRIBUTIONS.—Section 4973
23 of such Code (relating to tax on excess contributions to
24 individual retirement accounts, certain section 403(b) con-

1 tracts, and certain individual retirement annuities) is
2 amended—

3 (1) by inserting “**MEDICAL FINANCE AC-**
4 **COUNTS,**” after “**ACCOUNTS,**” in the heading of
5 such section,

6 (2) by redesignating paragraph (2) of sub-
7 section (a) as paragraph (3) and by inserting after
8 paragraph (1) the following:

9 “(2) a medical finance account (within the
10 meaning of section 220(c)),”,

11 (3) by striking “or” at the end of paragraph
12 (1) of subsection (a), and

13 (4) by adding at the end thereof the following
14 new subsection:

15 “(d) **EXCESS CONTRIBUTIONS TO MEDICAL FINANCE**
16 **ACCOUNTS.**—For purposes of this section, in the case of
17 a medical finance account (within the meaning of section
18 220(c)), the term ‘excess contributions’ means the amount
19 by which the amount contributed for the taxable year to
20 the account exceeds the limitation under section 220(b)
21 for such taxable year. For purposes of this subsection, any
22 contribution which is distributed out of the medical fi-
23 nance account in a distribution to which section 220(e)(3)
24 applies shall be treated as an amount not contributed.”

1 (f) TAX ON PROHIBITED TRANSACTIONS.—Section
2 4975 of such Code (relating to tax on prohibited trans-
3 actions) is amended—

4 (1) by adding at the end of subsection (c) the
5 following new paragraph:

6 “(4) SPECIAL RULE FOR MEDICAL FINANCE AC-
7 COUNTS.—An individual for whose benefit a medical
8 finance account (within the meaning of section
9 220(c)) is established shall be exempt from the tax
10 imposed by this section with respect to any trans-
11 action concerning such account (which would other-
12 wise be taxable under this section) if, with respect
13 to such transaction, the account ceases to be a medi-
14 cal finance account by reason of the application of
15 section 220(d)(2) to such account.”, and

16 (2) by inserting “or a medical finance account
17 described in section 220(c)” in subsection (e)(1)
18 after “described in section 408(a)”.

19 (g) FAILURE TO PROVIDE REPORTS ON MEDICAL FI-
20 NANCE ACCOUNTS.—Section 6693 of such Code (relating
21 to failure to provide reports on individual retirement ac-
22 counts or annuities) is amended—

23 (1) by inserting “**OR ON MEDICAL FINANCE**
24 **ACCOUNTS**” after “**ANNUITIES**” in the heading of
25 such section, and

1 (2) by adding at the end of subsection (a) the
2 following: “The person required by section 220(f) to
3 file a report regarding a medical finance account at
4 the time and in the manner required by such section
5 shall pay a penalty of \$50 for each failure to so file
6 unless it is shown that such failure is due to reason-
7 able cause.”

8 (h) CLERICAL AMENDMENTS.—

9 (1) The table of sections for part VII of sub-
10 chapter B of chapter 1 of such Code is amended by
11 striking the last item and inserting the following:

“Sec. 220. Medical finance accounts.
“Sec. 221. Cross reference.”

12 (2) The table of sections for subchapter B of
13 chapter 68 of such Code is amended by inserting “or
14 on medical finance accounts” after “annuities” in
15 the item relating to section 6693.

16 (3) The table of sections for part IV of sub-
17 chapter A of chapter 11 of such Code is amended by
18 adding at the end the following new item:

“Sec. 2057. Medical finance accounts.”

19 (i) EFFECTIVE DATE.—The amendments made by
20 this section shall apply to taxable years beginning after
21 December 31, 1995.

1 **TITLE II—REFORM OF THE**
2 **EARNED INCOME CREDIT**

3 **SEC. 201. AMENDMENT OF 1986 CODE.**

4 Except as otherwise expressly provided, whenever in
5 this title an amendment or repeal is expressed in terms
6 of an amendment to, or repeal of, a section or other provi-
7 sion, the reference shall be considered to be made to a
8 section or other provision of the Internal Revenue Code
9 of 1986.

10 **SEC. 202. EARNED INCOME CREDIT DENIED TO INDIVID-**
11 **UALS NOT AUTHORIZED TO BE EMPLOYED IN**
12 **THE UNITED STATES.**

13 (a) IN GENERAL.—Section 32(c)(1) (relating to indi-
14 viduals eligible to claim the earned income credit) is
15 amended by adding at the end the following new subpara-
16 graph:

17 “(F) IDENTIFICATION NUMBER REQUIRE-
18 MENT.—The term ‘eligible individual’ does not
19 include any individual who does not include on
20 the return of tax for the taxable year—

21 “(i) such individual’s taxpayer identi-
22 fication number, and

23 “(ii) if the individual is married (with-
24 in the meaning of section 7703), the tax-

1 payer identification number of such indi-
2 vidual's spouse.”.

3 (b) SPECIAL IDENTIFICATION NUMBER.—Section 32
4 is amended by adding at the end the following new sub-
5 section:

6 “(l) IDENTIFICATION NUMBERS.—Solely for pur-
7 poses of subsections (c)(1)(F) and (c)(3)(D), a taxpayer
8 identification number means a social security number is-
9 sued to an individual by the Social Security Administra-
10 tion (other than a social security number issued pursuant
11 to clause (II) (or that portion of clause (III) that relates
12 to clause (II)) of section 205(c)(2)(B)(i) of the Social Se-
13 curity Act).”.

14 (c) EXTENSION OF PROCEDURES APPLICABLE TO
15 MATHEMATICAL OR CLERICAL ERRORS.—Section
16 6213(g)(2) (relating to the definition of mathematical or
17 clerical errors) is amended by striking “and” at the end
18 of subparagraph (D), by striking the period at the end
19 of subparagraph (E) and inserting a comma, and by in-
20 serting after subparagraph (E) the following new subpara-
21 graphs:

22 “(F) an omission of a correct taxpayer
23 identification number required under section 32
24 (relating to the earned income credit) to be in-
25 cluded on a return, and

1 “(G) an entry on a return claiming the
2 credit under section 32 with respect to net
3 earnings from self-employment described in sec-
4 tion 32(e)(2)(A) to the extent the tax imposed
5 by section 1401 (relating to self-employment
6 tax) on such net earnings has not been paid.”.

7 (d) EFFECTIVE DATE.—The amendments made by
8 this section shall apply to taxable years beginning after
9 December 31, 1995.

10 **SEC. 203. REPEAL OF EARNED INCOME CREDIT FOR INDI-**
11 **VIDUALS WITHOUT CHILDREN.**

12 (a) IN GENERAL.—Subparagraph (A) of section
13 32(e)(1) (defining eligible individual) is amended to read
14 as follows:

15 “(A) IN GENERAL.—The term ‘eligible in-
16 dividual’ means any individual who has a quali-
17 fying child for the taxable year.”.

18 (b) CONFORMING AMENDMENTS.—Each of the tables
19 contained in paragraphs (1) and (2) of section 32(b) are
20 amended by striking the items relating to no qualifying
21 children.

22 (c) EFFECTIVE DATE.—The amendments made by
23 this section shall apply to taxable years beginning after
24 December 31, 1995.

1 **SEC. 204. MODIFICATION OF EARNED INCOME CREDIT**
2 **AMOUNT AND PHASEOUT.**

3 (a) MODIFICATION OF PHASEOUT.—Subparagraph
4 (B) of section 32(a)(2) is amended to read as follows:

5 “(B) the sum of—

6 “(i) the initial phaseout percentage of
7 so much of the adjusted gross income (or,
8 if greater, the earned income) of the tax-
9 payer for the taxable year as exceeds the
10 initial phaseout amount but does not ex-
11 ceed the final phaseout amount, plus

12 “(ii) the final phaseout percentage of
13 so much of the adjusted gross income (or,
14 if greater, the earned income) of the tax-
15 payer for the taxable year as exceeds the
16 final phaseout amount.”

17 (b) PERCENTAGES AND AMOUNTS.—

18 (1) IN GENERAL.—Subsection (b) of section 32,
19 as amended by section 203(b), is amended to read
20 as follows:

21 “(b) PERCENTAGES AND AMOUNTS.—

22 “(1) PERCENTAGES.—The credit percentage,
23 the initial phaseout percentage, and the final phase-
24 out percentage shall be determined as follows:

“In the case of an eligible individual with:	The credit per- centage is:	The initial phase- out percentage is:	The final phase- out percentage is:
1 qualifying child	34	15.98	20
2 or more qualifying children	36	21.06	25

1 “(2) AMOUNTS.—The earned income amount,
2 the initial phaseout amount, and the final phaseout
3 amount shall be determined as follows:

“In the case of an eligible individual with:	The earned in- come amount is:	The initial phase- out amount is:	The final phase- out amount is:
1 qualifying child	\$6,340	\$11,630	\$14,850
2 or more qualifying children	\$8,910	\$11,630	\$17,750”.

4 (2) INCREASE IN CREDIT FOR LOWER-INCOME
5 FAMILIES HAVING 2 OR MORE QUALIFYING CHIL-
6 DREN.—Subsection (d) of section 32 is amended to
7 read as follows:

8 “(d) INCREASE IN CREDIT FOR LOWER-INCOME
9 FAMILIES HAVING 2 OR MORE QUALIFYING CHILDREN.—

10 “(1) IN GENERAL.—If an eligible individual has
11 2 or more qualifying children, for purposes of apply-
12 ing paragraphs (1) and (2)(A) of subsection (a)—

13 “(A) the amount of the taxpayer’s earned
14 income shall be treated as being equal to 10% of
15 such income (determined without regard to this
16 paragraph), and

17 “(B) the earned income amount shall be
18 treated as being equal to 10% of such amount
19 (determined without regard to this paragraph).

1 “(2) PHASEOUT OF BENEFIT.—If the applicable
2 income of the taxpayer for the taxable year exceeds
3 \$14,000 (\$17,000 in the case of a joint return), the
4 amount of each increase under paragraph (1) shall
5 be reduced (but not below zero) by an amount which
6 bears the same ratio to such increase (determined
7 without regard to this subparagraph) as such excess
8 bears to \$4,000.

9 “(3) APPLICABLE INCOME.—For purposes of
10 this subsection, the term ‘applicable income’ means
11 adjusted gross income or, if greater, earned in-
12 come.”

13 (3) CONFORMING AMENDMENTS.—

14 (A) Subsection (j) of section 32 is amend-
15 ed—

16 (i) by striking “subsection (b)(2)(A)”
17 and inserting “subsection (b)(2) or (d)”,

18 (ii) by striking “1994” and inserting
19 “1996”, and

20 (iii) by striking “1993” and inserting
21 “1995”.

22 (B) Subsection (e) of section 32 is amend-
23 ed to read as follows:

24 “(e) OTHER SPECIAL RULES.—

1 “(1) MARRIED INDIVIDUALS.—In the case of an
2 individual who is married (within the meaning of
3 section 7703), this section shall apply only if a joint
4 return is filed for the taxable year.

5 “(2) TAXABLE YEAR MUST BE FULL TAXABLE
6 YEAR.—Except in the case of a taxable year closed
7 by reason of the death of an individual, no credit
8 shall be allowable under this section in the case of
9 a taxable year covering a period of less than 12
10 months.”

11 (c) EFFECTIVE DATE.—The amendments made by
12 this section shall apply to taxable years beginning after
13 December 31, 1995.

14 **SEC. 205. RULES RELATING TO DENIAL OF EARNED IN-**
15 **COME CREDIT ON BASIS OF DISQUALIFIED**
16 **INCOME.**

17 (a) DEFINITION OF DISQUALIFIED INCOME.—Para-
18 graph (2) of section 32(i) (defining disqualified income)
19 is amended by striking “and” at the end of subparagraph
20 (B), by striking the period at the end of subparagraph
21 (C) and inserting “, and”, and by adding at the end the
22 following new subparagraph:

23 “(D) the excess (if any) of—

24 “(i) the aggregate income from all
25 passive activities for the taxable year (de-

1 “(A) IN GENERAL.—The term ‘modified
2 adjusted gross income’ means adjusted gross in-
3 come—

4 “(i) increased by the sum of the
5 amounts described in subparagraph (B),
6 and

7 “(ii) determined without regard to—

8 “(I) the amounts described in
9 subparagraph (C), or

10 “(II) the deduction allowed under
11 section 172.

12 “(B) NONTAXABLE INCOME TAKEN INTO
13 ACCOUNT.—Amounts described in this subpara-
14 graph are—

15 “(i) social security benefits (as defined
16 in section 86(d)) received by the taxpayer
17 during the taxable year to the extent not
18 included in gross income,

19 “(ii) amounts which—

20 “(I) are received during the tax-
21 able year by (or on behalf of) a spouse
22 pursuant to a divorce or separation
23 instrument (as defined in section
24 71(b)(2)), and

1 “(II) under the terms of the in-
2 strument are fixed as payable for the
3 support of the children of the payor
4 spouse (as determined under section
5 71(c)),

6 but only to the extent such amounts exceed
7 \$6,000,

8 “(iii) interest received or accrued dur-
9 ing the taxable year which is exempt from
10 tax imposed by this chapter, and

11 “(iv) amounts received as a pension or
12 annuity, and any distributions or payments
13 received from an individual retirement
14 plan, by the taxpayer during the taxable
15 year to the extent not included in gross in-
16 come.

17 Clause (iv) shall not include any amount which
18 is not includible in gross income by reason of
19 section 402(c), 403(a)(4), 403(b)(8), 408(d)
20 (3), (4), or (5), or 457(e)(10).

21 “(C) CERTAIN AMOUNTS DISREGARDED.—
22 An amount is described in this subparagraph if
23 it is—

24 “(i) the amount of losses from sales
25 or exchanges of capital assets in excess of

1 gains from such sales or exchanges to the
2 extent such amount does not exceed the
3 amount under section 1211(b)(1),

4 “(ii) the net loss from the carrying on
5 of trades or businesses, computed sepa-
6 rately with respect to—

7 “(I) trades or businesses (other
8 than farming) conducted as sole pro-
9 prietorships,

10 “(II) trades or businesses of
11 farming conducted as sole proprietor-
12 ships, and

13 “(III) other trades or business,

14 “(iii) the net loss from estates and
15 trusts, and

16 “(iv) the excess (if any) of amounts
17 described in subsection (i)(2)(C)(ii) over
18 the amounts described in subsection
19 (i)(2)(C)(i) (relating to nonbusiness rents
20 and royalties).

21 For purposes of clause (ii), there shall not be
22 taken into account items which are attributable
23 to a trade or business which consists of the per-
24 formance of services by the taxpayer as an em-
25 ployee.”.

1 (c) EFFECTIVE DATE.—The amendments made by
2 this section shall apply to taxable years beginning after
3 December 31, 1995.

4 **SEC. 207. PROVISIONS TO IMPROVE TAX COMPLIANCE.**

5 (a) INCREASE IN PENALTIES FOR RETURN PREPAR-
6 ERS.—

7 (1) UNDERSTATEMENT PENALTY.—Section
8 6694 (relating to understatement of income tax li-
9 ability by income tax return preparer) is amended—

10 (A) by striking “\$250” in subsection (a)
11 and inserting “\$500”, and

12 (B) by striking “\$1,000” in subsection (b)
13 and inserting “\$2,000”.

14 (2) OTHER ASSESSABLE PENALTIES.—Section
15 6695 (relating to other assessable penalties) is
16 amended—

17 (A) by striking “\$50” and “\$25,000” in
18 subsections (a), (b), (c), (d), and (e) and insert-
19 ing “\$100” and “\$50,000”, respectively, and

20 (B) by striking “\$500” in subsection (f)
21 and inserting “\$1,000”.

22 (b) AIDING AND ABETTING PENALTY.—Section
23 6701(b) (relating to amount of penalty) is amended—

24 (1) by striking “\$1,000” in paragraph (1) and
25 inserting “2,000”, and

1 (2) by striking “10,000” in paragraph (2) and
2 inserting “20,000”.

3 (c) EFFECTIVE DATE.—The amendments made by
4 this section shall apply to penalties with respect to taxable
5 years beginning after December 31, 1995.

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