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# TAX REFORM STUDIES AND PROPOSALS
# U.S. TREASURY DEPARTMENT

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COMMITTEE ON WAYS AND MEANS

OF THE

U.S. HOUSE OF REPRESENTATIVES

AND

COMMITTEE ON FINANCE

OF THE

U.S. SENATE



FEBRUARY 5, 1969

PART 3

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NOTE: This document has not been considered by either the Committee on Ways and Means of the House of Representatives or the Committee on Finance of the Senate. As indicated in the letters of Chairman Mills and Chairman Long, the document is being printed for information purposes only so as to make it generally available.

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# VII. TAX EXEMPT ORGANIZATION PROPOSALS

## General and Technical Explanations

# VII–A. CORRECTION OF ABUSES IN PRIVATE FOUNDATIONS

## General Explanation

Private philanthropy plays a special and vital role in our society. Beyond providing financial aid to areas which government cannot or should not advance (such as religion), private philanthropic organizations are uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.

Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experiences. In doing so, they enrich the pluralism of our social order.

Because of this important role, generous provisions for tax exemptions of private foundations and tax deduction for contributions to such foundations have long been provided in the tax laws. However, since this tax treatment diverts amounts from the public treasury to private foundations, it is imperative that the tax laws insure that these private foundations put these funds to philanthropic purposes that benefit the public. Only if adequate restrictions are placed on the operation of private foundations to prevent subverting their ostensibly charitable purposes to private purposes will the public receive the benefit sought by the allowance of tax exemptions and deductions.

In order to determine if private foundations are indeed discharging the philanthropic obligations which justify their tax benefits, the Treasury Department, at the request of the Tax Committees of the House and Senate, conducted an extensive study into the operations of private foundations.[1] This study revealed that the preponderant number of private foundations are performing their functions without tax abuse. However, the study also revealed that a minority of such organizations are being operated so as to bring private advantage to certain individuals, to delay for extended periods of time benefits to charity, and to cause competitive disadvantage between businesses operated by foundations and those operated by private individuals.

The study also revealed that the imprecise restrictions in present law against unwarranted private advantage, delay in benefits to charity and participation by private foundations in business have been difficult and expensive to administer, hard to enforce in litigation, and otherwise insufficient to prevent these abuses.

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[1] "Treasury Department Report on Private Foundations," dated Feb. 2, 1965, printed for the use of the Senate Finance Committee.

Therefore, in order to insure that private foundations are being operated to secure for the public the benefits which justify their tax exempt status and deductibility of contributions to them, the Treasury Department has proposed legislation to deal with six major problem areas revealed by the study.

## SUMMARY OF PROBLEMS AND SOLUTIONS

1. In order to meet the problem of "self-dealing" in which foundation assets may be diverted to private advantage, the Treasury recommends a general prohibition against financial transactions between a foundation and its founders, contributors, officers, directors or trustees.

2. In order to meet the problem of "deferred benefits," in which there may be a substantial delay between the time revenue is lost—either in the form of an exemption for a foundation or a deduction for a donor—and the time charity benefits through actual expenditures by a foundation for charitable purposes, the Treasury recommends that private foundations be required to distribute to charity all of their net incomes on a relatively current basis. Generally, a foundation would be obligated to spend its net income (exclusive of income from long-term capital gains) 1 year after receipt. Exceptions would be made for foundations accumulating income for a specific charitable purpose and for foundations that had spent more than their annual income in prior years. In order to impose the same obligation upon those foundations which choose to hold investments producing long-term capital appreciation rather than current income, the Treasury recommends that foundations be required to maintain expenditures for charitable purposes at approximately the same level as if they had invested their funds in income-producing assets. As with foundations currently earning income, exceptions would be made for foundations accumulating for a specific purpose and for foundations that had spent more than the required amount in prior years. These rules on deferred benefits apply only to "nonoperating" foundations—those which make contributions to charity rather than operate charities themselves.

3. In order to meet the problem of "business involvement" the Treasury recommends that, with certain carefully limited exceptions, a foundation not be allowed to own 20 percent or more of any business, whether incorporated or not, that is unrelated to its charitable functions. This rule would prevent foundations from becoming so involved in private business that—

Competitors owned and operated by tax paying entities are placed at a serious competitive disadvantage;

Opportunities are created for self-dealing in forms too subtle for the specific prohibitions recommended in paragraph 1 above;

Benefits to charity are deferred through the build up of a large accumulation of income in controlled business; and

Foundations managements become so preoccupied with business affairs as to endanger the devotion of adequate time to charitable objectives.

4. In order to meet the problem of "family use" of a foundation as a device to maintain control of a family corporation or other controlled property, the Treasury recommends that where a donor or related party maintains control of a business or other property after contribution of

an interest in it to a private foundation, no charitable deduction be allowed until (1) the foundation disposes of the business or property (2) the foundation devotes the business or property to active charitable activities or (3) the donor's control over the business or property ends. Such a contribution of controlled property to a foundation lacks the finality which characterizes a true parting with property giving rise to a charitable contribution deduction and creates conflicts of interest to the detriment of charity.

5. In order to meet the problem of "unrelated financial transactions" the Treasury recommends that speculating and foundation borrowing to purchase investment assets be prohibited and that foundation lending be confined to categories which are clearly necessary, safe, and appropriate for charitable fiduciaries. This rule would prevent a foundation—

> From borrowing to purchase investment assets, thereby passing the benefits of its tax exemption on to the seller and divorcing the foundation from the healthy scrutiny that results from dependency on contributions;
>
> Lending to benefit a private individual rather than a charity; or
>
> Speculating in the securities markets, thereby subjecting funds ostensibly devoted to charitable purposes to unnecessary risks of loss, divorcing the foundation from contributor scrutiny if the speculation is successful and making demands upon the time and attention of the foundation management to the detriment of charitable projects.

6. In order to insure that a private foundation does not continue in perpetuity without an objective evaluation by outside interests of its value to society, the Treasury recommends that the donor and related parties be restricted to 25 percent of the foundation's governing body after the expiration of 25 years. This rule would allow the donor and his family adequate time to provide unique direction, spirit, and enthusiasm to the foundation's endeavors. On the other hand, it would restrict the opportunities for private advantage and public detriment too subtle and refined for specific prohibition and provide an assurance that the foundation will receive objective evaluation by private parties who can terminate the organization if, after a reasonable period of time, it has not proved itself as a true contributor to charity.

In addition to the six major recommendations, the Treasury has also recommended measures to meet four less significant problems. These problems are primarily technical in nature.

These Treasury Department proposals are based upon a recognition that private foundations can and do make a major contribution to our society. The proposals have been carefully devised to eliminate subordination of charitable interests to personal interests, to stimulate the flow of foundation funds to active, useful programs, and to focus the energies of foundation fiduciaries upon their philanthropic functions. The recommendations seek not only to end diversions, distractions, and abuses, but to stimulate and foster the active pursuit of charitable ends which the tax laws seek to encourage. Any restraints which the proposals may impose on the flow of funds to private foundations will be far outweighed by the benefits which will accrue to charity from the removal of abuses and from the elimination of the shadow which the existence of abuse now casts upon the private foundation area.

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Finally, provisions would be included to insure compliance with the prohibitions against self dealing, delay of benefits to charity, business involvement, unrelated financial transactions, and perpetual family control of foundation management. The provision to meet the problem of "family use" involves the disallowance of a deduction and is, therefore, self-enforcing.

The fundamental objective of the outlined proposals and the provisions to insure compliance is to make certain that the public receives through philanthropic endeavors the benefits for which tax exemptions and deductions are granted.

## VII–A. CORRECTION OF ABUSES IN PRIVATE FOUNDATIONS

### Technical Explanation

The following is a technical explanation of the Treasury Department's proposals for changes in the law dealing with private tax exempt foundations. The provisions would be made applicable only to corporations or trusts exempt from income tax as ones organized and operated for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals. However, the provisions would not apply to the following organizations:

(1) Organizations which normally receive a substantial part of their support from the general public or governmental bodies;

(2) Churches or conventions or associations of churches;

(3) Educational organizations with regular faculties, curriculums, and student bodies; and

(4) Organizations whose purpose is testing for public safety.

Nonexempt trusts empowered by their governing instruments to pay or permanently set aside amounts for certain charitable purposes would also be subject to these provisions.

#### 1. PROHIBITION AGAINST SELF-DEALING

*(A) Present law*

Present law places limited restrictions upon transactions between certain exempt organizations and their donors (and certain other related persons). In general, these restrictions require that certain specified transactions be conducted at arms length.

*(B) Treasury proposals*

The proposal would add a new rule for private foundations and certain trusts in the form of a general prohibition against engaging directly or indirectly in any transaction involving the transfer or use of the foundation's assets with a donor or parties related to the donor. Self-dealing transactions which a foundation would be prohibited from entering into under this general rule would include (although not be limited to)—

(1) lending any part of its income or corpus to;

(2) purchasing or leasing its property from; and

(3) selling or leasing its property to the donor (and certain other related persons).

The general prohibition would apply to both direct and indirect transactions involving the transfer or use of foundation assets. Thus, for example, a loan by a donor to a corporation which he controls, followed by a gift of the corporation's note to the foundation, would be prohibited. In addition, corporations controlled by private foundations would be prohibited to the same extent as the controlling private foundation.

The following transactions would be specifically exempted from the general prohibition against self-dealing:

(1) reasonable compensation for personal services actually rendered;

(2) services made available on a nonpreferential basis;

(3) purchases by the foundation of incidental supplies (at no more than fair market value).

(4) interest free loans to the foundation, and their repayment; and

(5) purchases of foundation assets (at no less than fair market value) divestiture of which is required by other provisions recommended herein.

The private persons subject to these provisions would be:

(1) the creator of, a substantial contributor to or an official (director, officer, trustee, etc.) of the foundation;

(2) brothers, sisters, spouse, ancestors, and lineal descendants of any person in (1) above;

(3) a corporation 20 percent or more of the stock of which is owned by one or more persons in (1) above and members of their families in (2) above;

(4) directors, officers and persons who own 20 percent or more of the stock of a corporation which is a substantial contributor to the foundation involved; and

(5) an estate or trust for the benefit of one or more of any of the above persons.

In addition, the provisions would apply to a trust of which any such person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners). These provisions would apply to transactions engaged in after the effective date of the provisions.

### 2. REQUIRED DISTRIBUTIONS TO CHARITY

*(A) Present law*

Under present law, certain exempt organizations are prohibited from accumulating income unreasonably, using accumulated income to a substantial degree for purposes other than those constituting the basis for the organization's exemption or investing accumulated income in such a manner as to jeopardize the carrying out of the function constituting the basis for the organization's exemption.

*(B) Treasury proposal*

*(1) Realized income distribution requirement*

The proposal would require all private nonoperating foundations to distribute all of their current net income by the end of the year

following the year such income is received. A private foundation would be considered "nonoperating" if it does not have substantially more than half of its assets devoted directly to or does not directly expend substantially all of its income for the active conduct of charitable activities. Holding assets for the production of income or distributing income to operating charities would not meet the "devoted directly" asset test or the "directly expended" income test. Thus, for example, a private foundation which holds investment assets and distributes the income from those investment assets to an operating charity would be a nonoperating private foundation subject to this provision. On the other hand, a private foundation which has, as its only substantial asset, a public museum, and which uses any income for the operation of the museum would be an operating foundation not subject to this provision.

Current net income would include investment income such as rents, interest, dividends, short-term capital gains and, with certain adjustments, income subject to the unrelated business income tax. Deductions would be allowed for expenses directly connected with the generation of this income. Long-term capital gains and contributions would not be considered income for this purpose.

The purposes for which the income would have to be expended would be—

(1) contributions to publicly supported charitable organizations;

(2) contributions to privately supported operating organizations;

(3) direct expenditures for charitable programs; and

(4) purchases of assets which the foundation devotes directly to charitable activities.

Two exceptions to this rule would be provided. The first would allow a foundation to treat as an expenditure amounts which are set aside for a definite charitable purpose specified at the time the funds are set aside, provided the purpose requires accumulations by the foundation rather than the intended charitable recipient. Under this exception, the funds would actually have to be expended within 5 years, unless the organization is granted an extention for an additional period not to exceed 5 years. No limitation would be imposed on the number of 5-year extensions that could, if justified, be granted.

A second exception would allow a private nonoperating foundation to accumulate its income to the extent that it had, during the immediately preceding 5-year period, expended amounts in excess of its realized income or income equivalent (described below), whichever is greater.

*(2) Income equivalent*

Where realized income subject to the realized income distribution requirement does not equal a specified percentage of the value of the foundation's investment assets, a new provision would require distributions, for one of the four charitable purposes described above, of an amount which would bring distributions up to that specified percentage level. Thus, under these two rules, requiring distribution of realized income or an income equivalent, a private nonoperating foun-

dation would be required to distribute its realized income or income equivalent, whichever is greater.

The Secretary of the Treasury would be given regulatory authority to determine the income equivalent specified percentage based upon market conditions existing from time to time.

The income equivalent would be applied only against the foundation's investment assets.[1] Assets in this class, which can be valued by reference to regularly available sources, such as stock exchanges or over-the-counter markets, would be valued at fair market value at the beginning of the foundation's accounting period. For other assets, cost or, if contributed, the value claimed as a deduction by the donor, would be used with a reassessment precedure once every 5 years.

The same two exceptions to the realized income distribution requirement would be provided for the income equivalent requirement. Thus, an amount equal to the yearly income equivalent could be set aside for 5 years under the same circumstances as realized income can be set aside. And, distribution of the income equivalent would not be required to the extent that, during the 5 immediately preceding years, distributions exceeded realized income or the income equivalent whichever was greater. For example, assuming a 5-percent income equivalent, a foundation with zero income for 6 years on $100,000 of corpus and $10,000 per year in distributions for the first 5 of those 6 years would not be required to distribute anything in the sixth year. Its income equivalent for the first 5 years was 5 percent of $100,000 per year, or $25,000. Its total distributions were $50,000. Therefore, it is entitled to accumulate up to $25,000 in realized income in the sixth year or forego the distribution of its income equivalent up to that amount.

The realized income distribution requirement and the income equivalent requirement would apply to foundations presently in existence as well as those to be created in the future. However, for those foundations presently in existence, a 2-year transition period would be provided so that they would have adequate time to adjust their investments.

Furthermore, a rule would be provided exempting from the realized income distribution requirement and the income equivalent requirement income required to be accumulated or corpus prohibited from invasion by the governing instruments of existing organizations. Of course, these existing organizations would be subject to the present prohibitions against unreasonable accumulations and other improper uses of accumulated income under existing law.

### 3. LIMITATION ON INVOLVEMENT IN BUSINESS

Under this provision, a private foundation would be prohibited from owning directly or indirectly 20 percent or more of the total combined voting power or 20 percent or more of the total value of the equity of a corporation conducting a business which is not substantially related (other than through the production of funds) to the exempt function of the foundation. The direct or indirect owner-

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[1] The income equivalent would not apply to assets during the period for which, under proposals subsequently to be discussed, the donor's contribution deduction is postponed.

ship of a 20-percent or larger interest in the capital or profits of an unincorporated business not substantially related to the exempt functions of the owner foundation would also be prohibited. The 20-percent limitation would apply to indirect as well as direct ownership. Thus, stock in a corporation owned by a trust for the benefit of a private foundation would be treated as owned by the foundation to the extent of its beneficial interest.

Three forms of activities for the production of income would be specifically excluded from the meaning of "business"—

Lending, other than that resulting from the active conduct of commercial lending or banking;

Holding of royalties and mineral production payments as inactive investments; or

Holding of leases of real property (and associated personal property) of a passive nature.

The present law defining businesses which are not substantially related to a foundation's exempt activities (for purposes of the unrelated business income tax) would be applied to this provision. The three specific exceptions to that definition would also be applied to this provision. Thus, a business would not be considered unrelated if (1) substantially all of the work in carrying it on is performed without compensation; (2) it is carried on primarily for the convenience of the members, officers, or employees of the foundation; or (3) it consists of selling merchandise substantially all of which has been received as gifts or contributions to the foundation.

For example, a foundation which solicits and receives as contributions old clothes, books, or furniture, could conduct a business of selling those articles to the general public; a foundation engaged in the rehabilitation of handicapped persons could maintain a store to sell items made in the course of the rehabilitation training, and a foundation would be permitted to operate a cafeteria or restaurant, primarily for the convenience of its employees.

Foundations would be afforded a specified reasonable period of time in which to reduce their unrelated business interests below the prescribed maximum limit. The Secretary of the Treasury would be given power to extend the period for a limited additional time in order to prevent hardship. Similar periods of disposition, similarly subject to extension, would apply in the future when a foundation receives a gift, devise or bequest, which involves business ownership beyond the prescribed limit. An exception to the general disposition requirement would be provided for existing foundations whose governing instruments, as presently drawn, compel them to hold specified business interests, but only if local law prevents suitable revision of such governing instruments. Foundations created in the future would, to qualify for tax exemption, be required to include appropriate prohibitions against business ownership in the documents under which they are organized.

The general prohibition against self-dealing would not apply to the sale of assets owned by the foundation on the effective date of this legislation whose disposition is required under this provision. However, that general prohibition would apply to business interests acquired after the effective date, as, for example, by gift, whose disposition is required by this provision.

### 4. DONATION OF CONTROLLED PROPERTY

*(A) Present law*

Under existing law, an immediate income tax deduction is granted to the donor of an interest in a business or property to a private foundation, even though he retains control over the business or property after the donation. Thus, for example, the donation of a 20-percent interest in a family corporation to a private foundation would give rise to an income tax deduction, even though the donor retained the remaining 80 percent and thereby control of the business.

*(B) Treasury proposals*

Where the donor and certain related parties maintain control of a business or other property after the contribution of an interest in it to a private foundation, no income tax deduction would be permitted until (1) the foundation disposes of the contributed asset, (2) the foundation devotes the property to active charitable operations, or (3) donor control over the business or property terminates. The occurrence of a qualifying event will give rise to an income tax deduction if it occurs at any time before a date 3 years from the date of the donor's death. The deduction would be allowed for the year in which the qualifying event occurs or, in the case of occurrence subsequent to the death of the donor, in the donor's last taxable year. The occurrence of a qualifying event more than 3 years after the date of the donor's death would not give rise to an income tax deduction. Correlatively, transfers of such interests, made at or before death, would be incomplete for all estate tax purposes unless one of the qualifying events occurs within 3 years after the donor's death (or an extension of that period determined by the Secretary of the Treasury to be appropriate). Absent such a post-transfer qualification, the contributed asset would be included in the donor's gross estate and would not give rise to an estate tax charitable deduction. Such transfers, similarly, would not be deemed to constitute gifts, within the meaning of the gift tax statute, until a qualifying event occurs.

A rebuttable presumption of control of an incorporated business would arise with ownership of 20 percent or more of the total combined voting power of the corporation by the donor and certain related parties. Control of an unincorporated business, or other property, would similarly be presumed where the donor and certain related parties own a 20 percent or larger interest in it.

The persons whose control would delay deductibility would be, in addition to the donor, his brothers, sisters, spouse, ancestors, and lineal descendants. In addition, if corporations controlled by, or trusts for the benefit of, the donor and these related persons own stock or interests in contributed businesses or property, it would be attributed to the appropriate person to the extent of his interest therein. In determining whether or not the donor and related parties possess control, interests held by the foundation would be attributed to them until all of their own rights in the business or to the underlying properties cease.

A qualifying disposition of contributed property by a foundation would consist of a gift to another organization in harmony with the

foundation's own purposes, or a sale. A gift to another private foundation would not be a qualifying disposition, although the property in its hands could subsequently be subject to a qualifying event, thereby making the contribution deductible. An application of the contributed property to active charitable operations would occur through the permanent and direct commitment of the asset to use in the conduct of the active charitable pursuits for which the foundation was organized. For example, water rights or land would be applied to charitable uses when they were permanently committed to the activities of a foundation which operates a beach or a park. A qualifying termination of control would come about by a reduction in the holdings of either the foundation or the donor and related parties, with no reacquisition by one of the specified parties within a prescribed subsequent period.

The value of the contributed property at the time of the occurrence of the qualifying event would determine the amount of the income tax deduction to which the donor would become entitled. The amount deductible for estate tax purposes would be the value of the property on the date of the donor's death or other governing date under the ordinary principles of the estate tax law.

Income from property subject to these provisions would not be taken into consideration for purposes of the distribution of realized income requirement, nor would the property itself be taken into consideration for purposes of the income equivalent requirement, until the occurrence of a qualifying event giving rise to an income or estate tax deduction. These provisions would apply to contributions made after the effective date.

### 5. UNRELATED FINANCIAL TRANSACTIONS

*(A) Foundation borrowing*

The proposal under the heading "Debt Financing of Acquisitions" would embody the Treasury recommendations with regard to borrowing by private foundations

*(B) Foundation lending*

(1) *Present law.*—Present law does not contain any specific prohibition upon lending by private foundations to third persons unrelated to the donor and certain related persons. Such lending is restricted only by the general requirements of exclusive devotion to charitable purposes and the prohibitions against the use of accumulated income in situations which amount to substantial diversion from the exempt purposes of the foundation or jeopardizing of that income.

(2) *Treasury proposal.*—The Treasury Department proposes that the loans of private foundations, unrelated to their exempt functions, be restricted to categories which are clearly necessary, safe, and appropriate for charitable fiduciaries. Related loans, such as those made to students for financial assistance in completing their educations would, of course, be permitted. Unrelated permissible loans would be bank deposits, loans which are evidenced by securities of a type regularly traded upon an exchange or in an over-the-counter market, loans to governmental units, and loans fully secured by first mortgages upon real estate. The Secretary of the Treasury would be granted regulatory

authority to prescribe other loans of a similar quality and character, such as short-term loans represented by the marketable commercial paper of prime borrowers and loans forming parts of sound private placements. Beyond these loans of enumerated character, lending by private foundations would be prohibited. These lending restrictions would apply to all loans made after the effective date. Existing loans would not be affected.

*(C) Trading and speculating by foundations*

(1) *Present law.*—Present law limits only the investment policy of accumulated income and imposes only the standard that such investments should not jeopardize the carrying out of the functions for which the organization is exempt.

(2) *Treasury proposal.*—The Treasury proposes that private foundations be prohibited from participating in any kind of trading or speculating with any of its assets, whether derived from income or corpus. The prohibition would include (although not be limited to) inherently speculative devices such as the purchase of "puts," "calls," "straddles" "spreads," "strips," "straps," and "special options." Selling short and trading commodity futures would also be prohibited. No exceptions to this provision would be provided.

This prohibition would apply to any transaction after the effective date.

### 6. BROADENING OF FOUNDATION MANAGEMENT

*(A) Present law*

Present law contains no limitations upon the life of a foundation or the degree of control that can be retained permanently by the donor and his descendants.

*(B) Treasury proposal*

A provision would be added limiting the donor and certain related persons to 25 percent of the managing board after the first 25 years of existence of a foundation. The donor would be any person who has made a substantial contribution to the foundation, who controls a corporation which has made a substantial contribution to the foundation, or is the beneficiary of a trust which has made a substantial contribution to the foundation.

Persons related to the donor, and thereby subject to this restriction, would be (1) the donor's brothers, sisters, ancestors, lineal descendants, and spouse; (2) persons with whom the donor has a direct or indirect employment relationship; and (3) persons with whom the donor has a continuing business or professional relationship. An example of an indirect employment relationship would be an employee of a coporation controlled by the donor. An example of a professional relationship would be the donor's law partner.

Foundations presently in existence would be required to broaden their management in compliance with this rule within the 25-year period or 10 years from the effective date of this provision, whichever is longer.

Foundations organized on or after the effective date would be required to comply within the 25-year period.

### 7. OTHER CHANGES

In addition to the six major recommendations, the Foundation Report also recommended measures to meet four less significant problems. The first recommendation would postpone deductions for contributions of property of doubtful utility to the private foundation until utility is assured. The second and third of these problems, involving the contribution of ordinary income assets and the computation of the estate tax marital deduction, are dealt with under the Treasury proposals dealing with "gifts of ordinary income property" and the "unified transfer tax," respectively. The fourth recommendation would correct existing law by providing adequate sanctions for failure to file information returns. The Treasury renews its recommendation for action on these matters.

## VII–B. CURBING OF ABUSES IN DEBT FINANCING OF ACQUISITIONS

### General Explanation

H.R. 12663 and H.R. 12664 are now pending before the Committee on Ways and Means. They are designed to deal with problems raised when tax exempt organizations borrow money for purposes unrelated to their exempt functions. These problems were emphasized by the 1965 decision of the Supreme Court in *Commissioner* v. *Clay B. Brown et al.* In the *Clay Brown* case, the Supreme Court approved capital gains treatment for persons who sold a sawmill and lumber business to a tax-exempt organization in an arrangement elaborately structured both to avoid payment of Federal income tax upon the earnings of the business and to immunize the exempt organization from any liability or risk of loss. By means of the arrangement, the exempt organization undertook to acquire ownership of the business—valued at $1,300,000—entirely without investment of its own funds.

The availability of the tax exemption for uses in transactions following this pattern creates several serious problems. First, where the purchase price of a business or other income-producing property is to be financed from the future earnings of the property, tax-exempt organizations are uniquely suited to pay a considerably higher price than other purchasers can afford; their exemption makes it possible for them, in effect, to pay to the former owners of the business the money which a taxable purchaser would have to pay to the Government in taxes. This advantage of exempt organizations creates a strong incentive for the sale of businesses to them. Secondly, the price inflation characteristic of transactions of this type diverts to the personal advantage of private parties a substantial measure of the benefit which Congress intended tax exemption to produce for the organizations on which it conferred the exemption. Dealing with a closely related problem some years ago, both the House Ways and Means Committee and the Senate Finance Committee referred to this result as a "sale of the exemption."

Finally, use of the exemption in transactions of the *Clay Brown* variety permits exempt organizations to grow altogether without

reference to the amount of contributions or membership fees which they receive from the public, or the income produced by investment of their own funds. It permits, in other words, growth which has no relation to public approval of the activities or purposes of the organization but rather arises from the organization's selling its exemption.

PREVIOUS CONGRESSIONAL ACTION

In 1950 Congress recognized the impropriety and danger inherent in such exploitation of the tax-exemption privilege. The Revenue Act of 1950 provided, generally, for taxation of a portion of the rent which certain types of exempt organizations receive from property acquired with borrowed funds. The fundamental approach of this provision (continued without material change as section 514 of the present Internal Revenue Code) was a simple and sound one: Tax exemption should be restricted to earnings arising from the exempt entity's own assets, so as to eliminate the abuses and artificial incentives attendant upon exemption of income produced by borrowed funds.

Despite the essential soundness of its policy, the form which the 1950 Act took contained several defects. Because the provision was engrafted upon legislation which had the rather different objective of taxing the business activities of exempt organizations—whether the organization owned them outright or not—it was made applicable only to those classes of organizations which Congress thought to be then significantly involved in business.[1] As a result, it imposes no restraints whatever upon the abuses which arise when other kinds of exempt organizations borrow to invest.

Again, because the measure was drafted to cope with the particular variety of investment borrowing specifically drawn to the attention of Congress in 1950—the leaseback—it was made applicable only to rental income. It thus affords no solution to the same fundamental problems which exist where the income produced by borrowed funds is realized in the form of royalties, dividends, interest or capital gains.

Furthermore, even in the area to which it does apply—even, that is, where the exempt organization is in one of the classes covered by the legislation and where its investment is in rental property—the 1950 Act has been crippled by the presence of an exception which permits rents from leases whose terms are not longer than 5 years to be received without tax.

Finally, the 1950 legislation contains several technical provisions which permit the purchasing organization to avoid the full impact of the tax. For example, the portion of rental income which is taxed to the purchasing organization decreases as the organization's equity in the property increases. Therefore, if the purchase price is to be paid solely out of future income, in equal installments for 10 years, 100 percent of the net income will be taxed to the purchasing organization

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[1] Thus, it does not reach churches, corporations organized under Federal law (c)(1), social welfare organizations (c)(4), social clubs (c)(7), fraternal organizations (c)(8), employees' beneficiary associations (c)(9) and (10), local teachers' retirement funds (c)(11), benevolent life insurance associations (c)(12), nonprofit cemetery companies (c)(13), credit unions (c)(14), small mutual insurance companies (c)(15), and corporations which finance crop operations (c)(16). However, the regulations under some of these provisions, e.g., social clubs, provide that business activity will result in loss of exemption.

during the first year, 90 percent in the second year, etc. Thus, it is the purchaser's advantage to accelerate its deductions as much as possible, since deductions become less "valuable" as the purchaser's equity increases. The deduction which is most susceptibie of acceleration is depreciation. Thus, an organization seeking to minimize taxes will elect one of the methods of accelerated depreciation (such as double declining balance) so as to reduce the amount of net income which is subject to taxation during the years immediately following the acquisition. While the acceleration of the depreciation will increase the amount of net income which will be generated by the property during subsequent years, the purchaser may have increased its equity in the property to the point that the increase in net income will be more than offset by the decrease in the percentage of that income which is taxable to the purchaser.

Tax planners have taken full and repeated advantage of these deficiencies of the 1950 legislation. The situation involved in the *Clay Brown* case typifies a growing body of transactions in which exempt organizations have fashioned their acquisitions of productive property to avoid the impact of the provision. Indeed, even before the announcement of the Supreme Court decision in *Clay Brown*, more than 30 similar cases—in which, for one reason or another, the tax imposed under the 1950 Act was, or was claimed to be, inapplicable—were pending before the courts or the Internal Revenue Service. With the impetus added by Supreme Court approval of capital gains treatment for the sellers, the already well-traveled avenues around the 1950 Act can be expected to become thoroughfares.

## DESIGN OF PROPOSED BILLS

The proposed bills continue the basic approach of the 1950 provision, but eliminate the deficiencies which experience has demonstrated that provision to possess. The bills impose income tax upon the "unrelated debt-financed income" of all exempt organizations described in sections 401(a) and 501(c) of the Internal Revenue Code. Under the bills, income would be subject to tax only if it meets two tests; it would have to be derived from property acquired or improved with borrowed funds, and its production would have to be "unrelated" to the educational, charitable, religious, or other operations constituting the basis of the organization's tax exemption. Income produced by investments of an organization's own funds would be unaffected by the bills. Further, borrowing by an exempt organization for its exempt purposes—for example, borrowing by a college to build a dormitory—would fall beyond the scope of the proposals.

The taxable portion of the unrelated income from any particular property would, in general, be the amount bearing the same ratio to the total income from the property as the amount of the average indebtedness for the year bears to the average adjusted basis of the property. Deductions would be limited by the same percentage figures. Certain special rules would be employed to prevent avoidance of the tax by shifting deductions from years in which indebtedness is largely or completely discharged to earlier years in which it is high; depreciation, for example, would be limited to the straight-line method.

Generally, during the 5 years 1966–71 the new rules would apply only where indebtedness has been incurred after the date on which similar bills were introduced in the 89th Congress (June 27, 1966) and only to income received after the date of enactment. The 5-year transition period would afford organizations with previously initiated unrelated borrowing an opportunity to prevent or minimize tax under the new rules by disposing of their acquisitions for fair value, by discharging indebtedness in full with exempt income or other assets, or at least by reducing the amount of outstanding indebtedness. After the transition period, the new rules would become applicable to all situations of exempt organization investment borrowing.

#### WHAT THE BILLS DO NOT DO

Possible misunderstanding can be eliminated by making very plain what the bills would *not* do. First, they would not have any effect upon the exempt organization which invests only its own funds. They would apply only to the organization which borrows—the organization which is earning money with someone else's funds. Second, they would have no effect upon the organization which borrows in pursuance of its exempt activities. Only the production of income unrelated to those activities would result in tax. Third, the bills would not change the rules which Congress enacted in 1950 for the taxation of businesses owned outright by exempt organizations. Those rules, with their present exceptions and exclusions, would remain as they are.[2] Finally, the bill would not single out any one kind of exempt organization and impose a special tax upon it. They would apply equally to all categories of organizations exempted under the general exemption section of the Internal Revenue Code.

#### EFFECT OF THE BILLS

Since many of the organizations which would be affected by these bills do not now file tax returns, neither the number of taxpayers nor the amount of revenue can be estimated.

## VII–B. CURBING OF ABUSES IN DEBT FINANCING OF ACQUISITIONS

### Technical Explanation

#### 1. GENERAL

H.R. 12663 and 12664 would use the general approach of the statute enacted in 1950 to deal with the leaseback problem (now section 514 of the Internal Revenue Code). Income derived from property acquired or improved with borrowed funds would be taxable if the use of the property is unrelated to the organization's exempt purpose or function. To make as much use as possible of the solution already adopted by Congress, H.R. 12663 and 12664 would integrate this proposed tax

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[2] Changes in these rules are also recommended, however. See the material entitled "Expansion of Taxation of Income from Unrelated Businesses and from Investments of Certain Organizations."

into the existing statutory structure. As a result, such basic concepts as the distinction between "related" and "unrelated" activities would be defined by existing law, and the necessity for new and unfamiliar definitions would be reduced.

### 2. ORGANIZATIONS SUBJECT TO TAX

Section 1 of H.R. 12663 and 12664 would amend section 511(a), which imposes the unrelated business tax, to make the tax apply to all organizations exempt from tax by reason of section 401(a) and section 501(c). Section 2 of the bills would expand the definition of "unrelated business taxable income" provided in section 512 to include a new category of unrelated income—"unrelated debt-financed income." The organizations already subject to the unrelated business tax (e.g., charitable organizations, labor unions) would be taxable both on this category of income and, as at present, on income derived from the active conduct of an unrelated trade or business. The organizations not now subject to the tax (e.g., churches, civic associations, fraternal associations) would be taxable only on the new category of income. This revision would not affect the tax imposed by existing law on unrelated business activities of exempt organizations;[1] its only effect would be to make all exempt organizations taxable on certain debt-financed income.

### 3. INCOME SUBJECT TO TAX

(a) "*Unrelated debt-financed income.*"—While H.R. 12663 and 12664 would apply to income whether or not it is "rent," they would in large part use rules similar to those of the existing leaseback provision in determining what income is to be taxed and in computing how much of it is taxable. Under the new rules, the tax base would be "unrelated debt-financed income." Such income would be the gross income taken into account under the new section 514(b) with respect to "debt-financed property," less the deductions allowable under the new section 514(c) with respect to such property. In general, subsections (b) and (c) of section 514 bring into the computation of the tax base a portion of the total gross income and deductions attributable to debt-financed property, determined by applying to those totals the fraction

$$\frac{\text{average acquisition indebtedness for the taxable year}}{\text{average adjusted basis of the property during the taxable year}}.$$

An addition to existing law is that gains from the sale or other disposition of debt-financed property are included in the gross income figure.

(b) "*Debt-financed property.*"—Debt-financed property would, with five exceptions, be all property (e.g., rental real estate, tangible personal property, corporate stock) which is held to produce income and with respect to which there is an "acquisition indebtedness" at any time during the taxable year (or during the preceding 12 months, if the property is disposed of during the year). The five exceptions from this definition would be these:

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[1] Changes in these rules are also recommended, however. See the material entitled "Expansion of Taxation of Income from Unrelated Businesses and from Investments of Certain Organizations."

(1) Property all of the use of which is related to the exercise or performance of the organization's exempt function. Thus, a college could finance construction of a dormitory for its students with borrowed funds and pay off the indebtedness from student rents without subjecting any of those rents to tax.

(2) Property all of the income from which is already subject to tax as income from the conduct of an unrelated trade or business. This exception would prevent double taxation of income from financed property used in a trade or business which is taxable under existing law. The exception would, of course, not apply to organizations presently excepted from tax on income deriving from unrelated business.

(3) Property all of the income from which is derived from research activities excepted from the present unrelated business income tax. There are three classes of such research: (a) that performed for governmental bodies; (b) that performed by colleges, universities, or hospitals for any person; and (c) that performed by certain fundamental research organizations for any person.

(4) Property all the use of which is in a trade or business exempted from tax by section 513(a) (1), (2) or (3). These exceptions apply where (a) substantially all the work in carrying on the business is performed without compensation (e.g., a church thrift shop), (b) a section 503(c)(3) organization carries on business primarily for the convenience of members, students, patients, officers, or employees (e.g., a college cafeteria), or (c) the business consists of selling merchandise substantially all of which has been received as contributions (e.g., Goodwill Industries).

(5) Real property which organizations plan to devote to exempt uses within 10 years of the time of acquisition. A typical situation for which this exception is intended is that of a college temporarily receiving small amounts of rental income from real estate which it has purchased close to its campus for future use in a planned expansion program.

(c) "*Acquisition indebtedness*".—Income producing property would become "debt-financed property"—and its income taxable—only where there is an "acquisition indebtedness" attributable to it. The latter term would be very similar to "business lease indebtedness" as defined in existing law. Generally, an "acquisition indebtedness" would exist with respect to any property whenever the indebtedness was incurred in acquiring or improving the property or would not have been incurred "but for" the acquisition or improvement of the property. If an indebtedness is incurred after the property was acquired or improved, it would have to meet a further requirement: it would not be "acquisition indebtedness" unless its incurrence was reasonably foreseeable at the time of the acquisition or improvement. Under special rules, if property is acquired subject to a mortgage, the mortgage would be treated as an acquisition indebtedness incurred by the organization when the property is acquired. The extension, renewal, or refinancing of an existing indebtedness would not be treated as the creation of a new indebtedness. The latter rule would preclude the argument that a refinancing was not reasonably foreseeable at the time of the original acquisition of the property and that, therefore,

the obligation extant after the refinancing is not an acquisition indebtedness. There are three exceptions to these rules. They are:

(1) Property which an exempt organization receives, subject to indebtedness, by devise, bequest, or, under certain conditions, gift. The exception permits organizations receiving such property a 10-year period of time within which to dispose of it free of tax or to retain it and reduce or discharge the indebtedness on it with tax-free income.

(2) Property which exempt organizations acquire by the issuance of annuities. The exception is subject to certain limitations, designed to prevent abuse.

(3) Indebtedness incurred in conjunction with federally financed or supervised housing programs.

(d) "*Average acquisition indebtedness*".—For purposes of the numerator of the fundamental debt/basis fraction, acquisition indebtedness would be averaged over the taxable year. The averaging mechanism precludes an exempt organization from avoiding the tax by using other available funds to pay off the indebtedness immediately before any fixed determination date. If debt-financed property is disposed of during the year, "average acquisition indebtedness" would mean the highest acquisition indebtedness during the preceding 12 months. Without such a rule, an exempt organization could avoid tax by using other resources to discharge indebtedness before the end of 1 taxable year and dispose of property after the beginning of the next taxable year. For example, suppose exempt organization E has purchased income-producing property for $20,000 and incurred an indebtedness, still unpaid, of $15,000 to make the purchase. If E sells the property on December 31 for $50,000, 75 percent of the $30,000 capital gain would be included in gross income. Suppose, however, E uses other available resources to discharge the indebtedness on December 31, and sells the property January 2. Without the described special rule for dispositions, the numerator of the fraction would be zero, and no part of the gain would be taxable. Under the special rule an organization would have to commit its own funds at least 12 months in advance of disposition to escape tax on gain from the disposition.

(e) *Basis*.—For purposes of the denominator of the debt/basis fraction, adjusted basis would be the average adjusted basis for the portion of the year during which the property is held by the exempt organization. The use of average adjusted basis is for purposes only of fixing the debt/basis fraction. Where property is disposed of, gain or loss will, as usual, be computed with reference to adjusted basis at the time of disposition.

If property is distributed from a taxable corporation to the exempt organization, the exempt organization would be required to use the basis of the distributing corporation, with adjustment for any gain recognized on the distribution either to the exempt organization (as, for example, might be the case if the exempt organization had an acquisition indebtedness applicable to its stock in the distributing corporation) or to the taxable corporation (for example, as recapture of depreciation under sections 1245 or 1250). This rule would prevent an exempt organization from acquiring the property in a taxable subsidiary to secure accelerated depreciation during the first several years of the life of the property, enabling the subsidiary to pay off

a large part of the indebtedness during those years and the exempt organization to obtain a stepped-up basis (advantageous both for depreciation purposes and for purposes of enlarging the denominator of the debt/basis fraction) on liquidation of the subsidiary.

(f) *Allowable deductions.*—The percentage used in determining the taxable portion of total gross income would also be used to compute the allowable portion of deductions "directly connected with" the debt-financed property or the income from it. The direct connection requirement is carried over from section 512 of present law. The general approach of the bills is to allow all deductions that would be allowed to a normal taxpayer, to the extent consistent with the purpose of the bills and the nature of the special problems to which they are directed. For example, net operating loss and charitable contribution deductions would be allowed, subject to the limitations imposed by existing law on organizations taxable on unrelated business income (e.g., the percentage limitations on the charitable deduction are computed with reference only to the organization's unrelated business income, not its total income).

The deduction for depreciation would be restricted to the straight-line method, however. Accelerated depreciation ordinarily has the effect of deferring tax on income from depreciable property. However, under the approach of the proposed bills, an exempt organization would become a taxpayer only for a limited period of time—while acquisition indebtedness remains outstanding—and would during that time be taxed on a declining proportion of its income. In that setting, accelerated depreciation can be used for more than mere tax deferral; it can be used to reduce the total amount of the tax payable or, in some situations, eliminate tax altogether. It accomplishes that result by enlarging deductions in early years, in which taxability would otherwise be high because of the large amount of indebtedness outstanding. To the extent that the useful life of the property is longer than the term of the indebtedness (and it would seem difficult to argue that a sale has occurred if it is not), acceleration of depreciation shields otherwise taxable income by means of deductions shifted from periods in which no tax at all would be paid. Hence, the bills' limitation of depreciation to the straight-line method is necessary to make their approach meaningful.

(g) *Multiple use of property.*—If property is used partly for exempt and partly for nonexempt purposes, the income and deductions attributable to the exempt uses are excluded from the computation of unrelated debt-financed income, and allocations are to be made, where appropriate, for acquisition indebtedness, adjusted basis, and deductions assignable to the property.

### 4. EFFECTIVE DATE PROVISIONS

(a) Taxable years 1966–71.—During a 5-year transition period extending through 1971, the bills would apply to income from property with respect to which a debt was incurred on or before June 27, 1966, only if the income would have been subject to tax as business lease income under existing law. Thus, during this period the bills would have no effect on pre-June 28, 1966, indebtedness of a church because churches are not currently subject to the rules dealing with

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debt-financed property. Similarly, the bills would not impose an immediate tax on mineral royalties where the acquisition indebtedness was incurred before June 28, 1966, because mineral royalties do not now fall within the category of business lease income under existing law. Since an extension or renewal of a debt is not considered a creation of a new debt, an extension of a debt incurred before June 28, 1967, would not result in immediate taxation unless the income would have been taxed under existing law.

While the bills generally would immediately tax income from property with respect to which a debt was incurred after June 27, 1966, two transition rules are provided for the year of enactment, however. First, income attributable to the portion of the year prior to date of enactment will be governed by existing law; only the income attributable to the remainder of the year will be taxed under the new rules. Second, in the case of income which would be business lease income under existing law, taxable income for the portion of the year following enactment will be computed under existing law. This means that the new rules will not apply to business lease income until the first taxable year beginning after enactment.

(b) *Taxable year 1972 and following.*—Starting in 1972, all organizations would have to report income from property which they had acquired through debt financing (irrespective of when the debt was incurred). By delaying the full impact of the bills for 5 years, organizations which have acquired property through debt financing will have sufficient time to dispose of these assets in an orderly market. Moreover, even if an organization wishes to retain assets which were mortgaged prior to the introduction of the bills, the 5-year transition may enable organizations to liquidate their indebtedness entirely from exempt income from the property or from other assets. Finally, even those organizations which retain their unrelated assets and which are unable to discharge the acquisition indebtedness in full by 1972 will be able to reduce the taxable portion of the income from the property by reducing the amount of the debt during the 5-year period.

### 5. MISCELLANEOUS MATTERS

(a) *Investment credit.*—Under section 48(a)(4) of the Internal Revenue Code, tax-exempt organizations are allowed an investment credit for certain investments in property used predominantly in the conduct of an unrelated trade or business. Where the credit is produced by investment in debt-financed property, the income from the property will be taxable only after reduction by the debt/basis fraction provided by the new section 514(b); deductions associated with the property are reduced by the same fraction; and it is necessary to provide a corresponding limitation on the investment credit attributable to the property. The present bills add a sentence to section 48(a)(4) to accomplish this result, specifying that the fraction applicable under section 514(b) for the year in which the property is placed in service will also reduce the base upon which the investment credit is computed.

(b) *Withholding on certain income of foreign organizations.*—Chapter 3 of the Internal Revenue Code provides rules for the with-

holding of tax on interest, dividends, rent, and other periodical income of foreign taxpayers. Section 1443 of that chapter extends these rules to foreign exempt organizations which are subject to the unrelated business income tax. Because rent has been the only class of periodical income heretofore taxable under the unrelated business income tax, section 1443 presently provides for withholding only on rent. With the present bills' general provision for the taxation of unrelated debt-financed income, whether or not the income is rent, a conforming amendment to section 1443 becomes necessary. Section 4(c) of each bill makes that amendment, substituting the term "income" for "rents" in section 1443.

## VII–C. EXPANSION OF TAXATION OF INCOME FROM UNRELATED BUSINESSES AND FROM INVESTMENTS OF CERTAIN ORGANIZATIONS

### General Explanation

#### BACKGROUND

The Internal Revenue Code has long provided for the exemption from Federal income tax of certain nonprofit organizations. The types of organizations which may qualify for exemption are described in the Internal Revenue Code (sec. 501), and include charitable, educational, religious, scientific, and social welfare organizations, as well as social clubs, trade associations, and fraternal beneficiary societies.

In the case of some organizations, such as educational or charitable organizations, the grant of tax exemption is designed to foster and support the purposes for which they are organized and operated by permitting moneys to be used in the advancement of their exempt functions which otherwise would be payable to the Government as taxes. In the case of other organizations, such as social clubs and fraternal beneficiary societies, the grant of tax exemption is designed to allow groups of individuals to form separate nonprofit organizations for purposes of recreation or mutual benefit without tax consequences which might technically result from accomplishing these purposes through such a separate organization.

Prior to 1950, it became general knowledge that some tax-exempt organizations were engaging in businesses unrelated to their exempt purposes. For example, an eduactional institution had purchased and operated a macaroni factory. Under the law as it then existed, the profits earned by the institution from this activity were untaxed since the tax exemption applied to all sources of income earned by an organization which qualified for exemption. These unrelated business activities were generally conducted in direct competition with taxpaying businesses. If tax exemption were available to shield the income from these unrelated business activities, exempt organizations could enjoy, vis-a-viz their taxpaying competitors, substantial competitive advantages such as the ability to charge lower prices and to expand their business operations out of earnings undiminished by taxation.

Congress responded to this problem of unfair competition by the passage in 1950 of the unrelated business income tax. Under these provisions, income tax is imposed upon the income derived by *certain* exempt organizations from the regular conduct of an unrelated trade or business.

PROBLEM

The unrelated business income tax under present law does not apply to all tax-exempt organizations. Although it applies, for example, to charitable, educational, and scientific organizations, it is expressly inapplicable to many classes of exempt organizations, including:

1. *Churches.*—In order to qualify as an exempt organization a church must be organized and operated exclusively for religious purposes. Generally, under present law, a church will qualify for exemption even though it engages in some unrelated business activity, unless its primary purpose is the carrying on of an unrelated trade or business. For example, in one actual case, an organization exempt as a church operated a wholesale distributorship of popular phonograph records in direct competition with taxpaying competitors without incurring any income tax on the income therefrom. Substantial unrelated business activities of churches do exist. The failure of the tax to apply in these situations creates an unfair competitive advantage in favor of churches.

2. *Social welfare organizations.*—A social welfare organization is one not organized for profit, whose exclusive purpose is to promote the common good or the general welfare of the people of the community. Such organizations include, for example, organizations for the advancement of good government, for the encouragement of amateur athletics, and veterans organizations. These groups can qualify for exemption under present law even though they engage in unrelated business for profit if their primary activity is not the carrying on of a business with the general public in a manner similar to organizations which are operated for profit. For example, a social welfare organization could operate a restaurant next door to a taxpaying competitor and receive the income therefrom free of tax. The failure of the unrelated business income tax to apply allows the tax exemption to create an unfair competitive advantage in favor of the social welfare organization to the detriment of their taxpaying competitors.

3. *Social clubs.*—Social clubs are clubs organized and operated exclusively for pleasure, recreation, or other nonprofit purposes of similar character, no part of the net earnings of which inures to the benefit of any private shareholder or member. Country clubs and swimming clubs are examples. Under present law, in order to qualify for exemption, a social club must, in general, be supported solely by membership fees, dues, and assessments. However, to the extent that there is leeway under this standard of exemption to engage in any unrelated trade or business, the failure of the unrelated business income tax to apply imposes an unfair burden upon taxpaying competitors.

In addition to the general problem of unfair competition resulting from the conduct of an unrelated trade or business, social clubs present a special problem with regard to *any income* from sources outside the membership, whether such income results from the conduct of an unrelated trade or business or passive investments.

Since the tax exemption for social clubs is designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without further tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit not contemplated by the exemption. In such a case, untaxed dollars can be used by the organization to provide pleasure or recreation to its membership. For example, if a social club were to receive $10,000 of untaxed income from investments in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without further tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose.

4. *Fraternal beneficiary societies.*—Fraternal societies which are organized under a lodge system (semiautonomous local chapters connected through a common parent organization) and which provide for the payment of life, sick, accident, or other benefits to the members of the society or their dependents are exempt from tax. Separate organizations providing such benefits exclusively to such members (and dependents) are also exempt. To qualify for exemption under this provision, a fraternal beneficiary society must be operated *both* in furtherance of its fraternal purposes, such as providing social or recreational facilities to the membership, and its beneficial purposes, such as providing life insurance to the members. To the extent that these organizations have income from unrelated business activities, the failure of the unrelated business income tax to apply permits an unfair competitive advantage through the tax laws.

In addition to the unfair competitive advantage enjoyed by fraternal beneficiary societies which choose to engage in competitive business activities, the receipt of untaxed income for use in providing recreational or social facilities in furtherance of the organization's *fraternal* purpose creates a similar problem to that of social clubs. To the extent that income is available to provide recreational or social facilities, tax-free dollars are being used to provide purely personal facilities for the membership. On the other hand, receipt of investment income for use in the insurance function presents a distinct problem. Investment income is an integral part of the insurance function of such organizations as it is part of the traditional and normal manner in which insurance companies provide for the covering of losses. The correct treatment of this income, then, is bound up in the overall question of the treatment of the insurance function of all exempt organizations presently permitted to engage in such activities. As noted below, this matter is presently under study.

PROPOSAL

(1) *Extension of the unrelated business income tax to churches and social welfare organizations.*—The proposal would extend the existing provisions of the unrelated business income tax to churches and to social welfare organizations. This would result in the elimination of unfair competition resulting from the present application of the tax exemption in these cases beyond its proper purpose.

(2) *Imposition of tax on certain income of social clubs and fraternal beneficiary societies.*

(a) *Social clubs.*—The proposal would also limit the tax exemption for social clubs to income from dues, fees, or other amounts *paid by members* for providing to such members or their guests goods, facilities or services constituting the basis for the tax exemption. Thus, income from sources outside the membership generated in any manner, and income from the membership generated other than in exchange for goods, facilities or services consistent with the club's exempt functions would be subject to the unrelated business income tax. This rule would apply as follows:

(1) *Payments for club facilities.*—A payment by a *member* for use of the club bar or restaurant would not be subject to the tax since the use of these facilities is consistent with the exempt function of the social club and the payment is from a source within the membership. However, a *payment* by a *nonmember* for use of the club bar or restaurant would be subject to the tax since the payment is from a source outside the membership.

(2) *Payments for other than club facilities.*—Payment of interest on a loan from the club (whether by a member or nonmember) would be subject to the tax since the payment of interest is not in exchange for goods, facilities or services constituting the basis for the tax exemption, *i.e.*, the recreational or pleasure functions of the organization.

Under the present provisions of the unrelated business income tax, income from rents, royalties, interest, dividends, and annuities as well as gains from sales or other dispositions of capital assets are exempt from tax. In order to effectuate the purpose of limiting the social club exemption to membership source income for exempt function facilities, these exceptions to the unrelated business income tax would be made inapplicable to social clubs.

These changes in the tax treatment of social clubs would result in the elimination of the unwarranted benefit to members resulting from pleasure and recreational facilities provided with untaxed income. They would also eliminate any unfair competition that might result were social clubs not subject to the tax.

(b) *Fraternal beneficiary societies.*—Fraternal beneficiary societies would be taxed in the same manner as social clubs with an additional exemption for income from property permanently committed to providing life, sick, accident or other benefits to the membership or their dependents. Property would be permanently committed to providing such benefits if it is held solely for the purpose of providing for such benefits, or producing income for providing such benefits, and under no circumstances could the property or income be used for any purpose other than providing benefits or meeting operating expenses of pro-

viding such benefits. For example, the income from the investment of funds held as an insurance reserve would be exempt under this provision since an insurance reserve must be used for providing benefits.

### FURTHER STUDY

The possibility of unfair competition resulting from the inapplicability of the unrelated business income tax may exist in classes of tax-exempt organizations other than those dealt with under this proposal. Furthermore, unwarranted benefits to members from nonmember income, similar to those encountered in connection with the social clubs and fraternal beneficiary societies, may also exist in other classes of tax-exempt organizations (including social welfare organizations). Finally, special problems are raised by the relationship between the unrelated business income tax and the insurance, banking, retirement or other business oriented functions of several exempt organizations (including the insurance function of fraternal beneficiary societies). The question of the proper tax treatment in all of these cases is under review and study by the Treasury Department. At a later date, when this study has been completed, the Treasury may have further recommendations to offer in this area.

### EFFECTIVE DATE

These provisions will become effective for taxable years beginning after December 31, 1969.

## VII–C. EXPANSION OF TAXATION OF INCOME FROM UNRELATED BUSINESSES AND FROM INVESTMENTS OF CERTAIN ORGANIZATIONS

### Technical Explanation

### PRESENT LAW

Under present law educational, religious, charitable, and social welfare organizations as well as social clubs and fraternal beneficiary societies meeting the requirements of the Internal Revenue Code (sec. 501) are among the organizations exempt from Federal income tax. Notwithstanding this exemption, *certain* of these organizations are subject to an income tax—called the unrelated business income tax—on income derived from a regularly carried on unrelated trade or business. Among the several organizations *subject* to the unrelated business income tax are charitable, educational, or religious organizations (other than churches), labor, agricultural or horticultural organizations, business leagues, certain mutual banking institutions, and certain employee benefit plans. Among the several organizations *not subject* to the tax are churches (including conventions or associations of churches), social welfare organizations, social clubs, fraternal bene-

ficiary societies, and certain other organizations for the mutual benefit of their members.

In general, the unrelated business income tax is imposed at the corporate rates upon income generated from (1) a trade or business (2) regularly carried on (3) that is not substantially related, aside from the need for funds, to the organization's exempt purposes. [1] The term "trade or business" has the same meaning under these provisions as it has under the income tax provisions dealing with the deductibility of business expenses. Generally, any activity carried on for the production of income from the sale of goods or the performance of services would constitute a "trade or business."

Business activities are considered to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

A trade or business is considered to be unrelated if the activities involved in conducting the business are not substantially related (aside from the need for funds) to the performance by the organization of its exempt function. For the conduct of a trade or business to be substantially related to an exempt function, it must contribute importantly to the accomplishment of the exempt function. For example, income from admission charges for a student performance derived by an educational organization operating a school training children in the performing arts, such as acting, singing, and dancing, would not be subject to the tax since student participation in performances before audiences is an essential part of their training. These activities, therefore, contribute importantly to the accomplishment of the educational organization's exempt purpose. On the other hand, if this educational organization were to operate a furniture factory, the income derived from these activities would be subject to the tax, since the activities of manufacturing and distributing furniture do not contribute importantly to the accomplishment of the organization's exempt function of teaching students in the performing arts.

Three specific exceptions are provided to the concept of "unrelated" trade or business:

(1) Any trade or business in which substantially all of the work of carrying it on is performed without compensation would not be considered an unrelated trade or business. For example, income derived by a charitable organization from a retail store selling furniture which was operated wholly by volunteers without compensation would not be subject to the tax.

(2) A trade or business operated by a charitable organization or by a college or university primarily for the convenience of the organization's members, students, patients, officers, or employees would not be considered an unrelated trade or business. Therefore, income from the operation of a school cafeteria for students would not be subject to the tax.

(3) A trade or business which consists of the selling of merchandise substantially all of which has been received by the organization as gifts or contributions also would not be considered an unrelated trade

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[1] In the case of an organization which is a trust, the individual rather than the corporate rates apply.

or business. For example, income derived by a tax-exempt organization from the operation of a so-called thrift shop where those who desire to benefit the organization contribute old clothes, books, furniture, et cetera, to be sold to the general public would not be subject to the tax.

In general, the income subject to tax (called unrelated business taxable income) is computed in the manner similar to the computation of taxable income for income tax purposes. However, several significant adjustments are made. Deductions normally allowable under the general rules of income tax may be deducted only to the extent that they meet the additional test of being "directly connected" with the carrying on of the unrelated trade or business. In order to be directly connected the deduction must have a proximate and primary relationship to the carrying on of that business.

Certain exceptions, additions, and limitations apply in computing unrelated business taxable income. Investment income, such as dividends, interest, annuities, royalties, and most rents from real property are excluded. However, in certain cases of rent received on a "business lease," a portion or all of that rent *is* includable in income. In general a "business lease" is defined as a lease of real property for a term of more than 5 years if at the close of the taxable year there is an outstanding indebtedness which was incurred in acquiring or improving the property. A lease will not be considered a business lease if it is entered into primarily to advance the organization's exempt purposes (other than through the use of funds) whether or not there is an outstanding indebtedness on the property. The amount of business lease income taken into account is the same percentage of total rental income from the property as is the outstanding indebtedness to the adjusted basis in the property.

Under a separate proposal dealing with debt-financed acquisitions of property, certain changes in the "business lease" rules would be made. That proposal would modify the "business lease" rule by, in general, eliminating the 5-year term requirement and extending the rule to any property, rather than just real property. However, as an exception, any property all the income from which is taken into account in computing the unrelated business income tax in general would not be considered property subject to the debt-financed acquisition rules. Thus, for example, income generated from the active conduct of an unrelated trade or business regularly carried on would not be taxed under the debt-financed acquisition rules (but would be under the general unrelated business income tax) whether or not some of the assets used in that business were subject to an outstanding indebtedness.

Most capital gains and losses are excluded from unrelated business taxable income. Thus, gain on the sale or exchange of shares of stock would be excludable.

The net operating loss deduction generally applicable under the income tax is allowed in computing unrelated business taxable income. It is computed, however, without taking into account any amount of income or deduction which is excluded from the computation of the unrelated business income tax. Thus, for example, deductions which are not directly connected with an unrelated trade or business could not be used to increase the amount of the net operating loss.

In certain specified cases, all income derived from research (and all deductions directly connected with such income) is excluded from unrelated business taxable income.

Charitable deductions, meeting the qualifications and within the limitations of the provisions dealing with such deductions generally, are allowed whether or not they are directly connected with the carrying on of a trade or business.

A specific deduction of $1,000 is provided.

In the case of a trade or business conducted by a partnership of which an exempt organization is a partner, the exempt organization includes in income or deductions its share of the partnership gross income or deductions.

ORGANIZATIONS NOT SUBJECT TO UNRELATED BUSINESS INCOME TAX

Among the organizations not subject to the unrelated business income tax are the following four with which this proposal deals:

(1) *Churches.*—Churches are exempt from income tax under the general category of organizations organized and operated exclusively for religious purposes. Under present law, churches may qualify for exemption even though they engage in unrelated business activities, so long as the primary purpose of the church is not the carrying on of an unrelated trade or business. The profits from the operation of a trade or business that fall within these permissible limits are not subject to the unrelated business income tax.

(2) *Social Welfare Organizations.*—Organizations not organized for profit but operated exclusively for the promotion of social welfare, such as the advancement of good government, the encouragement of amateur athletics, or veterans' organizations are exempt from tax as social welfare organizations. In addition, local associations of employees which are devoted exclusively to charitable, education, or recreational purposes are exempt from tax under this same provision. Such organizations may qualify for exemption even though they engage in unrelated business activities, so long as carrying on the business is not the primary activity of the organization. Profits earned from a business that fall within this permissible limit are not subject to the unrelated business income tax.

(3) *Social Clubs.*—Clubs organized and operated exclusively for pleasure, recreation, and other nonprofit purposes of similar character, no part of the net earnings of which inures to the benefit of any member or shareholder, are exempt from tax. Examples of organizations exempt under this provision are country clubs, tennis, golf, or swimming clubs. In order to qualify for exemption, a social club must in general be supported solely by membership fees, dues, and assessments. The conduct of profitmaking activities with the general public or the regular receipt of substantial investment income would result in loss of exemption. However, profitmaking activities which are incidental to the accomplishment of the club's exempt function would not result in loss of exemption. For example, income derived from opening club facilities to the general public for profit would result in a loss of exemption since the club would fail to be supported solely by membership fees, dues, or assessments. On the other hand, income, received

over a relatively short period of time, from the investment of the proceeds of the sale of its old clubhouse pending acquisition of a new home for the club would not result in loss of exemption since the transaction would be considered incidental to the exempt activities of the social club, i.e., providing a clubhouse. Within these standards, to the extent that a social club is permitted to derive income from an unrelated trade or business or investments without loss of exemption, that income is not subject to tax.

(4) *Fraternal Beneficiary Societies.*—Fraternal organizations operated under the lodge system and providing for the payment of life, sick, accident, or other benefits to the members of the association or their dependents are exempt from tax.[2] In general, such organizations consist of mutual fellowship and benefit societies operated through local branches with a centralized parent. To qualify, an organization must be operated both in furtherance of its fraternal purposes, such as providing social or recreational facilities for its membership, and its beneficial purposes, such as providing life insurance to members. To the extent that such organizations earn profits from an unrelated trade or business or from investments without loss of exemption, that income would not be subject to tax.

## THE PROPOSAL

(1) *Extension of unrelated business income tax to churches and social welfare organizations.*—The proposal would eliminate the specific exemption of "a church, convention, or an association of churches" from the present list of organizations subject to the tax and would add to that list social welfare organizations (and local employee associations). This change would subject these organizations to the existing provisions of the unrelated business income tax as presently applied to other tax-exempt organizations, such as charitable or educational organizations. Thus, income from an unrelated trade or business regularly carried on by a church, social welfare organization or local employee association would be subject to the tax. Unrelated business taxable income would be computed in the same manner as that described above for organizations presently subject to the tax. Thus, the allowance of the deductions and the exceptions, additions, and limitations applicable to the computation of unrelated business taxable income under present law would apply to the income derived by such organizations from regularly carried on trades or businesses. The present business lease rules or the proposed debt-financed acquisition rules would also apply to these organizations.

The three special exceptions to the meaning of the term "unrelated trade or business" under present law would be applicable to these organizations. Thus, a trade or business in which substantially all of the work in carrying it on is performed without compensation for a church, social welfare organization, or local employee association; or which is carried on by such an organization primarily for the convenience of its members, officers, or employees; or which consists of selling merchandise received as gifts or contributions, would not be considered as an unrelated trade or business.

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[2] An organization operated for the exclusive benefit of the members of a fraternity itself operating under the lodge system and providing life, sick, etc., benefits is also exempt.

(2) *Imposition of tax on certain income of social clubs and fraternal beneficiary societies.*

(*a*) *Social clubs.*—Under this proposal, the tax exemption for income of social clubs would be limited to the income from dues, fees, or other amounts paid by members for providing to such members or their guests goods, facilities, or services constituting the basis for the tax exemption (referred to as providing "exempt function facilities"). All other income would be taxable under the unrelated business income tax with certain modifications to be discussed below. Thus, in order to be exempt from tax, social club income would have to meet a two-part test: (1) The income would have to be generated from providing exempt function facilities, such as food or drink at the club bar or restaurant or playing facilities at the club golf course or tennis court, and (2) the income would have to be from amounts paid by the membership.

Under *part 1* of the test, *any* income which was not in exchange for exempt function facilities would be subject to the tax, regardless of whether it was from member or nonmember sources. Thus, for example, interest paid to a social club on a loan would be subject to the tax whether that loan were to a member or a nonmember. Under the *second part* of the test, income from providing exempt function facilities would nevertheless be taxable if it is received from sources outside the membership. For example, amounts paid by a nonmember for a dinner at the club restaurant would be subject to the tax. On the other hand, a similar amount paid by a member would not be subject to the tax, since it would be income from a member in exchange for providing exempt function facilities.

Thus, under the proposal, all income, other than that from members in exchange for exempt function facilities, would be included in gross income, whether or not the activities generating the income were sufficient to meet the requirements of a "trade or business regularly carried on" generally applicable under the unrelated business income tax. Income from an investment [3] would be subject to the tax whether or not the activities engaged in by the social club in generating that income were sufficient to meet the "trade or business" test of the unrelated business income tax. Similarly, an admission fee paid by a nonmember for entry into an annual fundraising dance would be taxable, whether or not the annual fundraising dance were an activity sufficient to meet the test of "regularly carried on."

The three specific exceptions to the term "unrelated trade or business" would not be applicable to social clubs. Thus, income would not be exempt from tax simply because it was generated by a trade or business carried on by persons who worked for the organization without compensation, because it was carried on by the organization primarily for the convenience of its members, or because it consisted of selling merchandise received as contributions. In all of these cases, the income would be exempt only if it met the two-part test described above.

The computation of income subject to the tax would be similar in most respects to the computation presently applicable under the unre-

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[3] The elimination of the present exemption from the unrelated business income tax for dividends, interest, rents, royalties, annuities, and gains from sale of property for social clubs under this proposal is discussed below.

lated business income tax in general. However, consistent with the elimination of the "trade or business regularly carried on" tests, deductions would be allowable if directly connected with *an activity generating income* subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on. For example, fees paid by a social club for the management of an income-producing portfolio of securities, otherwise deductible as an expense for the production of income, would be allowed as directly connected with that income-generating activity, even though that activity may not constitute a trade or business regularly carried on.

The specific exceptions for investment income (interest, dividends, annuities, rents, and royalties) would be made inapplicable with respect to social clubs. Thus, all investment income would be subject to the two-part test described above. Under the two-part test, income from interest, dividends, annuities, rents, and royalties would ordinarily be taxable since, in most cases, they would not be received in exchange for exempt function facilities. However, such income could be exempt if it were received from the membership in exchange for exempt function facilities. For example, rent paid by a member for a private dining room at the club would fall within this category.

The specific exemption under the tax for gains and losses from the sales, exchanges, or other dispositions of property constituting capital assets would be made inapplicable to social clubs. Such gains or losses would be subject to the normal rules of income tax treatment.

In all other respects, the computation of social club income subject to the unrelated business income tax would be the same as that of other tax-exempt organizations. Thus, for example, net operating losses, charitable contributions, and the specific $1,000 deduction would be available in computation of unrelated business taxable income.

(*b*) *Fraternal beneficiary societies.*—The tax exemption for fraternal beneficiary societies would be limited to—

(1) Income from dues, fees, or other amounts paid by members for providing to such members or their guests goods, facilities, or services in furtherance of the exempt function (both fraternal and beneficial) of the organization; and

(2) Income from property permanently committed to the insurance or other beneficial function (insurance function income).

Thus, with the exception of the treatment of income from property permanently committed to the insurance or other beneficial function of the fraternal organization, the remaining amounts would be subject to the unrelated business income tax in exactly the same fashion as income of social clubs. The portion of that remaining amount that is membership income in exchange for exempt function facilities would be exempt and all other amounts would be included in computing unrelated business taxable income.

With regard to insurance function income, all income from property (and losses and deductions directly connected to such income or property) permanently committed to providing for the payment of life, sick, accident, or other benefits to members of the society (or dependents), or for operating expenses of providing such benefits, would be excluded from the unrelated business income tax as "income from

property permanently committed to the insurance or other beneficial function."

Property would be permanently committed to the insurance or other beneficial function if it is held solely for the purpose of providing for such benefits, meeting operating expenses in providing such benefits, or producing income for those purposes, and it is impossible, at any time prior to providing all such benefits, for any part of the property or income to be used for or diverted to any other purpose.

For example, income earned on the investment of an insurance reserve would be exempt, since the insurance reserve is held solely for the payment of claims and could not be used for any other purpose prior to the satisfaction of those claims.

All income not falling within the categories of membership income for exempt function facilities or income from property permanently committed to the insurance function would be includable in the computation of unrelated business taxable income.

The computation of unrelated business taxable income would be subject to the same rules as social clubs with one addition. The business lease rules under present law and the proposed debt-financed acquisition rules *would be applicable* to property permanently committed to the insurance function. Thus, for example, if all the conditions of the debt-financed acquisition rules applied, income of a fraternal beneficiary society subject to those rules would be taxable even though the property producing the income were permanently committed to the insurance function.

### TITLE HOLDING COMPANIES OF SOCIAL CLUBS AND FRATERNAL BENEFICIARY SOCIETIES

Under present law, a corporation organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an exempt organization is itself exempt from tax. However, the unrelated business income tax applies to title holding companies if the organization for which it collects income is subject to the unrelated business income tax.

In the case of social clubs and fraternal beneficiary societies, title holding companies for their benefit would be subject to the unrelated business income tax. However, the rules for determining the tax exempt character of the income would be applied as if the purposes of the title-holding company were those of the exempt parent. Thus, for example, if a title-holding company subsidiary of a parent fraternal beneficiary society received rental income, that income would be exempt or taxable depending upon whether or not the income were from property permanently committed to the insurance function in the hands of the title-holding company.

Similarly, income from a member of a social club received by the social club's title-holding company in exchange for providing exempt function facilities would not be subject to the unrelated business income tax. On the other hand, income from a non-member would be taxable.

All transactions between the title-holding company and its parent exempt organization would be ignored. Thus, rent paid by a social

club to its title-holding company would not be income to the title-holding company and would not give rise to a deduction by the social club. Similarly, dividends paid to the social club would not be taxable.

The unrelated business taxable income of the title-holding company would be computed in the same manner as that of the parent.

### EFFECTIVE DATE

These provisions will become effective for taxable years beginning after December 31, 1969.

# VIII. ESTATE AND GIFT TAX PROPOSALS

## General and Technical Explanations

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# VIII–A. TAXATION OF APPRECIATION OF ASSETS TRANSFERRED AT DEATH OR BY GIFT

## General Explanation

### GENERAL EXPLANATION AND DESCRIPTION

Under present law, a person whose income consists of salaries, wages, dividends, or business profits is taxed at ordinary income rates on an annual basis. Special treatment is afforded to income from the sale of capital assets in that such income is taxed at a lower rate when the assets are sold. In both these situations, the estate which the taxpayer passes on to his wife and children at his death is accumulated after income taxes have been paid.

However, a person who holds capital assets which have appreciated in value until death can avoid taxation of this income altogether. Moreover, the recipient of the property takes as his cost or basis the fair market value at date of death, so that the capital gain income represented by the appreciation in value is never taxed under the income tax. This means that a person who can afford to accumulate income in the form or unrealized capital gains can then pass on that accumulated wealth free of income tax—in contrast to the wage earner, salaried individual, or taxpayer who has sold capital assets, all of whom transfer their accumulated wealth after it is reduced by income taxes.

As a result of this situation:

There is inequality in the income tax treatment of people who accumulate their estates out of currently taxable income as compared to those who accumulate estates by means of unrealized capital gains.

At least $15 billion a year of capital gains fall completely outside the income tax system.

There are undesirable economic effects because of the resulting "lock-in" effect.

These problems—taxpayer inequity, revenue loss, and lock-in effect—must be analyzed in some detail to appreciate their significance.

### TAXPAYER INEQUITY

A great deal of income after tax from wages, dividends, and the like is saved; that is, it serves to increase the wealth of the taxpayer. Another taxpayer may find that his wealth has increased because the assets he owns have increased in value.

A simple example will clarify the point that these two paths to wealth accumulation are at present given dissimilar tax treatment.

Assume Taxpayer A earns $200,000 and pays tax of 50 percent or $100,000. For simplicity, it is assumed that he intends to save half of his income and to consume half. This means that he will have $50,000 for consumption and $50,000 that he can invest in, say, common stock.

Taxpayer B earns $100,000 on which we will say he pays 50 percent in tax and he uses this entirely for consumption. Taxpayer B, however, differs from A in that when the year started he already owned common stock worth $200,000; and during this period it rose in value by 50 percent or by $100,000.

Clearly Taxpayer A tried to increase his wealth by $100,000. He wanted to save half of his income, but the tax cut it down. He only increased his wealth $50,000 after tax. B finds that his wealth has increased; and since our present tax law does not count unrealized appreciation in value as taxable income, he is able to add the whole increase in value to his wealth.

The fact is that the two taxpayers have paid quite different rates. A has paid $100,000 of tax, and B has paid only $50,000. But it cannot be said that A really has more ability to pay than B. They both paid the same tax on the $100,000 of the before-tax income that they used for consumption. They both spend the same on consumption, so it could even be assumed that they lived in the same kind of houses, ate the same food, and took the same vacations. The extra ability to pay that A has is really the extra income that he used to increase the value of his holdings in securities. But B increased the value of his holding in securities by twice as much as A did.

For administrative reasons the tax system does not every year make B calculate how much his holdings have appreciated in value. The law permits B to postpone including this appreciation until he sells his assets. But more often than not appreciation is not sold; it is used for estate building and at the time of death the gain is not subject to income tax. The heir treats as his "cost" the value of the property at the time of death.

The estate tax will fall on both A and B so it is not relevant to say that B ought not to pay any income tax on his accumulation of wealth "because he pays an estate tax." A has paid income tax on the money that he earned to build an estate *and* an estate tax. B avoided income tax on his wealth increase and *only* an estate tax was paid on it.

The substance of the present proposal is to reduce the estate tax rate by about the amount raised by capital gains tax at death. Thus the combined tax will be reduced on A and increased on B. The increase on B will be equivalent to what would have happened if B had sold his appreciated property just before death. B would then pay the capital gains tax, but the amount of the capital gains tax would be out of the estate making the estate tax somewhat lower. The proposal would tax the capital gain at death and then allow the capital gains tax as a deduction from the estate.

B. will still be taxed more favorably if he holds his appreciation until death than if he sold it during lifetime. This occurs because the postponement means that during his life B will have had more money invested and thus more income (or appreciation) than he would if he had sold before death. B is also benefited since a gain at death does not come into the proposed minimum tax base. B has an even greater advantage compared to an individual who accumulates his wealth out of ordinary income like salary or dividends. Not only does B get to postpone the tax on his wealth increase but he also pays tax on it at capital gains rates, not ordinary income rates.

Finally the transition proposal allows B to avoid tax on all appreciation up to the date of enactment.

To explain fully the case for this proposal, it is useful to address three issues that are often raised.

(1) *Question.* Is it sound to call the increase in value of B's property income at his death when the property has not yet been sold and may go down in value?

*Answer.* Assets that have not appreciated are valued under present rules for estate tax purposes and that value is the basis for an estate tax that goes up to 77 percent. These assets also might go down in value, and both kinds of assets might go up even more. These subsequent value changes can properly be treated as gains or losses to the heir.

(2) *Question.* Is it fair to tax B on an appreciation of value which just matches the general rise in consumer prices?

*Answer.* One answer is that A is taxed on the same thing. The entire tax system is based on money income. Inflation gains are not excluded, nor are deductions allowed for inflation losses. An obvious reason for taxing inflation gains is that to the extent of inflation gains an individual benefits by escaping from the reduction of purchasing power that inflation imposes on holders of fixed dollar claims. The burden can be shared more equally if some tax is imposed on the benefit from escaping inflation.

Further, over the long run the principal assets involved in appreciation, land and stocks, have increased in price over twice as fast as consumer prices. This is important when one recognizes that the capital gains rate is a maximum 25 percent.

(3) *Question.* Won't a tax on the appreciation transferred at death hurt families that have wealth in illiquid form?

*Answer.* To some extent the appreciation can be in relatively illiquid form, but the far greater portion of it will be in highly liquid common stocks. If there is reason to regard illiquidity as a problem, it makes far more sense to provide some appropriate means of paying death taxes in the illiquid cases than to favor a large group of estates with appreciation in liquid form. The present proposals deal with the illiquidity problem directly, both as to the proposed capital gains tax at death and the estate tax itself.

### REVENUE LOSS

On estate tax returns filed in 1966, the total value of property of a type that might show appreciation (stock, real estate, trust interests and noncorporate business assets) was about $15 billion. The portion of this that represented appreciation was probably in the range of 40 to 50 percent.[1]

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[1] B. Okun ("The Taxation of Decedents' Unrealized Capital Gains," *National Tax Journal,* December 1967, pp. 368–385.) Estimates the ratio of appreciation to value as 45 percent for real estate and 54 percent for stock. Brannon, McClung and Copeland ("Unrealized Appreciation Passing at Death," *American Statistical Association Proceedings,* 1967, pp. 147–167) derive minimum estimates of 37 percent for stock and 33 percent for real estate. These are minimum in the sense that they are derived from an assumption that assets sold by a taxpayer are randomly drawn from his holdings. A rational investment strategy would be to prefer to sell the assets with less appreciation and thus less current tax. This would imply a higher ratio of appreciation for assets left in the portfolio. Barlow, Brazer and Morgan (*The Economic Behavior of the Affluent,* Brookings, 1966) report the result of their interview survey that among the very high-income group capital appreciation was the source of 51 percent of their wealth.

This suggests that the appreciation passing through the estates of estate tax filers in 1966 must have been in the general magnitude of $6 to $8 billion, or about $7 billion. An additional amount of appreciation about 65 percent as large, or about $4.5 billion, passed from decedents for whom an estate tax return was not required.[2]

Table 1 following indicates some aspects of taxing appreciation at death by income level. The data indicate the situation 10 years after the new basis date (date of enactment), when it is assumed that the average property of a type subject to appreciation (principally stock, real estate, trust interests and noncorporate business assets) will reflect an average appreciation of about 25 percent.

TABLE 1.—DATA ON THE OPERATION OF THE PROPOSAL FOR TAXING GAINS AT DEATH 1981 [1]

| Economic estate class (in thousands of dollars) | Percent of estate of appreciable assets [2] | Percent of appreciation [3] | Appreciation as percent of economic estate | Net capital gains tax as percent of economic estate [4] | Net capital gains tax as percent of present law estate tax after credits |
|---|---|---|---|---|---|
| 60 to 100 | 62 | 20 | 12.3 | 0.7 | 84.0 |
| 100 to 200 | 67 | 22 | 14.5 | 1.4 | 30.0 |
| 200 to 400 | 75 | 23 | 17.4 | 1.6 | 15.2 |
| 400 to 600 | 78 | 25 | 19.7 | 1.9 | 12.9 |
| 600 to 1,000 | 80 | 27 | 21.4 | 2.2 | 13.3 |
| 1,000 to 2,000 | 83 | 30 | 24.5 | 2.6 | 13.5 |
| 2,000 to 3,000 | 82 | 32 | 26.2 | 2.7 | 12.4 |
| 3,000 to 5,000 | 83 | 35 | 29.1 | 2.9 | 12.0 |
| 5,000 and up | 86 | 37 | 32.2 | 2.8 | 11.7 |

[1] An effective date of Jan. 1, 1970, is assumed.

[2] Includes stock, real estate, trust interests, and noncorporate business assets. The economic estate is gross estate less debts.

[3] This takes into account the observed patterns that appreciation rates and holding period are higher at the upper wealth levels plus some shifting asset composition. (E.g., the personal residence with a low appreciation rate is more important at low wealth levels.)

[4] This takes into account 4 factors: (a) the tendency for applicable capital gain rates to be higher at upper wealth levels, (b) the deduction for contributions which is higher at upper wealth levels, (c) the deduction of marital bequests which is greater at lower wealth levels, and (d) the deduction of the capital gains tax against the estate tax (at 1980 rates) which is more valuable at higher wealth levels.

## UNDESIRABLE ECONOMIC EFFECTS

When tax liability is allowed to depend on whether an appreciated asset is sold or kept until death, the tax law operates to produce undesirable economic effects, particularly in cases of older people. Assets become immobilized; investors become "locked-in" by the prospect of avoiding income tax completely if they hold appreciated assets until death rather than selling them. This freezing of investment positions deprives the economy of the fruits of an unencumbered flow of capital toward areas of enterprise promising larger rewards.

## PROPOSAL

To remedy these problems, under the proposal persons holding appreciated capital assets at death would be treated as if they had sold such assets just before death, and such gains would be taxed in the final income tax return of the decedent. The tax rate would be that now applicable to capital gains on assets sold during life. The tax on these gains at death would be due under the income tax, but the amount

[2] Okun, *op. cit.*, p. 385.

of the tax would be deducted in determining the amount of property subject to estate tax. The taxable estate would thus be net of the income tax paid, as is the case for those who accumulate their estates out of ordinary income or out of capital assets sold prior to death. The assets taxed at death would take as their cost or basis the fair market value at death, as is true today.

The transition to the new system will be smoothed for those who are now holding appreciated assets in anticipation of tax-free transfers at death, by a provision that only appreciation occurring after the date of enactment would be subject to tax at death.

The following measures insure the equitable operation of the new law:

Only appreciation occurring after the date of enactment would be subject to tax;

Taxpayers would be allowed a minimum basis of $60,000, with the result that no tax at all would be imposed on the appreciation when the total value of assets transferred is $60,000 or less;

Complete exemption would be allowed for gain on property transferred to a spouse or to charity;

Limited exemption would be allowed for gain on transfers of property to orphans and transfers of ordinary personal and household effects;

Present rules for payment of taxes due at death for those estates that have liquidity problems will be liberalized, and the new rules will apply to capital gains taxes as well as transfer taxes.

The tax on appreciation on transferred assets would be allowed as a deduction for estate tax purposes;

Net unrealized losses on business or investment property would be allowed as an offset against capital gain and, subject to appropriate limitations, against ordinary income for the 3 taxable years preceding the decedent's final income tax return;

Gains on assets giving rise to ordinary income transferred at death would be eligible for averaging.

## OPERATION OF PROPOSAL

Under present law, property that has appreciated in value can be transferred at death without any income tax being imposed on the increase in value that accrued during the decedent's lifetime. At the same time these assets receive a new basis equal to their fair market value at the death of the decedent, so that the predeath appreciation escapes income taxation forever.

Under the proposal the appreciation in assets held at death will be subject to income taxation at that time. The tax will be reported in the decedent's final income tax return (prepared by the executor) and will be due at the same time as the estate tax return of the decedent, that is, 15 months after the date of death.

As under the present estate tax, the fair market value[3] of the decedent's property for income tax purposes would be determined as of the date of death or the alternate valuation date (generally 1 year

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[3] The "fair market value" is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of all relevant facts.

after the date of death except with respect to property disposed of during the year following death). The 50-percent exclusion and the alternative 25-percent maximum rate applicable to long-term capital gain will be available regardless of the length of time the decedent has actually held the property. The transferee of the decedent's property would take as his basis the fair market value of the property on the date of death of the decedent, as under present rules.

LOSSES

Where an individual holds capital assets whose fair market value is less than their adjusted tax bases (ordinarily, cost) at the date of his death, the resulting losses will be allowed for tax purposes in the year of death. These losses, as well as losses sustained on sales during the last year of the decedent's life, and any capital loss carryforward from prior years, will be deductible as under the regular rules applicable to capital losses, by first offsetting capital gains of the last taxable year, with any excess allowed, to the extent of $1,000, as a deduction against ordinary income of that year. If there are still additional unused capital losses remaining, a special rule will permit an offset against capital gains of the decedent in his 3 prior taxable years. If there still remain unused capital losses, an offset against ordinary income in the last taxable year of a decedent will be permitted and then in his 3 prior taxable years.

This special offset of additional amounts of losses against ordinary income will, however, be limited so that capital losses will be deductible only to the same extent that capital gains are included in ordinary income. Thus, generally, 50 percent of capital losses will be deductible, but in no event will the tax benefit resulting from the offset against ordinary income be greater than the tax benefit that would have resulted had the income to be offset been capital gain rather than ordinary income. In other words, the tax saving resulting from the offset of a loss will not be permitted to exceed 25 percent of the amount of the ordinary income offset by the offset. The basis of the loss property in the hands of the decendent's transferee would be fair market value at death as under present law.

RELATION OF INCOME TAX TO ESTATE TAX

The income tax on the gain at death will constitute a debt of the estate and will be deductible for transfer tax purposes, so as to reduce transfer tax liability. The treatment here follows present estate tax rules dealing with debts of an estate and, coupled with the reduction in rates under the unified transfer tax proposal, means that on the average the total taxes paid on death under these proposals will be substantially the same as is paid for estate taxes under present law.

EXCEPTIONS

*(A) Basic exemption*

For purposes of computing gain, every taxpayer would be deemed to have a minimum basis in property owned at death of $60,000 or fair market value, whichever is lower. If the actual basis exceeds $60,000,

then gain (or loss) is computed from actual basis. Thus, if a taxpayer has property the total basis of which was $80,000, gain would be computed from this figure; but if a taxpayer's property had a total basis of $20,000 and a fair market value of $35,000 at date of death, no gain would be taxed. In each case, a stepped-up basis equal to the fair market value will be acquired by the transferee.

In addition to the basic exemption, the following exemptions will also be available:

*(B) Personal and household effects exemption*

The proposal will permanently exempt all gain on ordinary personal and household items of the decedent of a value of less than $1,000 each. This includes the clothing of the decendent, furniture, appliances, cars, jewelry, furs, works of art, and so forth. Assets of this type that have a value in excess of $1,000 will not be exempt and will be treated like any other assets of the decedent.

Losses due to depreciation in value of personal and household items will be disallowed following the usual rules relating to losses of a personal nature.

The basis to the decedent's transferee of the personal and household effects passing under the exception will be their fair market value at the decedent's death.

*(C) Marital exclusion*

As part of the unified transfer tax proposal, a 100-percent marital deduction will apply to transfers between spouses by gift or at death. The marital exclusion under the gain proposal will correspond to the unified transfer tax provisions. No gain will be recognized on the appreciation in value of property passing to the surviving spouse at death which qualifies for the transfer tax marital exclusion.[4] Where the transferee spouse receives all the property of the decedent, the property will not receive a new basis but will carry over the basis of the decedent. Where the transferee spouse receives less than all the property of the decedent, the basis in such property will be allocated under the rules outlined in (F) below.

*(D) Orphan exclusion*

Gain on property passing to orphans, which is excluded from the transfer tax under the unified transfer tax proposal, will also be excluded from the gain proposal. The property will have a basis in the hands of the transferees computed under the rules set forth in (F) below, and gain will be subject to taxation upon disposition by them.

*(E) Charitable bequests exemption*

Gain on assets transferred to charity will be permanently exempt from tax if the amount of the interest given to charity can be measured with certainty. Thus, no tax would be imposed on the appreciation in property given outright to a qualified charity. Where a transfer creates split interests (e.g., a trust to pay the income to the transferor's son for life, with the remainder to the *x* charity or vice versa), the same rules will apply as apply to gifts or bequests to charity.

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[4] This provision, the orphan exclusion, and the basic $60,000 exemption make it unnecessary to establish a separate rule for personal residences. Gain on intrafamily transfers will generally be exempted under these provisions. There is no reason to exempt gain on transfers of residences to persons other than spouses or orphans.

*(F) Allocation of basis*

The exemption of gain on property passing at death to a surviving spouse, to orphans, or to charity requires a special rule relating to basis, so that, in the case of the spouse or orphans, the gain that escapes tax at the death of the decedent will be taxed when the property is later transferred by such spouse or orphan. The basic objective of using allocated, rather than actual, basis is to eliminate any tax incentive for the decedent or his executor to transfer any particular piece of property to any particular person or entity, where such a disposition might be undesirable from a nontax standpoint. For example, if an estate consists of low-basis stock in a family corporation that the decedent would, in the absence of tax considerations, want to go to his son, and of high-basis property of equal value that he would want to go to his wife, it seems improper to create a significant tax incentive for achieving precisely the opposite disposition. A rule that taxed or exempted gain on the basis of the particular property going to each would have such an effect, since under such a rule the gain on the shares of stock in the family business could escape taxation at the decedent's death only if that property were left to the wife. To avoid this effect the proposed basis rule would require allocation of total basis among all property (other than cash) before computing the taxable gain, with a carryover of such allocated basis in the case of property on which gain is exempt. (This rule need not, and will not, apply where all the decedent's property passes to one person.) The same considerations that require allocation in the case of an estate passing in part to a spouse also require allocation in the case of property passing in part to orphans or charities.

## ITEMS GIVING RISE TO ORDINARY INCOME

Under present law, special treatment is given to items of income which are earned by a decedent prior to his death, but which are not reportable in the decedent's final income tax return. Example of this type of income are wage claims of the decedent, receivables, certain deferred compensation payments, and interest on U.S. savings bonds. Such income must be reported by the person to whom the asset is given by the decedent at the time it is received by that person. Although the recipient of the income does not receive any step up in basis on the decedent's death, a deduction is allowed to the receipient for the estate tax attributable to the inclusion of the item in the decedent's estate for Federal estate tax purposes.

Present rules were designed to avoid bunching of ordinary income in the decedent's final return. However, complexities of present law have produced troublesome problems. Therefore, this proposal substitutes a new rule for decedents dying after December 31, 1969.

The new rule would be that gain on an asset, the sale or exchange of which would produce ordinary income or capital gain, or a combination of both, will be taxed at death with ordinary income to the required extent and capital gain as to the remainder. Thus, for example, in the case of a wage claim of a decedent, the entire amount of the wage claim will be includible in the decedent's final return and taxed at ordinary income rates.

To avoid the bunching problems for which the present rules were developed, the usual averaging rules will apply to ordinary income that is taxed at death by virtue of this proposal. In addition, the 100-percent marital exclusion, the orphans exclusion, the deduction for income taxes as a debt of the estate, and the basic $60,000 exemption [5] will all be applicable to such items of income, thereby further ameliorating the bunching problem.

Special rules for assets that give rise both to ordinary income and to capital gains will be provided. Deductions attributable to income taxed at death will be allowed, but no double deductions will be permitted as is sometimes the case under present rules.

Recipients of items giving rise to the taxation of ordinary income under this proposal will receive a market value basis as to such items.

### TRANSFER OF LIFETIME GIFTS

In order that the proposed imposition of the tax on gain will neither encourage nor discourage lifetime transfers as opposed to death transfers, the gain on appreciated property transferred by gift by a taxpayer will be subject to income taxation at the time of transfer. A gift will not be treated as "completed," that is, subject to tax, unless the transfer is of a type on which the transfer tax is imposed under the unified transfer tax proposal. Generally, the rules applicable to death transfers will apply to lifetime transfers.

The following exceptions, corresponding to the exceptions for death transfers, will be applicable to lifetime gifts:

There will be an exclusion for ordinary personal household effects;

There will be an exclusion for charitable gifts;

There will be a marital exclusion on gifts between husband and wife so as to produce a result comparable to that produced by the marital exclusion on transfers at death.

Losses will be allowed on lifetime gifts under the same rules as apply at death. However, no losses will be allowed on transfers between related parties.

### FUTURE INTERESTS

Under the unified transfer tax, a substitute tax, in addition to the basic tax, would be imposed on certain complex arrangements designed to avoid tax by passing property through several generations without subjecting the property to tax in each generation. A similar problem exists in the case of capital gains tax imposed on the appreciation in the value of property transferred at death or by gift. The tax could be avoided by transferring property in such a form that the appreciation would go untaxed through several generations.

To foreclose such a possibility, thereby assuring that all taxpayers will be treated equally, a special rule would tax the appreciation when distribution following an initial transfer is made to persons who are more than one degree lower than the transferor, for example, a grandchild.

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[5] On death, the basic $60,000 exemption must be allocated first to capital assets. To the extent if it is not used up, the balance can be allocated to ordinary income items. The basic exemption will not be available for lifetime transfers of ordinary income items.

#### EFFECTIVE DATE

The new rule would apply to transfers by gift or by death after December 31, 1969.

For purposes of computing gain on property acquired before the date of enactment the taxpayer, or his personal representative, will have the option of using as his basis, either—

(1) Adjusted basis as computed under existing rules; or

(2) The value on the date of enactment as adjusted under present rules for any changes occurring after that date, including the depreciation or depletion (cost or percentage) actually taken after such date.

For purposes of computing losses on property acquired before the date of enactment, the basis is the lower of (1) or (2) above.

## VIII–A. TAXATION OF APPRECIATION OF ASSETS TRANSFERRED AT DEATH OR BY GIFT

### Technical Explanation

#### 1. GENERAL MANNER OF OPERATION OF PROPOSAL

Under present law, property that has appreciated in value can be transferred at death without any income tax being imposed on the increase in value that accrued during the decedent's lifetime. At the same time these assets receive a new basis equal to their fair market value at the death of the decedent, so that the predeath appreciation escapes income taxation forever. Under the proposal the gain on assets held at death, including assets over which the decedent has a general power of appointment will be subject to income taxation at that time. The gain will be reported in the decedent's final income tax return (prepared by the executor) and will be due at the same time as the estate tax return of the decedent, 15 months after the date of death. As under the estate tax, the fair market value of the decedent's property for income tax purposes could be determined as of the date of death or the alternate valuation date (generally 1 year after the date of death except with respect to property disposed of during the year following death). The 50 percent exclusion and the alternative 25 percent maximum rate applicable to long-term capital gain will be available regardless of the length of time the decedent has actually held the property. Various exceptions that reduce the taxable gain will be provided for personal and household effects, property transferred to a surviving spouse, and property transferred to charity. A minimum basis will be proposed in the case of transfers at death. The basis of the property subject to tax will be stepped up to fair market value in the hands of the decendent's transferee as under present law. Only appreciation in value that occurred after the date of enactment will be taxed. The income tax attributable to the gains taxed at death will be deductible from the gross estate of the decedent in determining estate tax liability, thereby reducing Federal estate taxes.

2. LOSSES

Where an individual holds capital assets whose fair market value is less than their adjusted tax basis at the date of his death, the losses will similarly be allowed on the transfer at death. These losses, as well as losses sustained on sales or exchanges during the last year of the decedent's life and any capital loss carryforward from prior years, will be deductible, as under the regular rules applicable to capital losses, by first offsetting capital gains of the last taxable year (including gains exempted under the minimum basis rule in 4(a) below) and then being allowed to the extent of $1,000 against ordinary income of that year. If then there are additional unused capital losses remaining, a special rule will permit an offset against capital gains of the decedent in his 3 prior taxable years. If then there are still unused capital losses, an offset against ordinary income in the last taxable year of a decedent, and then in his 3 prior taxable years, will be permitted. This special offset of additional amounts of losses against ordinary income will, however, be limited so that capital losses will be deductible only to the same extent that capital gains are included in ordinary income. Thus, generally, 50 percent of capital losses will be deductible, but in no event will the tax benefit resulting from the offset against ordinary income be greater than the tax benefit that would have resulted had the income to be offset been capital gain rather than ordinary income. In other words, the tax saving resulting from the offset of a loss will not be permitted to exceed 25 percent of the amount of ordinary income so offset. The basis of the loss property in the hands of the decedent's transferee would be fair market value at death as under present law.

3. RELATION OF INCOME TAX TO ESTATE TAX

The income tax on the gain at death will constitute a debt of the estate and will be deductible from the gross estate for estate tax purposes, so as to reduce any estate tax liability. The treatment here follows estate tax rules dealing with debts of an estate. Refunds are assets of the estate.

4. EXCEPTIONS

Appropriate exceptions are provided under the proposal so that its application will be equitable and moderate. Exceptions are provided for ordinary personal and household effects, so that any appreciation in such assets will not be taxed and the transferee of the assets will have a basis equal to the fair market value at the decedent's death. In order that small estates will generally be exempt from income tax as well as estate tax, gain will only be taxed at death to the extent the value of the property exceeded the greater of the decedent's aggregate basis or $60,000. In effect, every decedent will have a minimum basis of $60,000, so that gain will only be taxed to the extent fair market value exceeds $60,000, or the decedent's actual basis, whichever figure is the larger. Thus if a decedent owned property at death with a basis of $40,000 and a fair market value of $80,000, only $20,000 in gain would be subject to income tax. A marital exclusion will cover property

transferred to a surviving spouse and will be analogous to the marital deduction for estate tax purposes. The property passing under this exception will retain the basis of the decedent, so that upon disposition of the property by the surviving spouse there will be a recognition of the gain involved. A similar exclusion would cover property passing to orphans. There is also an exception for bequests to charity, the gain involved thus receiving a permanent exemption from income tax. These exceptions are described more fully below.

(*a*) *Basic exemption*

Every taxpayer would be deemed to have a minimum basis in property owned at death of $60,000 or fair market value, if lower. Thus, if a taxpayer had property the total basis of which was $80,000 and a value of $100,000, the $20,000 gain would be taxed; but if a taxpayer's property had a total basis of $20,000 and a fair market value of $35,000 at date of death, no gain would be realized. In each case, a stepped-up basis equal to the fair market value will be acquired. If a decedent had property worth $25,000 but with a basis of $80,000, the exemption would not come into play, and a loss of $55,000 would be allowed.

The provisions for the 100-percent marital exclusion, the orphan exclusion, and the basic exemption make it unnecessary to establish separate rules for personal residences. Gain on intrafamily transfers of residences will generally be exempted under these provisions. There seems to be no reason to provide any additional exemption (beyond the basic exemption) for gain on the transfers of residences to persons other than spouses or orphans.

(*b*) *Personal and household effects exemption*

The proposal will permanently exempt all gain on ordinary personal and household effects of the decedent of a value of less than $1,000 per item. This includes the clothing of the decedent, drapery, and carpeting, furniture, appliances, cars, jewelry, furs, works of art, and so forth. Assets of this type that have a value in excess of $1,000 will not be exempt and will be treated like any other assets of the decedent. For purposes of this rule, assets that constitute a set or collection, such as stamps, guns, coins, or works of art, will be treated as a single asset. When it is determined that a set or collection exceeds $1,000 in value then each item will be valued individually; gain will be recognized on individual items in the set that have appreciated in value and losses due to depreciation in value will be disallowed under usual rules relating to losses of a personal nature.

Any loss on personal and household effects due to depreciation in value will not be allowable, as under present rules since the loss is of a personal nature.

The basis to the decedent's transferee of the personal and household effects passing under the exception will be their fair market value at the decedent's death.

This exemption provides recognition of the fact that it would be impractical to have the provision apply to a wide range of miscellaneous items of small value. For the most part, of course, the exemption would not be necessary, since these items do not appreciate in value. Nevertheless, generally it will not be necessary to determine whether in fact there has been appreciation in value of these types of

assets. This exemption supplements an annual exception for gifts of ordinary personal and household effects of the type described above.

(*c*) *Marital exclusion.*

As a part of the unified transfer tax proposal, a 100-percent marital deduction will apply to transfers between spouses by gift or at death. The marital exclusion under the income tax proposal will correspond to the unified transfer tax provisions so that on transfers that qualify for the transfer tax marital exclusion no gain will be recognized on the appreciation in value of property passing to the surviving spouse at death.[6] Thus, gain will be exempt on any property (1) that passes outright to a spouse (either during the life of the transferor spouse or at his or her death), or (2) that passes subject to any kind of legal arrangement assuring the transferee spouse for life or for any other period of time the enjoyment or use of such property, or the income from it, or the right, through the exercise of an unrestricted power vested solely in the transferee spouse, to such outright ownership, enjoyment, use, or income, if the transferee spouse consents to having the termination of such limited interests treated as a taxable transfer by him or her. If the transferee spouse does not receive outright ownership, then a taxable transfer occurs upon termination of the transferee spouse's interest.

To protect the transferee spouse from liability from tax on property not fully subject to his or her control or power of disposition, the tax imposed on the gain at termination of one of the kinds of limited interests that is sufficient to quality property for the marital exemption will be collectible only out of such property.

The rate that will be applied upon the termination of a limited interest in a transferee spouse that qualifies for the marital deduction will be the rate of the legal owner of the property. Thus, in the case of a legal life estate or term for years, gain will be taxed upon the termination of the transferee spouse's interest at his or her rate. On the other hand, in the case of property placed in trust, the rates applicable to the trust will apply. In the case of some form of outright interest passing to a transferee spouse, an option will be made available to have taxed any portion of the property passing under the marital deduction at the time of the transfer. A step up in basis would, of course, accompany this event. The election to be taxed will be exercisable by the transferor and, in the case of a transfer at death, if the transferor makes no election, then by the transferee spouse. Where the transferee spouse receives all the property of the decedent, the property will not receive a new basis but will carry over the basis of the decedent. Where the transferee spouse receives less than all the property of the decedent, the basis in such property will be computed under the rules outlined in (*f*) below.

(*d*) *Orphan exclusion.*

Provision will be made that gain on property passing to orphans, which is excluded from the transfer tax under the unified transfer tax proposal, will also be excluded from tax on the death of the de-

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[6] This includes appreciated property transferred pursuant to a separation agreement or divorce decree. Under present rules a capital gains tax is imposed and the transferee spouse receives a stepped-up basis. Under the proposal, the transferee spouse will take a carryover basis, unless the option to pay the tax is exercised by the transferor-spouse.

cedent. The property will have a basis in the hands of the transferees computed under the rules set forth in (*f*) below, and gain will be subject to taxation upon disposition by them.

(*e*) *Charitable bequests exemption.*

Gain on assets transferred to charity will be permanently exempt from tax if the amount of the interest given to charity can be measured with certainty. Thus, no tax would be imposed on the appreciation in property given outright to a qualified charity. Where a transfer creates split interests (that is, a trust to pay the income to the transferor's son for life, with the remainder to the X charity or vice versa), the portion going to the charity will qualify for the exemption only if—

(1) The income beneficiary receives an outright annuity (stated in terms of a fixed annual dollar amount or a fixed percentage of the fair market value of the property at the time of the transfer); or

(2) The governing instrument provides that the transferred property is to be valued annually, and a fixed percentage of the fair market value of the property on each valuation date is to be distributed to the income beneficiary. The required distribution is to be made first from income and then from corpus. To insure that fair market values will be determined objectively, in the case of lifetime transfers the donor will be subject to a 10-year waiver of the statute of limitations with respect to assessment of a capital gains tax on the transfer. In the case of deathtime transfers, the trustee or other person determining fair market value must be independent of the beneficiaries of the transfer.

Only split-interest tranfers satisfying one of the above tests will qualify for the charitable exemption. All other types of split-interest transfers will be subject to capital gains tax even though a charity may be a potential beneficiary. Thus, for example, if there exists any contingency which could result in the defeat of the charitable interest, or a power to divert the property to or for the benefit of someone other than the charity, the above tests are not met and the transfer does not qualify for the exemption. Also, in cases where the charity has only an income interest, if the period of the charity's interest is measured by the life of any person, no charitable exemption is allowed.

The purpose of these rules is to insure that the charity will in fact receive a specified and determinable amount. The rules for treatment of gain on transfers to charity basically follow the proposal setting forth the rules for deductibility of charitable contributions for income tax purposes, and insure that any charitable transfer will be exempt under this proposal if it is also exempt from transfer tax under the unified transfer tax proposal.

Where an asset giving rise to ordinary income is transferred to charity at death, the exemption will not apply and the ordinary income will be taxed in the decedent's final return.

(*f*) *Allocation of basis.*

The exemption of gain on property passing to a surviving spouse, to orphans, or to charity requires a special rule relating to basis, so that, in the case of the spouse or orphans, the gain that escapes tax at

the death of the decedent will be taxed when the property is transferred by such spouse or orphan. The basic objective of using allocated, rather than actual, basis is to eliminate any tax incentive for the decedent or his executor to transfer any particular piece of property to any particular person or entity, where such a disposition might be undersirable from a nontax standpoint. For example, if an estate consists of low-basis stock in a family corporation that the decedent would, in the absence of tax considerations, want to go to his son and of high-basis property of equal value that he would want to go to his wife, it seems improper to create a significant tax incentive for achieving precisely the opposite disposition. A rule that taxed or exempted gain on the basis of the particular property going to each would have such an effect, since, under such a rule, the gain on the shares of stock in the family business could escape taxation at death only if that property were left to the wife. To avoid this effect the proposed basis rule will require allocation of total basis among all property (other than cash) before computing the taxable gain, with a carryover of such allocated basis in the case of property on which gain is exempt. (This rule need not, and will not, apply where all the decedent's property passes to one person). The same considerations that require allocation in the case of an estate passing in part to a spouse also require allocation in the case of property passing in part to orphans or charities.

To illustrate the process of allocation of basis, assume that an estate, after all debts, expenses, and taxes have been paid or provided for, consists of $100,000 in cash, $450,000 worth of stock of X corporation with a basis of $50,000, and $450,000 worth of stock of Y corporation with a basis of $450,000. Thus the total gain is $400,000. If half of the estate is left to the wife and half to the son, then regardless of how particular property is disposed of, half the gain will be taxed in the decedent's final return and the wife will receive a basis such that the remaining gain would be taxed to her if she sold the property at a time when it had not changed in value. Specifically, suppose that the X stock goes to the son and the Y stock goes to the wife and each gets half of the cash. Total basis is $600,000, of which $100,000 must be assigned to the cash. The remaining $500,000 is allocated half to the X stock and half to the Y stock. Thus, the $450,000 worth of X stock which passes to the son has an allocated basis of $250,000 and a gain of $200,000. This gain is taxed in the decedent's final return and, as a result, the son's basis will become $450,000. The $450,000 worth of Y stock passing to the wife will have an allocated basis of $250,000, but this gain is exempt from tax and, as a result, the wife's basis for the Y stock will be $250,000. If the facts are changed so that $90,000 worth of X stock is left to a charity and the son simply receives that much less X stock, then the results are as follows:

| Recipient | Property | Value | Allocated basis |
|---|---|---|---|
| Wife | Y stock | $450,000 | $250,000 |
| | Cash | 50,000 | 50,000 |
| Son | X stock | 360,000 | 200,000 |
| | Cash | 50,000 | 50,000 |
| Charity | X stock | 90,000 | 50,000 |

Only the $160,000 gain on the X stock passing to the son will be taxed in the decedent's final return. The wife's basis for her Y stock will again be $250,000. Technically, the basis of the stock passing to the charity will be $50,000 though ordinarily this will be irrelevant since any gain realized by the charity on disposition will be nontaxable.

Where assets giving rise to ordinary income comprise part of the estate, special adjustments must be made in the allocation of basis rules. Where a beneficiary receives an ordinary income asset, the basis of the ordinary income item is allocated according to the portion actually received by the particular beneficiary. That beneficiary's portion of the allocated basis in the capital assets (computed as above) which he receives is then reduced (dollar-for-dollar) by the amount of the basis attributable to the ordinary income item received by the beneficiary.

The following examples illustrate the application of the allocation of basis rules where ordinary income items are involved: *Example 1:* A husband leaves one-half of his estate to his wife and one-half to his son. The estate consists of inventory worth $120,000 with a basis of $20,000; $450,000 worth of X stock with a basis of $50,000; and Y stock with a value of $450,000 and a basis of $450,000. If one-half of the inventory and the X stock are left to the wife, and one-half of the inventory and the Y stock to the son, then the results are as follows:

| Recipient | Property | Value | Allocated basis | Gain |
|---|---|---|---|---|
| Wife | Inventory | $60,000 | $10,000 | [1] $50,000 |
| | X stock | 450,000 | 250,000 | [2] 200,000 |
| Son | Inventory | 60,000 | 10,000 | [3] 50,000 |
| | Y stock | 450,000 | 250,000 | [3] 200,000 |

[1] Taxed to wife at ordinary income rates upon receipt or disposition.
[2] Taxed to wife at capital gain rates on disposition.
[3] Taxed in decedent's final return at ordinary income rates and capital gain rates respectively. Son picks up new basis.

*Example 2:* If all the inventory and $390,000 worth of X stock were left to wife and the balance to the son, then the results are as follows:

| Recipient | Property | Value | Allocated basis | Gain |
|---|---|---|---|---|
| Wife | Inventory | $120,000 | $20,000 | [1] $100,000 |
| | X stock | 390,000 | 240,000 | [2] 150,000 |
| Son | X stock | 60,000 | 10,000 | [3] 50,000 |
| | Y stock | 450,000 | 250,000 | [3] 200,000 |

[1] Taxed to wife at ordinary income rates upon receipt or disposition.
[2] Taxed to wife at capital gain rates upon disposition.
[3] Taxed in decedent's final return at capital gain rates. Son picks up new basis.

*Example 3:* If all the inventory had been left to the son, then the results are as follows:

| Recipient | Property | Value | Allocated basis | Gain |
|---|---|---|---|---|
| Wife | X stock | $450,000 | $250,000 | [1] $200,000 |
| | Y stock | 60,000 | 10,000 | [1] 50,000 |
| Son | Inventory | 120,000 | 20,000 | [2] 100,000 |
| | Y stock | 390,000 | 240,000 | [2] 150,000 |

[1] Taxed to wife at capital gain rates on disposition.
[2] Taxed in decedent's final return at ordinary income rates and capital gains rates respectively. Son gets new basis in each item.

### 5. PROVISIONS DEALING WITH LIQUIDITY

It is recognized that in some circumstances there may be difficulty in having liquid assets available for payment of the tax on gain at death. Several provisions of the tax law presently deal with the problem of liquidity in connection with the payment of estate taxes. Thus, section 303 of present law permits the redemption of stock in closely held corporations in certain cases, without the payment of ordinary income tax on the redemption, in order to provide funds for the payment of estate taxes. Section 6166 of present law permits, under similar circumstances, installment payment of estate taxes for a period of up to 10 years with the application of a 4-percent rate of interest. Section 6161 provides for installment payments for up to 10 years in cases of undue hardship with the application of a 4-percent rate of interest.

The proposals broadening the liquidity provisions governing payment of transfer taxes at death will also cover the income taxes attributable to the gains taxed at death.

### 6. TREATMENT OF NONCAPITAL AND HYBRID ASSETS

Under present law, section 691 provides, in general, that all items of income which were earned or realized by the decedent prior to his death but which were not reportable in the decedent's final return under general (e.g., cash or accural method) or special (e.g., statutory installment sales provision) accounting rules must be reported as income by the successor in interest of the decedent at the time of receipt. Such income must be treated in the same manner by the recipient (e.g., as ordinary income or capital gain) as it would have been treated by the decedent had he lived and received the item. Such items are includible in the decedent's gross estate. Although they do not receive a step-up in basis (sec. 1014(c)), the estate tax attributable to such items is allowed as a deduction to the successor in interest of the decedent in computing the income tax on the item (sec. 691(c)).

The rules presently contained in section 691 were developed to avoid the bunching of income in the decedent's final return. But the complexities of section 691 have created troublesome problems. Therefore, for decedents dying after December 31, 1969, section 691 would cease to have application. The basic rule would be that gain on an asset, the sale or exchange of which would produce ordinary income or capital gain, or a combination of both, will be taxed at death with ordinary income to the required extent and capital gain as to the remainder.

The bunching problem for which present rules were designed would be solved by providing that the general averaging rules will apply to ordinary income taxed at death because of this proposal. In addition, the 100-percent marital exclusion, the orphans' exclusion, the deduction of income taxes as a debt of the estate, and the basic exemption [7] will all apply to gain on items that have heretofore been covered by section 691.

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[7] On death, the basic $60,000 exemption must be allocated first to capital assets. To the extent it is not then used up, the balance can be allocated to ordinary income items. The basic exemption will not be available for lifetime transfers of ordinary income items.

Examples of assets which would give rise to the taxation of ordinary income on the death of the decedent include wage claims of the decedent, stock in trade and inventory (wholesale value), accounts receivable, interest on the U.S. savings bonds, and stock of foreign investment companies under section 1246.

Installment obligations, options (including stock options), and assets on which gain may produce ordinary income only because of an insufficient holding period will be taxed as long term capital gains in the final return of the decedent. Thus, gain on depreciable real estate and on stock in collapsible corporations would receive capital gain treatment. Dispositions of section 306 stock would give rise to capital gain; however, in the case of lifetime transfers the stock would retain its "taint" in the hands of the donee.

Partnership interests, as under ordinary rules for such interests, will produce capital gain at death, except in special circumstances governed under existing rules in the case of a retiring or deceased partner.

Assets such as depreciable property subject to section 1245, and stock of foreign corporations under section 1248 will produce ordinary income or capital gain as if the property had been sold by the decedent. The transferee of the property will then have a stepped-up basis.

Deductions in respect of a decedent presently provided for in section 691(b) will be allowable in the final return of the decedent. No double deduction for such items will be allowed and section 642(g) would be changed accordingly.

Recipients of items giving rise to taxation of ordinary income under these rules would receive a stepped-up basis as to such items. Amounts received by the recipient in excess of (or below) basis will result in ordinary income (or loss). Ordinary rules will govern the sale of such assets by a beneficiary.

### 7. TREATMENT OF LIFETIME GIFTS

In order that the proposed method of taxing gain will operate neutrally (i.e., that imposition of the tax will neither encourage nor discourage lifetime transfers as opposed to death transfers), the gain on appreciated property transferred by gift by a taxpayer will be subject to income taxation at the time of transfer. A gift will not be treated as "completed," and the gain on the property will not be subject to income taxation, unless the transfer is of a type on which the transfer tax is imposed under the unified transfer tax proposal. Generally, the rules applicable to death transfers will apply to lifetime transfers.

With respect to gifts involving present and future interests in property, rules to determine the appropriate amount of gain to be taxed will be applied which are analogous to those presently used to determine the value of the various interests. For example, if a donor gives a life interest in certain property to A with a remainder to X charity, and the life interest is determined to be equal to 40 percent of the value of the property and the remainder 60 percent, then 40 percent of the gain from the appreciation in the property would be subject to income tax and 60 percent would be exempt under the charitable exception. (The same procedure will be followed with

respect to bequests of present and future interests in property transferred at death.)

However, the donor will realize ordinary income where he makes a lifetime transfer of depreciable property to or for the benefit or his minor issue, or their spouses, or makes a transfer in which he retains a reversionary interest. This rule is similar to that presently contained in section 1239.

The present basis rules of section 1015 applying to gifts will be revised to provide an increased basis for property transferred by gift to the extent of the gain recognized at the time of the gift.

Certain exceptions corresponding to the exceptions discussed above in the death situation will be applicable. First, there will be an annual exception for ordinary personal household effects (see 4(b) above). Second, there will be an exception for charitable gifts subject to the same rules as apply to deathtime transfers. Third, there will be a marital exclusion on gifts between husband and wife so as to produce a result comparable to that produced by the marital exclusion on transfers at death.

Losses will be treated as sustained by reason of a gift and deductible under the usual rules. However, the gift will be considered to be the same as a sale for purposes of applying section 267 (which prevents losses from being realized on sales or exchanges between related parties).

Unlike the death situation, no special rule automatically according the donor the longest applicable holding period will be available. The actual holding period of the donor will be used in determining whether the gain was long term or short term, the amount of ordinary income in gain on depreciable real estate, etc. The gift in this regard will be treated like any other sale.

Further, it is not necessary to provide for liquidity problems in connection with gifts since a gift is a voluntary event and taxpayers will be able to provide for payment of the tax.

Under present law, taxpayers may sell appreciated property for a private annuity and realize no gain on the sale or exchange, on the theory that the value of the private annuity cannot be ascertained. Since this arrangement would be likely to receive increased use in order to avoid the capital gain tax on transfers of appreciated property, it is appropriate to change present law by providing that the sale will be taxed. The approach to be taken will be, in general, to value the private annuity received as if it were a commercial one.

### 8. FUTURE INTERESTS

The purpose of taxing gain on the appreciation in value of assets at appropriate times such as gift or death could easily be frustrated if assets were transferred in a form that would pass the gain untaxed through several generations. In order to foreclose such a result, a special rule will impose an income tax on appreciation in value on specific occasions, unless it is certain on the date of the original transfer that outright ownership, or its equivalent, of the transferred property will pass under the transfer to a person who is one degree lower than, or in the same degree as, or in a higher degree than, the transferor. If on the date of the transfer, property may be distributed

to a person who is outside the above group, for example, a grandchild, then appreciation in value will be taxed on each such distribution made in kind. In any event, a tax will be imposed on appreciation in value at the time of the death of the last surviving beneficiary who is in an equal, higher, or one lower degree than the transferor. In the case of a transfer for the benefit of persons who are not related to the original transferor, the gain on appreciated assets will be taxed upon distribution of such assets, and every 20 years in the case of assets not distributed.

In the case of a trust the tax will be payable by the trustee out of trust property. In the case of legal estates, the tax will be paid by the personal representative of the decedent whose death gives rise to the taxation of gain. The personal representative is not, however, personally liable for the tax and the tax is a lien only against the property itself.

For example, if A transfers property to B for life, remainder to C, who is A's son, no income tax will be imposed upon B's death under this special rule (A's transfer would result in tax to the extent of appreciation in value.) But if A transfers property in trust, the income to be paid to A's wife or A's children in the discretion of the trustee, with ultimate distribution to the grandchildren of A, per stirpes, upon attaining age 21, the special rule would impose, in addition to the tax on the transfer by A, tax on appreciation in value upon the death of A's last surviving child. Any distribution in kind to A's grandchildren during the lifetimes of A's children would also result in taxation of gain. The tax would be paid by the trustee. There is no taxation on the ultimate distribution to A's grandchildren after the death of A's last surviving child. (However, if A's greatgrandchildren were to take upon the death of the last surviving grandchild, then the rule would start operating again upon the death of A's last surviving child. That is, distributions in kind to greatgrandchildren while grandchildren were living would be taxable, and a tax on appreciation in value would be imposed on the death of the last surviving grandchild). An increase in basis would, of course, accompany each taxable event.

Losses will be allowed in cases where future interests are created upon the same occasions that require taxation of gain. In the case of legal estates, any loss will be reported by the personal representative of the decedent whose death gives rise to the taxation of gain but the loss will be deemed to be a long-term capital loss distributed to the remaindermen pro rata to their interests in the property. During the existence of a trust, losses will be allowed at the specified occasions and net losses will be carried forward in the trust. Upon termination of the trust, net losses will be carried over to the beneficiaries under section 642. Thus, if A transfers a legal interest in stock to his son B for life, then to his grandson C, any gain will be taxed on A's transfer, and if the property has depreciated in value upon B's death, any loss will be allowed and carried over as long-term capital loss in C's hands. If the property had been placed in trust, the loss is carried over to C under section 642.

The basis of loss property in the hands of a distributee will be governed by present rules under section 1015.

#### 9. EFFECTIVE DATE

The new rule should apply to transfers by gift or by death after December 31, 1969.

For purposes of computing gain on property acquired before the date of enactment the taxpayer, or his personal representative, will have the option of using as his basis, either:

(1) Adjusted basis as computed under existing rules; or

(2) The value on the date of enactment as adjusted under present rules for any changes occurring after that date, including the depreciation or depletion (cost or percentage) actually taken after such date. This option will not apply to items giving rise to the taxation of ordinary income under the rules of section 8 above. Gain on such items will be computed from the adjusted basis (as determined under existing rules) without regard to the special rules set forth in this paragraph.

For purposes of computing losses on property acquired before the date of enactment the basis is the lower of (1) or (2) above.

Of course, the basis for property acquired after the date of enactment is its cost.

The need for tacking rules will be considerably reduced because of the increased number of events which produce taxation of gain under the new rules. When applicable, present tacking rules will continue to apply.

## VIII–B. UNLIMITED MARITAL DEDUCTION AND UNIFICATION OF ESTATE AND GIFT TAXES

### General Explanation

#### PRESENT LAW

Under present law a Federal estate tax is imposed upon property transferred at death. The estate tax utilizes a progressive rate structure, so that the larger the estate, the higher the rate of tax. Property which is transferred during lifetime is not subject to the estate tax. In order to prevent avoidance of the estate tax by the transfer of property before death, present law also imposes a gift tax upon lifetime transfers. This is also a progressive tax, the rate increasing with the cumulative lifetime total of property transferred. But the estate tax is separate from the gift tax so that even where there are lifetime transfers the estate tax starts all over again with a new exemption and a new rate schedule. This present dual transfer tax structure contains a number of inequitable and unwarranted preferences for lifetime gifts, as opposed to transfers at death. These preferences increase in magnitude with the size of the estate involved; the larger the estate the greater the tax advantage for lifetime gifts. This situation is not only inequitable, but it reduces the intended progressivity of the transfer tax structure.

### DUAL TAX BASE

The estate tax and the gift tax are independent in that the cumulative total of property transferred during lifetime is disregarded in determining the estate tax rate bracket applicable to property transferred at death. The estate tax rate is based only upon the size of the estate passing at death. Thus, in effect, this dual tax system permits two separate starts at the bottom of two separate progressive rate schedules for persons who transfer a portion of their estate during lifetime. This dual rate base, plus the fact that the gift tax rate schedule is significantly lower than estate tax rates, results in lower total transfer tax liability for a person who transfers some property during lifetime than for a person with an estate of equal size who holds it until death, as illustrated by the following examples:

*Examples*

(1) A and B each have total accumulated wealth of $7 million. A transfers $3.5 million during lifetime and $3.5 million at death. B makes no gifts and transfers his entire estate at death. A's total transfer tax would be approximately $2.7 million whereas B's total transfer tax would be over $3.8 million, or nearly 40 percent greater than A's.

(2) C has accumulated wealth of over $10 million. If he holds all of his property until death it will all be subject to tax, in brackets reaching the 77-percent maximum estate tax rate. However, by making transfers during lifetime he is able to remove property from the top transfer tax bracket and have such property taxed beginning at the bottom of the separate gift tax rate schedule, which allows the first $30,000 of lifetime gifts to be made without any tax and which begins at a bottom rate of only 2½ percent.

### PROPERTY FROM WHICH TAX IS PAID

This substantial advantage to lifetime transfers under the present dual tax system is further accentuated by the fact that while the estate tax is paid out of the property transferred (i.e., the tax is "withheld" from the transfer), the gift tax is paid out of other property of the donor. Thus, the amount used to pay the gift tax is itself removed from the donor's taxable estate. The magnitude of this advantage to lifetime giving is of minor advantage to moderate estates but of great advantage to large estates.

*Examples*

(1) If taxpayer A dies with a $100,000 estate, the estate tax is $20,700 and A's heirs will receive $79,300. If A were to transfer his entire estate prior to his death he would be able to transfer nearly $89,000, retaining the remaining $11,000 for payment of the gift tax on that amount.

(2) If taxpayer B dies with an estate of $10 million, the estate tax is $6,088,200 and B's heirs will receive slightly less than $4 million. If B wished to transfer his entire estate prior to his death he would

be able to transfer slightly more than $7 million, retaining approximately $3 million for payment of the gift tax on that amount. In this case B is able to preserve 75 percent more of his wealth by transferring it before he dies than if he were to hold it until death.

### LIFETIME EXEMPTION AND EXCLUSIONS

A further advantage which present law provides for lifetime gifts is the $30,000 lifetime gift tax exemption. This exemption may not be applied against deathtime transfers, and hence, is lost to the extent that it is not used up during lifetime. In addition to the $30,000 lifetime gift tax exemption, a further exclusion of $3,000 is allowed each year with respect to each donee. In the case of a married couple each spouse is entitled to his own annual exclusion and lifetime exemption. Furthermore, a gift made by one spouse may be considered as having been made by the other spouse to the extent of one-half of the gift. This is known as gift-splitting and, in effect, permits a married person an annual exclusion of $6,000 per donee and a total lifetime exemption of $60,000. Also, under the estate tax marital deduction up to one half of a decedent's estate may pass tax-free to his surviving spouse.

In summary, the defect in the present separation of estate and gift tax is that wealthy persons who can arrange to transfer significant amounts of property during life can realize substantial tax savings because—

gift tax rates are lower;

under the gift tax, unlike the estate tax, the tax itself is not in the tax base; and

by making some gifts and passing some property at death a wealthy owner can arrange to use both exemptions and to get two applications of the low rates in the rate schedule.

The significance of these advantages is demonstrated by the fact that little use is made of lifetime gifts by those with smaller accumulations of wealth. Rather, lifetime gifts are used by the wealthy to take advantage of the lower gift tax rates, the exemption granted to lifetime gifts, and the smaller tax base that applies to lifetime transfers as compared to deathtime transfers. Table 1 shows that the wealthy transfer a little more than 10 percent of their total wealth accumulations during lifetime. On the other hand, those with small accumulations of wealth transfer less than 2 percent of their property by means of lifetime gifts. Put in another way, table 2 shows that 52 percent of those with large estates make gifts during lifetime. However, only 10 percent of those with small estates made lifetime transfers. These data demonstrate that the present disparity between the tax treatment of lifetime gifts and deathtime transfers confers a very substantial advantage on the wealthy, because the tax advantages of making lifetime gifts become increasingly greater as the size of wealth accumulations increase. The preferential gift treatment thus serves to confer very great benefits on those whose situation permits utilizing lifetime gifts—generally those who are so prosperous that they do not depend on this wealth and the income it yields for living expenses and security.

TABLE 1.—GROSS TRANSFERS AT DEATH AND DURING LIFE, ALL DECEDENTS, 1957 AND 1959

[Dollar amounts in thousands]

| Estate size | Number of decedents | Total amount of gross transfers | Number of decedents making noncharitable transfers during life | Non-charitable gifts | Gift tax paid | Non-charitable bequests | Taxes paid by estate |
|---|---|---|---|---|---|---|---|
| 1957 | | | | | | | |
| Small | 398 | $46,333 | 40 | $1,147 | $3 | $41,388 | $2,255 |
| Medium | 876 | 403,544 | 263 | 15,311 | 517 | 297,411 | 70,545 |
| Large | 1,119 | 2,787,869 | 583 | 154,652 | 19,999 | 1,415,053 | 775,149 |
| 1959 | | | | | | | |
| Small | 471 | 56,318 | 48 | 1,509 | 9 | 50,331 | 3,084 |
| Medium | 968 | 461,536 | 299 | 21,579 | 884 | 341,359 | 78,363 |
| Large | 1,137 | 2,706,969 | 636 | 180,933 | 21,063 | 1,437,266 | 675,591 |

Special program study, 1957–59, table printed in Carl Shoup, Federal Estate Gift Taxes.

TABLE 2.—GROSS TRANSFERS DURING LIFE AND AT DEATH, PERCENTAGES, ALL DECEDENTS, 1957 AND 1959

[Dollar amounts in thousands]

| | | | Noncharitable lifetime gifts | | | Taxes | |
|---|---|---|---|---|---|---|---|
| Estate size | Number of decedents | Amount of gross transfers | Number of estates reporting | As a percentage of gross transfers | Gift tax paid as a percentage of noncharitable gifts | Estate tax paid as a percentage of noncharitable bequests |
| 1957 | | | | | | |
| Small | 398 | $46,333 | 10.0 | 2.5 | 0.3 | 5.4 |
| Medium | 876 | 403,544 | 30.0 | 3.8 | 3.4 | 23.7 |
| Large | 1,119 | 2,787,869 | 52.1 | 5.5 | 12.9 | 54.8 |
| 1959 | | | | | | |
| Small | 471 | $56,318 | 10.2 | 2.7 | 0.6 | 6.1 |
| Medium | 968 | 461,536 | 30.9 | 4.7 | 4.1 | 23.0 |
| Large | 1,137 | 2,706,969 | 55.9 | 6.7 | 11.6 | 47.0 |

## COMPLEXITY UNDER PRESENT LAW

The lower rates applicable to lifetime transfers create an incentive to make what essentially amount to testamentary transfers in forms which are intended to appear as lifetime transfers. The separation of the gift tax has thus necessitated the creation of elaborate rules for determining which tax should apply to situations in which a donor transfers property during his lifetime but retains until death some interest in it or some opportunity to recover it. As a consequence, under the present dual transfer tax system complexity and controversy often prevail. Slight differences in the form of lifetime transfers often lead to substantial differences in the amount of tax which must be paid.

In general, under present rules, a lifetime transfer under which the transferor retains sufficient beneficial enjoyment of, or control over, the property transferred is treated for transfer tax purposes as an incompleted transfer. For example, assume A transfers securities in trust for B, but A retains the right to receive the dividends for the rest of his life, or A transfers in trust for the benefit of B, but A retains the right to retake the property for himself or retransfer it to some third person. If such a transfer remains incomplete (i.e., the transferor still retains beneficial enjoyment or control) at the death

of the transferor, the property is included in his gross estate subject to estate tax. However, any gift tax which was paid at the time of the purported lifetime transfer is allowed as a credit against the estate tax liability, and is itself excluded from the gross estate for estate tax purposes. The general policy underlying these rules of present law is known as the "hard-to-complete-gift" rule.

## UNIFIED TRANSFER TAX

To eliminate the distinction in tax treatment between lifetime and deathtime transfers, it is recommended that the estate and gift taxes be combined into a single united transfer tax. Under this system a single exemption and a single rate schedule would be made applicable to the total wealth subject to transfer taxation. The same rate schedule would apply to both lifetime and deathtime transfers. Thus, the transfer tax liability upon death would be directly related to the total amount of wealth transferred during lifetime. The exemption and the rate bracket applicable to transfers at death would be based, respectively, upon the extent to which the overall exemption was absorbed by lifetime gifts and on the rate bracket attained upon lifetime transfers. All transfers between spouses, whether during lifetime or at death, would be completely exempt from tax.

In addition to eliminating the dual rate base, the unified transfer tax would further equate lifetime and deathtime transfers by providing rules for computing the tax on lifetime transfers so that, in effect, the tax is paid out of the property transferred, as is the case with transfers at death. Thus, the proposal provides for computation of the tax on lifetime transfers by valuing the gift ("grossing-up" the gift) so as to include the amount of the tax within the amount of the gift upon which the tax is computed. A simplified table would be available to compute the grossed-up transfer, so that taxpayers would not be burdened by complex calculations.

Since some incentive for making lifetime gifts is economically desirable, the present $3,000 annual exclusion would be retained.

*Proposed rate of tax*

The proposed level of rates under the unified transfer tax incorporates a general reduction of about 20 percent from present estate tax rates. The schedule has been set at a level which is intended to produce (together with the revenue from the proposed tax upon capital gains transferred at death) the same general amount of revenue as is produced under present law, but with a revised rate schedule which will provide a more equitable distribution of the total tax burden. There is widespread criticism of the present structure of estate tax rates, especially the rapid increase in rates over the first $50,000 of taxable estate. The rates move up from 3 percent to 25 percent in that range and thereafter do not go higher than 32 percent until a taxable estate of $500,000 is reached. In general, under the proposed rates the excessively steep progression in the lower brackets of the present estate and gift tax rate structures would be reduced and the slower progression in the upper brackets would be stepped up.

The proposed rate schedule would become effective immediately with respect to lifetime transfers. In the case of transfers at death, the

changes from the present estate tax rate schedule would be instituted gradually in month-to-month steps over a ten-year period. After the transition, the top transfer tax rate would be 65 percent, compared to the 77 percent rate for the present estate tax. The proposed rate schedule is set forth below, along with schedules of the present estate tax rates:

| Taxable transfer | Present estate tax rate (percent) | Unified transfer tax rate (percent) | Tax at top of bracket | |
|---|---|---|---|---|
| | | | Present | Proposed |
| 0 to $5,000 | 3 | 3 | $150 | $150 |
| $5,000 to $10,000 | 7 | 7 | 500 | 500 |
| $10,000 to $20,000 | 11 | 11 | 1,600 | 1,600 |
| $20,000 to $30,000 | 14 | 11 | 3,000 | 2,700 |
| $30,000 to $40,000 | 18 | 14 | 4,800 | 4,100 |
| $40,000 to $50,000 | 22 | 16 | 7,000 | 5,700 |
| $50,000 to $60,000 | 25 | 16 | 9,500 | 7,300 |
| $60,000 to $80,000 | 28 | 18 | 15,100 | 10,900 |
| $80,000 to $100,000 | 28 | 20 | 20,700 | 14,900 |
| $100,000 to $150,000 | 30 | 22 | 35,700 | 25,900 |
| $150,000 to $250,000 | 30 | 24 | 65,700 | 49,900 |
| $250,000 to $350,000 | 32 | 25 | 97,700 | 74,900 |
| $350,000 to $500,000 | 32 | 27 | 145,700 | 115,400 |
| $500,000 to $750,000 | 35 | 29 | 233,200 | 187,900 |
| $750,000 to $1,000,000 | 37 | 31 | 325,700 | 265,400 |
| $1,000,000 to $1,250,000 | 39 | 33 | 423,200 | 347,900 |
| $1,250,000 to $1,500,000 | 42 | 35 | 528,200 | 435,400 |
| $1,500,000 to $2,000,000 | 45 | 37 | 753,200 | 620,400 |
| $2,000,000 to $2,500,000 | 49 | 41 | 998,200 | 825,400 |
| $2,500,000 to $3,000,000 | 53 | 44 | 1,263,200 | 1,045,400 |
| $3,000,000 to $3,500,000 | 56 | 47 | 1,543,200 | 1,280,400 |
| $3,500,000 to $4,000,000 | 59 | 49 | 1,838,200 | 1,525,400 |
| $4,000,000 to $5,000,000 | 63 | 53 | 2,468,200 | 2,055,400 |
| $5,000,000 to $6,000,000 | 67 | 56 | 3,138,200 | 2,615,400 |
| $6,000,000 to $7,000,000 | 70 | 59 | 3,838,200 | 3,205,400 |
| $7,000,000 to $8,000,000 | 73 | 61 | 4,568,200 | 3,815,400 |
| $8,000,000 to $10,000,000 | 76 | 63 | 6,088,200 | 5,075,400 |
| $10,000,000 and up | 77 | 65 | ---------- | |

The structural revisions incorporated in the new rate structure consist of 3 parts:

(*a*) The very low rates in the first 3 brackets are left unchanged.

(*b*) In the brackets above the third bracket there is provided a net decrease in the present net Federal rate (i.e., the Federal rate after the State tax credit) further modified as described below.

(*c*) To temper the steep progressivity of rates in the middle estate brackets a further structural change is introduced in the size of the brackets from $40,000 to $500,000.

The final rates were rounded. The details of the structural revision are shown below:

| Taxable estate bracket (in thousands of dollars) | Present rate | Rate after basic "20 percent of net Federal tax" reduction | Structural change | New rate |
|---|---|---|---|---|
| $30 to $40 | 18 | 14.4 | ---------- | 14 |
| $40 to $50 | 22 | 17.8 | −2 | 16 |
| $50 to $60 | 25 | 20.2 | −4 | 16 |
| $60 to $80 | 28 | 22.6 | −5 | 18 |
| $80 to $100 | 28 | 22.6 | −3 | 20 |
| $100 to $150 | 30 | 24.2 | −2 | 22 |
| $150 to $250 | 30 | 24.2 | 0 | 24 |
| $250 to $350 | 32 | 26.2 | −1 | 25 |
| $350 to $500 | 32 | 26.2 | +1 | 27 |
| $500 to $750 | 35 | 28.9 | 0 | 29 |

*Overall exemption*

Under present law a lifetime gift tax exemption of $30,000 is provided plus an estate tax exemption of $60,000. The entire estate tax exemption is available regardless of the extent to which the gift tax exemption may or may not have been used. In addition, there is a 50-percent exemption ("marital deduction") for all property transferred between spouses.

The unified transfer tax proposal would replace this structure with an overall exemption of $60,000 plus a complete exemption for transfers between spouses. The overall $60,000 exemption could be used against lifetime or deathtime transfers at the option of the taxpayer. To the extent that the exemption is not used during lifetime it would be applied against transfers at death. Although the single $60,000 exemption is less than the total $90,000 combined lifetime and deathtime exemptions under present law, this effect is more than offset by the raising of the marital deduction from 50 to 100 percent. Table 3 demonstrates the percentage change in tax due that would result from unification of the estate and gift taxes under a $60,000 exemption.

TABLE 3.—TAX CHANGE DUE TO UNIFICATION UNDER A $60,000 EXEMPTION, ALL DECEDENTS

| Gross transfer class (in thousands of dollars) | Unification | |
|---|---|---|
| | Percent of tax | Percent of transfer |
| Below 100 | 5.0 | 0.05 |
| 100 to 150 | 8.7 | .3 |
| 150 to 200 | 6.1 | .5 |
| 200 to 300 | 7.2 | .7 |
| 300 to 400 | 5.8 | .8 |
| 400 to 500 | 4.8 | .8 |
| 500 to 750 | 6.9 | 1.3 |
| 750 to 1,000 | 5.9 | 1.2 |
| 1,000 to 1,500 | 5.3 | 1.2 |
| 1,500 to 2,000 | 6.4 | 1.5 |
| 2,000 tc 3,000 | 6.1 | 1.7 |
| 3,000 to 5,000 | 8.0 | 2.4 |
| 5,000 to 10,000 | 7.5 | 2.5 |
| Over 10,000 | 11.0 | 4.1 |

*Unlimited marital deduction*

Under present law, a special deduction is permitted both for estate and gift tax purposes for transfers of property from one spouse to another. This deduction is commonly referred to as the "marital deduction." However, there are limitations on the amount of the deduction which may be claimed; in the case of the gift tax the deduction may not exceed one-half of the amount transferred, and the case of the estate tax the deduction is limited to one-half of the adjusted gross estate. Thus, generally, one spouse may transfer up to one-half of his property to the other spouse free of tax.

In order for a transfer from one spouse to another to qualify for the marital deduction under present law, several tests must be met. On a transfer at death, the property must be transferred directly from the decendent to his surviving spouse; the value of the property must be included in the decedent's taxable estate; and she must be given outright ownership (or its equivalent) over the property. These rules have curtailed the use of some natural forms of transfers between spouses. For example, a transfer of property from a husband to his

wife with income payable to her for life, and upon her death all remaining property to their children, does not qualify for the marital deduction and is taxed in the husband's estate. In addition, because the deduction is limited to 50 percent of the adjusted gross estate, highly complex drafting arrangements have developed and are used in many estates to insure that no more property than the exact amount needed to utilize the marital deduction passes to the surviving spouse. The result of overqualifying is to leave property in a way in which it is taxable in the surviving spouse's estate without a corresponding deduction in the first decedent's estate. The limited marital deduction also creates problems in cases where property is jointly owned by a husband and wife. Under present law, generally, the spouse furnishing the funds has made a taxable gift to the other. Yet most husbands and wives really consider the property to be "ours" from the time of its acquisition since it was acquired with family funds.

It does not appear, then, that transfers of property between husband and wife are appropriate occasions for imposing tax. An especially difficult burden may be imposed by the tax when property passes to a widow, particularly if there are minor children. The present system of taxing transfers between spouses does not accord with the common understanding of most husbands and wives that the property they have accumulated is "ours." Furthermore, the distinctions drawn by existing law between transfers which qualify for the marital deduction and those which do not qualify have generated drafting complexities, artificial limitations upon dispositions, and considerable litigation.

In order to reduce the tax burden in the case of small- and medium-sized estates, where the property on the death of the husband must usually provide for the widow and children, to provide flexibility in the planning of transfers between spouses and to reduce complexity, it is proposed that—

the present 50-percent limitation should be removed entirely and replaced by an unlimited marital deduction to permit almost all transfers of property between spouses to be tax free;

present restrictions upon the types of interests which quality for the marital deduction should be liberalized;

spouses should be given the power to determine the extent to which they wish the marital deduction to apply and, thus, the extent to which the transferred property will be subject to tax upon subsequent disposition by the transferee spouse.

Under the unified transfer tax there will be an exemption from taxation for the full amount of any property that passes to a spouse, either during the life of the transferor spouse or at his or her death. However, property received by the transferee spouse will, of course, become part of his or her taxable estate, unless consumed.

The proposals for modifying the marital deduction rules will benefit a number of family situations:

(1) The most important case is the one in which it is expected that the surviving spouse will consume part of the capital which she inherits to provide for herself and the children. This would ordinarily be expected where the estate is modest in size or where the widow will face heavy financial demands for educating the children.

In these cases the first spouse to die (typically the husband) leaves his entire estate outright to the spouse. Under present law, only half is deductible, and any part of the estate left at the wife's death is fully taxable when it is left to the children on her death. In effect, the estate is taxed twice, as it passes down to the children. Typically, this does not happen however in very large estates because the husband can be certain that his spouse will not need all of the estate. Thus, he can leave outright to the wife only an amount that will qualify for the marital deduction; and he can give the remainder either directly to the children or in a trust which will not be taxable on the wife's death. Thus, in the estates of wealthy married decedents it is generally possible, under present law, to arrange things so that the family estate is only taxed once as it goes to the children. The unlimited marital deduction will make this result possible even where the husband now has to encounter a double tax because the wife may need the funds.

The importance of this case can be seen in table 4, which describes the pattern of bequests among married decedents. It is clear that married decedents in the lowest estate size class leave outright to the spouse very large amounts in excess of what can be deducted under the 50-percent marital deduction. In the largest estate class the amount left outright to the spouse in excess of the amounts passing under the marital deduction is small. It is only outright bequests to spouses that are, under present law, subject to tax on the death of the surviving spouse.

(2) The proposal for the unlimited marital deduction, as it applies to the gift tax, will be of advantage where the poorer spouse dies first. Under present law, the minimum tax is paid if the estate is split equally between husband and wife for tax purposes by, for example, taking a 50-percent marital deduction on the estate of the first to die, paying tax on half, and then paying tax on the other half at the death of the survivor. (The combined tax on two half million dollar estates is $253,000, and the tax on one $1 million estate is $303,200.)

This tax saving is lost (except in a community property State) if the poorer spouse dies first. It could be preserved by giving half the property to the poorer spouse during life but under present law the gift tax marital deduction (which is limited to half of the actual gift to the spouse) would involve a tax penalty at the time of gift. The proposal would permit a married couple to so arrange their property holdings that there would be no tax penalty arising from the order of their death. This would also remove an undesirable discrimination between common law and community property States because there is already an unlimited exemption from interspousal "transfers" resulting from creation of community rights.

(3) Another benefit of the proposal arises from the extention of the deduction to all life interests given to the spouse. Under present law, if property is left so that the income of the property goes to the spouse the bequest only qualifies for the marital deduction if the spouse has such control over the property underlying her income interest that it can be considered her property (and taxable at her death). A husband may want to leave the income from his property to his wife but make sure that the property goes on her death to the children. Ordi-

narily this would imply that the wife has no control over the underlying property and thus the bequest would not qualify under present law for the marital deduction. It is not of significant concern, however, to the Federal Government whether the husband or the wife makes the decision as to who gets the property ultimately. The substance of the proposal therefore is to let an income interest to the surviving spouse qualify for the marital deduction whether or not the spouse controls the underlying property so long as it is agreed that the property will be taxed on the death of the spouse.

In substance, the proposal is designed to provide that property of a married couple will be taxed once as it passes to the next generation, not twice. This will result in some postponement of revenue in many cases. An indication of this postponement is given in table 5 which shows an estimate of the distribution of the period of survival of a surviving widow. It will be seen that about half of widows survive their husbands by 11 years or less. This means that in the early years of the new provision there will be a significant revenue loss because in, say, 1970 dying husbands will postpone tax; and the bulk of the dying widows will have had husbands who died before 1970. By 1981, about half of the widows dying will have had husbands who died after 1970, and the Treasury will be "picking up" previously postponed tax to the extent of about half of the postponement being extended with respect to husbands dying in 1981.

There is also a permanent revenue loss due to the fact that much property is now left outright to spouses in excess of the marital deduction (see table 4). This revenue loss is associated under the proposal with removing the "double tax" as property moves from husband to wife to children.

TABLE 4.—PATTERN OF BEQUESTS OF MARRIED DECEDENTS

| Gross transfer class (in thousands of dollars) | Percent of adjusted gross estate | | | |
|---|---|---|---|---|
| | Marital deduction | Outright bequests to spouse | Property left outright to spouse not under marital deduction | Bequests to spouse in trust |
| Below $300 | 41.6 | 71.5 | 29.9 | 10.6 |
| $300 to $1,000 | 40.9 | 55.0 | 14.1 | 14.5 |
| $1,000 and over | 38.2 | 42.3 | 4.1 | 10.3 |

TABLE 5.—*Period of widows' surviving their husbands*

| Years after husbands death: | *Percent of widows surviving* |
|---|---|
| 1 | 94 |
| 2 | 88 |
| 5 | 73 |
| 10 | 54 |
| 20 | 27 |
| 30 | 9 |

NOTE.—This is based on data from matching estate tax returns. The data were smoothed.

*Annual exclusion*

Present law contains an annual per donee exclusion intended to permit relatively small gifts (e.g., Christmas and birthday gifts) to be made free of tax. Thus, the first $3,000 of lifetime transfers to any

person during each year is excluded from gift tax. This applies with respect to each donee, regardless of the number of donees.

The united transfer tax would continue the $3,000 annual per donee exclusion for gifts of present interests. As under present law, a married person may use his spouse's exclusion with her consent, so that in effect the annual per donee exclusion for a married person is $6,000.[1]

*Taxable and nontaxable transfers—In general*

Under the unified transfer tax the complexity of present law will be largely eliminated and it will be possible to shift to an "easy-to-make-a-complete-gift" rule as compared with the "hard-to-complete-gift" rule under present law described above. This is so because under the unified transfer tax the overall tax cost of transfers will be approximately the same regardless of whether they are made during lifetime or at death. Since the excessive advantages under present law for lifetime gifts would be eliminated, the tax avoidance possibilities in attempting to have an incomplete transfer qualify as a completed lifetime gift would also be eliminated. Thus, transfers which under present law are not sufficient to remove the subject property from the transferor's estate, may be treated as completed transfers under the unified transfer tax.

Under the unified transfer tax, transfers, whether during lifetime or at death, which are subject to a tax at the time of the initial transfer are referred to as "included transfers." Those dispositions which are not taxable events at the time of the initial transfer are referred to as "excluded transfers." The treatment of the significant types of included and excluded transfers is summarized below. The tax is imposed upon the aggregate amount of lifetime transfers in each year; at death the tax is levied against the aggregate amount of transfers at death plus any transfers made during the calendar year of death. In all cases the rate of tax would be determined by cumulating the current transfers with transfers made in prior years.

*Gifts in contemplation of death*

Because of the very considerable transfer tax savings inherent in lifetime gifts under present law, there is a natural incentive for persons anticipating death to transfer all or most of their property before death arrives in an effort to have the more favorable gift tax treatment apply. Since such "deathbed transfers" are considered a form of tax avoidance, present law contains a rule that all transfers made within 3 years of death are presumed to be made "in contemplation of death" (unless it can be proven otherwise), and property transferred in contemplation of death is included in the taxable estate (with a credit allowed for any gift tax previously paid) although the amount of the gift tax itself is excluded from the estate. This rule is difficult to apply and has engendered considerable wasteful litigation over the motives of decedents in an infinite variety of fact situations.

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[1] It can be argued that $6,000 per donee is a larger amount than is necessary to accommodate Christmas gifts and the like. However, it is generally felt that it is appropriate to retain some incentive for lifetime transfers. The $6,000 exclusion that is available to a married couple accomplishes this result in a manner that is simple for taxpayers and is easily administrable for the Internal Revenue Service. Other methods of providing some incentive for lifetime giving might, of course, be selected, but none appears to contain the elements of simplicity and administrative feasibility to the degree that inheres in the annual exclusion.

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The "contemplation of death" rule can generally be dispensed with under the unified transfer tax. Since there will be no significant difference in tax burden whether a transfer is during lifetime or at death, the substantial incentive under present law for making gifts in contemplation of death is eliminated.

*Life insurance*

Under present law the proceeds of a life insurance policy are included in the taxable estate of the decedent if he was the owner of the policy at the date of death. An insurance policy may be transferred by the insured (so as to remove the proceeds from his estate on death) during his lifetime by transferring all of the incidents of ownership in the policy. At the time of such a transfer a gift tax is imposed on the then interpolated terminal reserve value of the policy. These rules would not be changed. However, present rules regarding the treatment of the proceeds of life insurance transferred in contemplation of death would be modified.

Although unification of the estate and gift taxes substantially eliminates the problem of gifts in contemplation of death, there still remains opportunity for tax avoidance in the case of "death-bed" transfers of life insurance. This is because the face amount of a life insurance policy, which would be taxed in the insured's estate, is usually greater than the interpolated terminal reserve value upon which the transfer tax is based if the policy is transferred by gift. Under present law, if a person transfers ownership of an insurance policy on his life within 3 years prior to his death, the transfer is treated as a gift in contemplation of death. This rule would be retained under the unified transfer tax.

Under present law, if the insured transfers all of the incidents of ownership of a policy on his life, but continues to pay the premiums on the policy, the portion of the insurance proceeds attributable to premiums paid by the insured during the 3 years preceding his death is includable in the insured's estate. Such portion is computed under present rules by applying a ratio equal to the ratio of premiums paid during the 3 years preceding death to the total premiums paid on the policy. This method of computation, however, does not properly reflect what any given life insurance premium pays for. In order to more properly reflect the economic character of a life insurance policy, present rules would be modified to provide that, in addition to the lifetime transfer tax, the deathtime transfer tax will be imposed upon the portion of life insurance proceeds equal to the increase in cash value of the policy resulting from premiums paid during the 3 years preceding death plus the difference between the face amount of the policy and its cash value at date of death.

*Powers of appointment*

The possession by a person of a right to designate the disposition of property which he himself does not own is referred to as a "power of appointment" over the property. Under present law if a power of appointment is sufficiently broad so that the power holder is able to appoint to himself or his creditors (known as a "general" power of appointment), his beneficial interest in the property is considered sufficient to justify his being treated as the owner of the property.

Thus, any exercise, lapse, release or termination of such a power is treated as a taxable transfer. These rules will remain essentially unchanged under the unified transfer tax.

*Joint ownership*

Under present law a transfer of a fractional interest in property is subject to gift tax upon the value of the interest transferred. If the joint interest created involves an indestructible right of survivorship (i.e., when one joint owner dies the other(s) takes over the decedent's interest) the value of the gift requires consideration of the relative life expectancies of the coowners. Upon the death of a joint owner under present law there is included in his gross estate that portion of the jointly held property corresponding to the portion which the decedent supplied of the original consideration for the acquisition of the property. A credit is allowed for any gift tax paid by the decedent upon the creation of the joint ownership. These rules of present law are unnecessarily complex and often difficult to apply. There are significant tracing problems involved in determining the portion of consideration which a decedent had furnished in the purchase of jointly held property particularly where the purchase may have been many years prior to death.

Under the unified transfer tax, as under present law, a tax will be imposed upon the creation of a joint interest in another person, to the extent that the value of such interest exceeds any consideration paid by the donee. In the case of a joint interest with right of survivorship, upon the death of a joint owner the passage of his interest to the survivor(s) is treated as an included transfer of the then value of his interest. The fractional portion and value of all joint interests are considered equal (regardless of life expectancies) unless otherwise specified by the creator(s) or controlling local law.

When a joint ownership arrangement is established under which either of the coowners may unilaterally draw down the entire value of the property (e.g., a joint bank account) there is no included transfer at that time since the one who furnishes the consideration for such an arrangement can unilaterally draw back to himself the entire joint interest, and, thus, there has been no completed gift. It should be noted that under the unlimited marital deduction there would be no transfer tax consequences, in the case of a joint ownership between husband and wife, upon its creation or upon the death of the first joint owner to die.

*Employee death benefits*

Under present law employee death benefits under a qualified pension plan, to the extent such benefits stem from employer contributions, are excluded from estate and gift taxation as long as they are not paid to the employee or his estate. There is no justification for this preferred tax treatment for an asset that clearly is part of the decedent's total wealth.

Under the unified transfer tax this exclusion would be eliminated and the employee would be treated as having made a deathtime transfer to the person receiving the benefits. An irrevocable inter vivos designation by the employee of the beneficiaries to receive employee death benefits will not be treated as an included transfer at the time

of designation; an included transfer will occur only upon the employee's death. Under the 100-percent marital deduction the effect of treating employee death benefits as a deathtime transfer is significant only when the benefits are received by someone other than the employee's spouse.

*Transfers with current beneficial enjoyment retained*

Under present law, an irrevocable transfer under which the transferor retains the right to current beneficial enjoyment for some limited period of time, such as his life, is treated as a transfer of a future interest which may be subjected to a gift tax. If the transferor still has the right to the current beneficial enjoyment when he dies, the full value of the property in which his retained interest existed is includable in his gross estate for estate tax purposes, with a credit allowed against the estate tax for the gift tax previously paid.

The unified transfer tax would simplify existing law by providing that a tax would be imposed only once, when the current beneficial enjoyment terminates. Thus, a transfer under which the transferor retains the current beneficial enjoyment is treated as an excluded transfer. The situation is viewed as if there had been no transfer at all; the transfer, in effect, does not take place until the current beneficial enjoyment terminates by death, lapse of time, transfer, or the occurrence of some contingency. If, however, the transferor wishes to pay the tax at the time of the initial transfer on the basis of the then value of the property he may elect to do so and the property would not again be subject to tax upon the termination of current beneficial enjoyment.

*Example.*—If A transfers certain property in trust to pay the income to A for his life, then the principal to B, the transfer would be an excluded transfer since A has retained beneficial enjoyment. When A dies there is an included transfer from A to B, the property being valued as of A's death. However, A may elect to have the initial transfer in trust treated as an included transfer. If such an election were made there would not be an included transfer upon A's death. If the transfer in trust were for A's spouse for her life, then to B, there would be no tax upon the spouse's taking beneficial enjoyment, but when she died there would be an included transfer from her to B.

*Transfers with reversionary interest retained*

Under present law, some transfers under which the transferor retains a reversionary interest are not treated as completed transfers. At the time such a transfer is made a gift tax is imposed upon the value of the entire property reduced by the value of the transferor's reversionary interest. If, at the time of death, the value of the reversionary interest exceeds 5 percent of the value of the property and beneficial enjoyment of the property is conditioned upon survival of the decedent, the entire value of the property at death is included in the decedent's gross estate with a credit allowed for the gift tax previously paid.

Under the unified transfer tax the treatment of transfers with retained reversionary interests is greatly simplified. If the reversionary interest is a contingent interest (i.e., the property will revert back to the transferor only if some contingency is satisfied) then the full value of the property will be taxed as an included transfer at the time of transfer. If the reversionary interest is not contingent but the property

is certain to revert at some future date, then only the interests which precede the retained reversionary interest will be treated as included transfers. The reversionary interest and any interest which may follow it will be excluded transfers at the time of the initial conveyance.

*Example 1.*—A makes a transfer in trust, the income to be paid to B for B's life, then if A survives B, to A for A's life, then the principal to go to C. If A dies before B, the beneficial enjoyment (i.e., the income) from the property will not revert to A. Thus, A's reversionary interest is a contingent interest, and the entire amount of the property transferred by A is an included transfer.

*Example 2.*—A transfers property in trust, the income to be paid to B for 10 years, then the principal to revert back to A and his heirs. Since the property is certain to revert back to A (or to his heirs if he should die) after 10 years (i.e., there is no contingency), only the 10-year interest in B is taxed as an included transfer at the time of the initial transfer.

*Transfers with power of appointment retained*

Under the unified transfer tax a transfer with power of appointment retained will be a completed gift (i.e., an included transfer) except to the extent that the transferor will be certain to be treated as the owner of the transferred property (under the rules described above) when the power is exercised, released, allowed to lapse, or terminated. Many lifetime transfers that are not completed ones under present law would be completed ones under this proposal. For example, under present law a transfer under which the transferor retains the power to designate who may enjoy the benefits of the transfer, even though he cannot benefit himself by any exercise of the power, is not a completed gift for Federal gift tax purposes. This change can be made under a unified tax system because treating such lifetime transfers as completed ones does not permit any significant tax avoidance.

*Disclaimers*

It not infrequently happens that a person named in a decedent's will to receive certain property does not wish to receive the property and disclaims the transfer. Bequests are often disclaimed in order to lessen the overall tax impact on the estate. For example, under present law if the child of a decedent disclaims his bequest in favor of the widow, in general, the estate tax liability would be reduced since 50 percent of the property going to a surviving spouse is exempt under the marital deduction.

Under the unified transfer tax rules governing disclaimers of transferred interests will be more specifically detailed than in present law. A transferee will be entitled to disclaim all or part of an interest within 15 months after the transfer, or within 6 months after he learns of the transfer, which ever period ends later, if he has not knowingly accepted any benefits from or exercised control over the property. No tax will be incurred as the result of a disclaimer satisfying these tests. The property interest will be treated as having passed from the original transferor to the person taking by virtue of the disclaimer, which person may be named by the transferor or by local law, in the absence of direction by the transferor. The dis-

claiming party, in the absence of a controlling provision in the governing instrument, will be permitted to disclaim in favor of a person to whom the original transferor could have made an excluded transfer, i.e., the surviving spouse or an orphan of the original transferor, or a qualified charitable organization. In such cases the property interest will be treated as having passed from the original transferor to the person taking by virtue of the disclaimer.

*Orphan exclusion*

A transfer at death to any orphan child of the decedent under age 21 will be nontaxable to the extent it does not exceed an amount equal to $3,000 multiplied by the number of years remaining until the child reaches age 21. There is no such exclusion under present law.

*Charitable transfers*

Under present law, outright transfers to charity are exempt from estate and gift tax. However, many transfers to charity involve splitting the interest in the property transferred between a charity and private persons, usually a member of the transferor's family. Abuses have arisen from the use of split interest transfers and considerable litigation has resulted.

Present rules provide that, in the case of split interest transfers, the income beneficiary's interest is to be valued on the assumption that the property will be invested to yield 3½ percent interest per year. Obviously, the actual investment experience will rarely correspond to the 3½ percent assumption. Abuses have arisen because of this fact. For example, assume a charity is the income beneficiary for a specified term, the property then to go to the transferor's grandchildren. The transfer is exempt for gift tax purposes to the extent of the value of the charity's interest, which is based on an assumed 3½ percent return. But if the property is invested to maximize growth for the benefit of the transferor's grandchildren, then the charity will in fact get less than assumed. The result is that the transferor has paid less gift tax than he should have. If the charity gets the remainder and an individual has the income interest, then the abuse possibility is the reverse, i.e., the property can be invested to maximize the income yield, even at the risk of the principal. Again, a deduction for the charitable transfer has been permitted in a greater amount than in fact goes to charity. Another problem in cases where the charity has the remainder interest arises where discretionary powers are granted to divert principal from the charity to the income beneficiary under specified conditions. A great deal of litigation has been engendered under present rules to determine if such powers in fact reduce the charitable interest or not.

In general, under the proposal, a transfer of a property interest to a charity is tax free if the amount of the interest transferred to charity can be measured with certainty at the time of the transfer. Thus, outright transfers to charity will continue to be not subject to the transfer tax.

However, where a transfer creates split interests (e.g., a trust to pay the income to the transferor's son for life, with the remainder to the X charity or vice versa), the portion going to the charity will qualify for the exemption only if—

(1) the income beneficiary receives an outright annuity (stated in terms of a fixed annual dollar amount or a fixed percentage of the fair market value of the property at the time of the transfer); or

(2) the governing instrument provides that the transferred property is to be valued annually, and a fixed percentage of the fair market value of the property on each valuation date is to be distributed to the income beneficiary. The required distribution is to be made first from income and then from corpus. To insure that fair market values will be determined objectively, in the case of lifetime transfers the donor will be subject to a 10-year waiver of the statute of limitations with respect to assessment of tax on the transfer. In the case of deathtime transfers, the trustee or other person determining fair market value must be independent of the beneficiaries of the transfer.

Only split interest transfers satisfying one of the above tests will qualify for the charitable exemption. All other types of split interest transfers will be subject to the transfer tax even though a charity may be a potential beneficiary. Thus, for example, if there exists any contingency which could result in the defeat of the charitable interest, or a power to divert the property to or for the benefit of someone other than the charity, the above tests are not met and the transfer does not qualify for the exemption. Also, in cases where the charity has only an income interest, and the period of the charity's interest is measured by the life of any person, no charitable exemption is allowed. The purpose of these rules is to insure that the charity will in fact receive a specified and determinable amount. These provisions will correct abuses noted above that have arisen in this area.

As a final guarantee of the integrity of gifts of income interests to charity, a rule will be provided that the exclusion will not be available if the value of the income interest passing to charity exceeds 60 percent of the value of the property transferred. This rule is designed to insure that the charity will in fact receive the full amount of its specified interest. For example, unless such a rule were imposed the donor could provide an annuity to a charity, the remainder to his family, but limit the contribution to the trust to the discounted amount necessary to fund the charity's interest only. Thus the donor would be claiming a deduction for the entire amount transferred to the trust since the actuarial value of the remainder interest would be zero. The trust could then invest in highly speculative property which, if it increased in value, would benefit the family, but if it became valueless, the charity only would lose. Nevertheless, the donor would have received a deduction for the full value of the speculative property. Eliminating the deduction where the intervening interest of the charity is more than 60 percent of the amount transferred in trust protects the charitable interest by providing a deterrent to what are essentially gambling arrangements where the charity has nothing to gain and may well lose.

The rules for treatment of transfers to charity under the unified transfer tax basically follow the proposal setting forth the rules for deductibility of charity contributions for income tax purposes.

*Credits*

As under present law, the unified transfer tax proposal provides that the transfer tax imposed upon death may be reduced by any state or foreign death taxes paid with respect to property upon which Federal transfer tax is payable, subject to the limitations which apply under present law.

*Deductions*

The same deductions which are allowed under present law to reduce the gross estate are allowed under the unified transfer tax in reduction of the aggregate amount of transfers at death. These deductions include funeral expenses, administration expenses, claims against the decedent's estate and postdeath casualty losses. As under present law, amounts which are deductible for income tax purposes as well as under the transfer tax may be deducted for purposes of one tax or the other, but not both.

*Effective date and transition rules*

The rules of the unified transfer tax will become effective on January 1, 1970. Each individual will be entitled to a $60,000 lifetime exclusion which may be applied against any transfers made after December 31, 1969, regardless of his age or the total lifetime gifts made under present law prior to that date.

For purposes of determining the rate bracket applicable to transfer after December 31, 1969, all transfers after December 31, 1968, which would be taxable under the unified transfer tax, will be counted as transfers under the unified transfer tax (and thus cumulated with transfers made after December 31, 1969), even though such transfers will be taxed under the rules of present law.

## VIII–B. UNLIMITED MARITAL DEDUCTION AND UNIFICATION OF ESTATE AND GIFT TAXES

### Technical Explanation

#### TAX IMPOSED AND LIABILITY THEREFOR

*1. General summary*

Lifetime and deathtime transfers by gift are taxable under present law. However, different sets of rates apply to lifetime and deathtime transfers. Under the unified transfer tax a single, cumulative tax will be imposed on all transfers by gift, whether during lifetime or at death, except for those which are specifically excluded. A single set of rates will apply, as explained in section 3 below. Most important among the classes of transfers specifically excluded from the unified transfer tax are transfers to a spouse. Thus, all interspousal transfers, whether at death or by gift, will be tax-free (that is, a 100-percent marital deduction). Under present law the marital deduction is limited to 50 percent of the adjusted gross estate (or 50 percent of the gift in the case of lifetime transfers).

As a supplement to the unified transfer tax, appreciation on assets transferred at death or by gift will be subject to income tax as long-term capital gain and the transferee will take a basis equal to the fair

market value at the time of the transfer.[1] Under present law, in the case of gifts, taxation of the appreciation is deferred by assigning a carryover basis to the transferee. In the case of transfers at death such appreciation escapes income tax altogether. Special provisions are included in the unified transfer tax proposal to help provide liquidity for the payment of capital gain and transfer taxes upon death.[2]

As a further integral part of the unified transfer tax structure, a substitute tax will be imposed upon certain generation-skipping transfers.[3]

*2. Imposition of unified transfer tax*

The tax will be imposed upon the aggregate amount of lifetime transfers during the calendar year, except for the calendar year of death. Upon death a tax will be imposed upon the aggregate of property passing at death plus any property transferred during the calendar year of death. In all cases the rate would be determined by cumulating the current transfers with prior transfers.

The tax will be imposed upon the fair market value of the property transferred, including in the case of lifetime transfers the amount of the Federal transfer tax incurred on the transfer, which is an integral part of the making of the gift. Under present law the tax upon lifetime gifts is based upon the fair market value of the property transferred exclusive of any gift tax. However, in the case of testamentary transfers, the present estate tax is imposed on the full value of the property in the estate, including that portion used to pay the estate tax imposed. Under the unified transfer tax this difference in treatment between lifetime gifts and testamentary transfers is eliminated by "grossing up" the fair market value of lifetime gifts, thus causing the transfer tax in effect to be paid out of the property taxed, as is the case with testamentary transfers. A table would be provided showing the amount of the grossed-up transfer in order that taxpayers will not be burdened with complex calculations.

Fair market value will be determined as of the date of transfer in the case of lifetime gifts. Generally, in the case of property passing upon death, the value will be determined as of the date of death or 1 year later (the alternative valuation date), as under present law. The value placed upon an included transfer in a transfer tax return required to be filed cannot be questioned for any purpose after the applicable period of limitations with respect to such return has expired. Under a unified tax system, where the tax rate applicable to transfers on death depends on the rate bracket already attained by lifetime transfers, any change in the valuation of lifetime included transfers affects the determination of the rate bracket for deathtime transfers. Under the present dual-tax system, although a change in the valuation of prior gifts affects the rate bracket as to subsequent gifts, it does not affect the rate applicable to transfers on death.

*3. Rate of tax*

(*a*) *Unified bracket rate.*—As under present law, the tax rate bracket on lifetime transfers each year will be based upon the cumulative life-

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[1] Income tax on capital gain at death is fully discussed in VIII–A.
[2] The liquidity provisions are fully discussed in VIII–D.
[3] Full discussion of the substitute tax on generation-skipping transfers is contained in VIII–C.

time total of such transfers. In determining the cumulative total of lifetime transfers at the beginning of each year, the amount of a transfer shall be determined under the gross-up principle described above; that is, the net amount received by the transferee plus the net Federal transfer tax imposed on the transfer.

Under present law, the bracket rate applicable to transfers at death is based solely upon the aggregate of property passing at death (that is, the gross estate) and is entirely independent of the aggregate amount of lifetime transfers. Under the unified transfer tax, the bracket rate upon transfers at death is based upon previous aggregate lifetime transfers. This is the essence of the unified transfer tax system.

(*b*) *Realinement of rate schedule.*—There is widespread criticism of the present structure of estate tax rates. The rate progression is excessively steep within the estate tax brackets up to $50,000 (moving from 3 to 25 percent) and is not steep enough in the brackets from $50,000 (25 percent) to $500,000 (32 percent). The unified transfer tax rate schedule incorporates a general reduction from present estate tax rates of about 20 percent. In addition, realinement is made of the rate brackets, designed to produce a more equitable progression. The new unified rate will become effective immediately with respect to lifetime transfers and will be instituted gradually in month-to-month steps over a 10-year period with respect to transfers taking place upon death.

The following table shows the entire proposed final unified transfer tax rate structure, after completion of the 10-year transition period, compared with the present estate tax rate structure:

PROPOSED TRANSFER TAX RATES

| Taxable transfer | (1) Present estate tax rate (percent) | (2) Unified transfer tax rate (percent) | (3) Tax at top of bracket | |
|---|---|---|---|---|
| | | | Present | (4) Proposed |
| 0 to $5,000 | 3 | 3 | $150 | $150 |
| $5,000 to $10,000 | 7 | 7 | 500 | 500 |
| $10,000 to $20,000 | 11 | 11 | 1,600 | 1,600 |
| $20,000 to $30,000 | 14 | 11 | 3,000 | 2,700 |
| $30,000 to $40,000 | 18 | 14 | 4,800 | 4,100 |
| $40,000 to $50,000 | 22 | 16 | 7,000 | 5,700 |
| $50,000 to $60,000 | 25 | 16 | 9,500 | 7,300 |
| $60,000 to $80,000 | 28 | 18 | 15,100 | 10,900 |
| $80,000 to $100,000 | 28 | 20 | 20,700 | 14,900 |
| $100,000 to $150,000 | 30 | 22 | 35,700 | 25,900 |
| $150,000 to $250,000 | 30 | 24 | 65,700 | 49,900 |
| $250,000 to $350,000 | 32 | 25 | 97,700 | 74,900 |
| $350,000 to $500,000 | 32 | 27 | 145,700 | 118,400 |
| $500,000 to $750,000 | 35 | 29 | 233,200 | 180,900 |
| $750,000 to $1,000,000 | 37 | 31 | 325,700 | 258,400 |
| $1,000,000 to $1,250,000 | 39 | 33 | 423,200 | 340,900 |
| $1,250,000 to $1,500,000 | 42 | 35 | 528,200 | 428,000 |
| $1,500,000 to $2,000,000 | 45 | 37 | 753,200 | 613,000 |
| $2,000,000 to $2,500,000 | 49 | 41 | 998,200 | 818,000 |
| $2,500,000 to $3,000,000 | 53 | 44 | 1,263,200 | 1,038,000 |
| $3,000,000 to $3,500,000 | 56 | 47 | 1,543,200 | 1,273,000 |
| $3,500,000 to $4,000,000 | 59 | 49 | 1,838,200 | 1,518,000 |
| $4,000,000 to $5,000,000 | 63 | 53 | 2,468,200 | 2,048,000 |
| $5,000,000 to $6,000,000 | 67 | 56 | 3,138,200 | 2,608,000 |
| $6,000,000 to $7,000,000 | 70 | 59 | 3,838,200 | 3,198,000 |
| $7,000,000 to $8,000,000 | 73 | 61 | 4,568,200 | 3,808,000 |
| $8,000,000 to $10,000,000 | 76 | 63 | 6,088,200 | 5,068,000 |
| $10,000,000 and up | 77 | 65 | | |

*4. Credits*

(*a*) *State and foreign death taxes.*—As under present law, the transfer tax imposed upon death may be reduced by any State or

foreign death taxes paid with respect to property upon which Federal transfer tax is payable, subject to the maximum limitations which apply under present law.

(*b*) *Credit for tax on prior transfers.*—Under present law, if a decedent acquired property from a prior decedent whose death occurs within 10 years before (or 2 years after) the death of the decedent, the decedent's estate is allowed a credit against its estate tax for the estate tax paid by the prior decedent's estate upon the transferred property. The amount of the credit diminishes by 20 percent for each 2 years intervening between the death of the two decedents.

This rule is designed to ameliorate the burden of taxation which would result from subjecting the same property to multiple transfer taxes within a relatively brief timespan. The situation which gives rise to the most concern occurs upon the early death of a surviving spouse, thereby unduly taxing the marital wealth which passes to the issue of the marriage. However, since the unified transfer tax proposal includes a provision for an unlimited marital deduction, this problem is eliminated, since no tax need be paid on the death of the spouse first to die. The remaining situations in which two transfer taxes will be levied on successive deaths occurring within a brief period of time do not involve patterns of disposition which warrant special relief.

Thus, the present credit for tax on prior transfers is eliminated. However, the credit provisions of existing law will be retained in cases of property held by a surviving spouse which was received on the death of the decedent spouse, and which was subject to estate tax under existing law. Hence, after 10 years the present credit will be fully eliminated.

*5. Liability for tax*

In general, liability for the payment of transfer taxes will be upon the donor in the case of lifetime transfers and upon the donor's personal representative in the case of transfers at death, as under present law. Special rules are provided with respect to liability in cases where the time for payment of the deathtime transfer tax is postponed in order to avoid the forced sale of a closely held business.[5]

In the cases of certain lifetime transfers by one spouse which are deemed to have been made by the nondonor spouse under the tax-free interspousal transfer rules, the liability for the tax may be joint and several, or the tax may be collectible only out of the property transferred, depending upon the particular situation.[6]

A special rule is provided to protect personal representatives against personal liability which could arise under the unified transfer tax system as a result of a later discovery of unreported lifetime transfers, which would produce an increase in the aggregate amount of lifetime transfers and thus cause an increase in the rate applicable to aggregate transfers at death. After 40 months[7] from the transferor's death no personal representative may be held personally liable for any deathtime transfer tax deficiency which results from an increase in the rate

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[5] This matter is fully discussed in VIII–D.

[6] These situations are more fully described hereinafter.

[7] A 40-month period is used (rather than 3 years) in order to assure that exposure to liability does not terminate prior to the termination of the period within which values used in the decedent's transfer tax return for the year preceding the year of death may be questioned. See sec. 2 above.

bracket resulting from improperly reported or unreported lifetime transfers of which he had no actual knowledge, except to the extent of property transferred by the decedent which is under the representative's control at the time he is notified by the Government of the deficiency. The only requirement to establish absence of actual knowledge is a showing that all lifetime transfer tax returns were examined and no underpayments discovered. The fiduciary will be deemed to have examined all transfer tax returns if he (1) requests in writing all such returns from the Internal Revenue Service, and (2) examines all such returns which the Service supplies within 3 months after receiving the request.

*6. Returns*

The present gift and estate tax return requirements are essentially retained in the unified transfer tax proposal. Thus, any individual who during a calendar year makes a gift of a future interest or makes outright gifts which total in excess of the annual per-donee exclusion ($3,000) to any recipient must file a transfer tax return for such year. In the case of a decedent, a return must be filed if the aggregate amount of transfers at death together with the aggregate amount of all lifetime transfers (in excess of the annual per-donee exclusion) total more than $60,000, the amount of the overall exemption.

Under present law a nondonor spouse is permitted to treat up to one-half of a donor spouse's gift as having been made by such nondonor spouse, that is, "gift-splitting." If the total gifts by a donor spouse under existing law exceed the amount of the donor spouse's annual exclusion ($3,000) then, even if the nondonor spouse elects to gift-split and thus reduce the donor spouse's gift to an amount less than the annual exclusion, a return must be filed by the donor spouse to show the gift-splitting election.

This filing requirement is retained in the unified transfer tax. Thus, a transfer tax return must be filed for any year in which transfers by one spouse to any one recipient exceed $3,000, regardless of whether the nondonor spouse elects to split the gift with the other spouse.

## INCLUDED TRANSFERS

*1. General*

Under present law a gift tax is imposed on an annual basis upon the aggregate amount of gifts made during the taxable year. Gifts up to $3,000 to each donee are excluded, a lifetime exemption of $30,000 is allowed, and a 50 percent marital deduction is allowed against gifts to a spouse. Those transfers which are subject to tax are referred to as "taxable gifts." An estate tax is imposed upon the total amount of property passing at death, reduced by the estate tax exemption of $60,000, and by certain exclusions and deductions, including the 50 percent marital deduction.

As under present law, the unified transfer tax is imposed upon completed transactions in which the owner of a particular property interest disposes of all or part of his beneficial ownership. Those transfers which are subject to tax at the time of initial transfer are classified as "included transfers;" those dispositions which are not taxable events at such time are "excluded transfers." The tax is based upon value of lifetime transfers in each year, "grossed-up" as explained hereinabove. At

death the tax is based upon the aggregate value of property passing from the decedent by reason of his death. The rate applicable to transfers at death takes into account prior lifetime transfers.

*2. Included transfers defined*

(*a*) *Beneficial interests.*—A transfer by the beneficial owner of a property interest of all or part of the interest is an included transfer subject to tax, unless it is one of the excluded transfers set forth below. A transfer takes place upon any disposition of a property interest, whether by lifetime transfer or at death, and regardless of the method by which the transfer is effected, for example, by will or by statutory rules of intestate succession. Property interests subject to tax include all types of property and all forms of ownership interests therein.

(*b*) *Powers of appointment.*—Under present law, a distinction for estate and gift tax purposes is made between general and special powers of appointment. The exercise, release, lapse, or termination of a general power of appointment, that is, one that is exercisable by the powerholder in favor of himself, his estate, his creditors, or creditors of his estate, is subject to tax. On the other hand, a special power of appointment, that is, one which may not be exercisable by the powerholder in favor of one or more of the above-named class, is not so taxed.

The present rules governing powers of appointment will be retained in the unified transfer tax proposal. A transfer tax will be imposed on the partial or complete exercise, release, termination, or lapse of a general power of appointment (as defined above) that is exercisable by the powerholder alone or in conjunction with another who does not have a substantial interest adverse to that of the powerholder. Where a general power of appointment is exercisable jointly by two persons in favor of each other, each shall be deemed the holder of a general power over one-half of the property subject to the power. (As under present law, special rules will provide relief for powers created on or before October 21, 1942.) The partial or complete exercise, lapse, release, or termination of (1) a general power of appointment (a) requiring the joinder of one who has a substantial interest adverse to the powerholder, or (b) which is limited by a reasonably fixed or ascertainable standard, or (2) a special power of appointment, is not an included transfer.

A person may be given a noncumulative power to draw down for his own benefit some stated amount annually. In each year, to the extent he does not withdraw the amount subject to the power, the power lapses and the powerholder has made on included transfer of the amount subject to the power. However, this rule shall apply to the lapse of a power during any calendar year only to the exent that the property which could have been appointed by the exercise of the lapsed power exceeded in value the greater of the following amounts: $5,000 or 5 percent of the aggregate value, at the time of such lapse, of the assets out of which or the proceeds of which, the exercise of the lapsed powers could be satisfied. This provision follows present law.

(*c*) *Life insurance.*—The death of an insured is a transfer by him of the proceeds of any insurance policy on his life if (*a*) the proceeds are received by the insured's executor or administrator; or (*b*) the insured possessed at his death an incident of ownership with respect

to such policy. (Present rules for determining what constitutes an incident of ownership will be retained.)

Transfer of all of the incidents of ownership during life is an included transfer. If the insured transfers some but less than all of the incidents of ownership, this will not be an included transfer, and the face amount of the policy will be treated as an included transfer upon the death of the insured.

The insured may continue to pay the premiums on a transferred policy of which he has made a completed transfer, and each premium payment itself will constitute a gift.

Present rules regarding the treatment of the proceeds of life insurance transferred in contemplation of death would be modified. Under current law, if the insured transfers all the incidents of ownership of a policy on his life, but continues to pay the premiums thereon, a transfer in contemplation of death of a part of the policy proceeds is made because of the premium payments made during the 3 years preceding death. The amount of the transfer includible in the decedent's estate is the proportion of the face amount of the policy which the payment of premiums during the 3 years preceding death bears to the total premiums paid under the policy. Thus, if the decedent has paid 15 premiums on a $10,000 policy which he had transferred during his life, this rule values the transfer in contemplation of death at $2,000 ($3/15 \times \$10,000$).

There has been criticism of the present contemplation of death rules because they do not reflect what any given life insurance premium pays for. Each premium can be regarded as constituting three elements: The annual increase in the cash value of the policy, a loading charge, and the purchase of the protection element of the policy (essentially 1-year-term insurance).

In order to reflect the economic realities of life insurance, in this regard, the contemplation of death rules as applied to life insurance will be modified. If the insured transfers the incidents of ownership of a policy but makes any premium payments during the 3 years preceding death, a transfer in contemplation of death of a portion of the policy proceeds will be deemed to have been made. The value of the transfer at death will be the increase in cash value in the policy resulting from the premium payments so made plus the difference between the face amount of the policy and its cash value at date of death) the protection element of the policy).

For example, assume an insured transferred a $10,000 policy to his son more than 3 years prior to death and paid all premiums due prior to his death. At date of death the policy had a cash surrender value of $5,000. Three years prior to death the policy had a cash value of $4,600. Under this rule, $5,400 would be included in the decedent's gross estate—the $5,000 in term insurance protection purchased with the last premium payment and the $400 increase in cash value occasioned by the payment of the last three premiums.

Since term insurance generally has no cash value, each year's premium is the purchase of the protection equal to the face amount of the policy. Therefore, payment of a premium on a term policy within the 3 years preceding death will be a transfer in contemplation of death equal in value to the full face amount of the policy.

Special rules will be provided to determine what constitutes the payment of premiums by an insured for purposes of this rule. Generally, an insured will be treated as paying the premiums on a policy if he, or his spouse, makes cash gifts or loans to the owner of the policy during the 3 years preceding death.

(*d*) *Concurrent interests.*—Present law has certain unsatisfactory complexities in dealing with the creation and maturing of concurrent (joint ownership) interests in property. This proposal simplifies tax treatment in this area.

(1) If the form of concurrent ownership created vests the entire ownership in the surviving owner, but permits the coowners to take down only a part or none of the interest during the joint lives of the owners (e.g., tenancy by the entirety or joint tenancy), then under the proposal the creator makes a transfer to the other concurrent owners in the amount of the excess of his contribution over the amount of the interest he retains. Each concurrent owner is treated as having an equal undivided interest in the property unless their undivided shares are in some other proportion under the terms of the transfer or controlling local law.

Under present law, the valuation of the gift made by the donor when he creates a concurrent interest in himself and another with an indestructible right of survivorship requires a calculation which takes into account the ages of the donor and the other concurrent owner. In other words, the younger of the two concurrent owners has a more valuable interest in the concurrently held property than the older because his chance of becoming the sole owner by the right of survivorship is greater. This complication in valuing the interest of each concurrent owner is eliminated under the proposal. Under present law there is an election given to the donor spouse under 1954 I.R.C. Section 2515 to treat the creation of a tenancy by the entirety (or joint tenancy) in real property as a transfer for gift tax purposes. This provision in present law has been eliminated because the exclusion of transfers by one spouse to another makes it unnecessary.

The concurrent owner who dies first makes a transfer at death under the proposal only of that portion of the property that the decedent is treated as owning at such time after the application of the foregoing rules. Thus, in the case of a joint tenancy between two equal coowners, there will be a transfer of only one-half of the jointly owned property on the death of one of the owners. The consideration-furnished test of present law is no longer necessary under the above rules, and has therefore been discarded, except in the limited situation described below.

(2) If the form of ownership permits any one of the concurrent owners to take down the entire interest during the joint lives of the owners, as in the case of joint bank accounts or jointly owned Government bonds, there is an excluded transfer at the time of the creation of the transfer because the creator has retained the power to get back what he has transferred. The first owner to die makes a transfer to the survivor of the portion of the interest corresponding to the consideration he furnished to acquire the interest. During the joint lives of the owners, withdrawals by any coowner will be included transfers to the extent that the aggregate of such withdrawals exceeds

the consideration furnished by such coowner. Where there are more than two coowners, a withdrawal which is treated as an included transfer shall be treated as having been made by the nonwithdrawing coowners in proportion to the amounts each contributed.

The above rules may be illustrated by the following examples:

(A) A transfers an undivided one-half interest in Blackacre to B. There is an included transfer of such one-half interest at the time of the creation of the joint ownership. Any later disposition by A of his retained one-half interest during lifetime or at death will be a transfer at such time of such retained interest.

(B) A transfers Blackacre to A, B, and C as joint tenants with right of survivorship. At the time of the creation of the interest A makes an included transfer of one-third of the property each to B and C. If A is the first of the three joint tenants to die, upon death he makes an additional transfer of his one-third interest equally to B and C.

(C) A creates a joint bank account between A and B depositing $10,000 therein. The creation of the joint account is an excluded transfer since A has retained the right to draw down the full amount of the account for his own benefit. If B makes a withdrawal of $5,000 during the joint lives of A and B, an included transfer of that amount is made from A to B. Upon the death of A there is an included transfer of the balance of the account.

(D) A, B, and C created a joint checking account. A initially contributes $10,000, B $20,000, and C $30,000. B withdraws $30,000 during the joint lives of the owners. There is an included transfer of $10,000 ($30,000−$20,000) to B. This transfer is deemed made $2,500 by A ($10,000/$40,000), $7,500 by C ($30,000/$40,000). The consideration furnished by A and C is reduced by the amounts deemed to be transferred by each. Thus, if A then withdraws $10,000, C makes a gift to A of $2,500 ($10,000—$7,500; A's consideration furnished as adjusted for the gift to B).

There may be problems of tracing inherent in the treatment of joint bank accounts involving more than two joint owners. However, outside of business or family arrangements, it is difficult to see that there is any reason for widespread use of such accounts. Thus, the marital exclusion, the nongift business situation, and the $3,000 annual per donee exclusion should cover most multiple joint owner situations.

(*e*) *Employee death benefits.*—Under present law employee death benefits under a qualified pension plan, to the extent such benefits stem from employer contributions (see sections §§ 2039 (c) and 2517), are excluded from estate and gift taxation as long as they are not paid to the employee or his estate. There is no justification for this preferred tax treatment.

Under the proposal this exclusion would be eliminated and the employee would be treated as having made a deathtime transfer to the person entitled to receive such benefits. This rule would apply to benefits from employee annuities, employee benefit plans (qualified or nonqualified), group term life insurance proceeds, or any other cash payments by the employer, regardless of whether such payments are voluntary or pursuant to contract. Individual life insurance policy proceeds would be governed by the rules in paragraph *c* above. An irrevocable intervivos designation by the employee of the beneficiaries

to receive employee death benefits will not result in any included transfer. The transfer will be regarded as taking place on the employee's death.

(*f*) *Transfer of dower or curtesy interest.*—Under present law (I.R.C. § 2034) the gross estate includes the value of property to the extent of any interest taken by a surviving spouse as dower or curtesy. Under the unified tax system interests taken as dower or curtesy will be classified as included transfers; however, in practically all cases they will be treated as transfers of current beneficial enjoyment to a spouse and hence not taxed.

### EXCLUDED TRANSFERS

*1. Annual exclusion*

As under present law, the unified transfer tax system permits relatively small gifts to be made free of tax. Thus, the first $3000 of intervivos transfers of present interests to any person during each taxable year will be excluded from the total amount of transfers subject to tax for such year. If gifts are made to more than one donee, a $3000 exclusion is available with respect to each donee. A married person may utilize his spouse's exclusion with her consent, so that in effect the annual per donee exclusion for a married person is $6000. This annual exclusion applies only with respect to gifts of present interests. Thus, the transfer of future interests will not qualify, with one exception: gifts to minors to take effect at age 21, as presently provided in section 2503(c).

The annual per donee exclusion carries forward existing law.

*2. Overall exemption*

Each individual would be entitled to an overall exemption from transfer tax of $60,000. This exemption may be used against lifetime or deathtime transfers at the option of the taxpayer. To the extent that the exemption is not used during lifetime it will be applied against transfers at death.

Under present law there is a lifetime gift tax exemption of $30,000 plus an estate tax exemption of $60,000. The entire estate tax exemption is available regardless of the extent to which the gift tax exemption may or may not have been used. Under the unified transfer tax a single exemption, applicable to lifetime and deathtime transfers, is provided. The amount of the exemption has been set at $60,000. Although the single $60,000 exemption is less than the total $90,000 combined lifetime and deathtime exemption under the present dual tax structure, the effect of this change is offset by the lower rate structure and the unlimited marital deduction under the unified transfer tax.

*3. Unlimited marital deduction*

(*a*) *In general.*—There will be an exemption from taxation under the unified transfer tax for the full amount of any property (1) that passes outright to a spouse (either during the life of the transferor spouse or at his or her death), or (2) that passes subject to any kind of legal arrangement assuring the transferee spouse for life or for any other period of time commencing currently the enjoyment or use of such property, or the income from it, or the right through the exercise of an unrestricted power vested solely in him or her to such outright

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ownership, enjoyment, use, or income, if the transferee spouse consents to having the termination of such limited interest treated as a taxable transfer by him or her. Property received outright by the transferee spouse will of course become part of his or her taxable estate, unless consumed. In addition, even though the transferee does not receive outright ownership, where the transfer of an interest in the property was excluded by virtue of the marital deduction then that property will be taxable as a transfer by the transferee spouse upon termination of his or her interest; if a transfer between spouses was tax free by virtue of some provision other than the marital deduction (e.g., exercise of certain powers of appointment) then this rule will not operate.

To protect the transferee spouse from liability for tax on property not fully subject to his or her control or power of disposition, the tax imposed on termination of one of the kinds of limited interests that is sufficient to qualify property for the marital deduction will be collectible only out of such property. The amount subject to taxation will be the value of the property at the time the transfer by the transferee spouse is deemed to occur. In the case of transfers occurring upon the death of the transferee spouse, the tax attributable to such property will be the amount by which the total tax at death exceeds the tax which would have been payable had such property not been included in the total taxable transfers at death. In the case of property deemed to be transferred during the life of the transferee spouse, the tax attributable to the limited interest property will be the pro-rata portion of the entire tax payable on all transfers during the same period.

In the case where a transferee spouse is given an income interest in trust subject to a power exercisable by the trustee to invade corpus for the benefit or use of others, the transfer in trust qualifies for the marital deduction. However, any payments from corpus to persons other than the transferee spouse are treated as included transfers by the transferee spouse at the time such payments are made. If the transferee spouse has no control over the invasion power, in accordance with the rule discussed above, the tax will be collectible only out of the property distributed from corpus.

(*b*) *Partial interests.*—If the transferee spouse receives a determinable portion of property (or a qualifying interest in such portion) then such portion will qualify for the marital deduction. If the transferee spouse receives the right to an annual payment specified in dollar terms then the portion of the property to be excluded will be determined by multiplying the total property transferred by a ratio equivalent to the ratio of the specified annual income to the putative annual income from the property, the putative income being 5 percent of the value of the property. The portion of the transferred property to be taxed upon termination of the interest of the transferee spouse in such cases will be the same as the portion originally excluded, regardless of changes in value subsequent to the original determination and exclusion.

Thus, if property worth $100,000 is transferred to a trust under whose terms the transferee spouse is entitled to 40 percent of the income for life, and if, upon the death of the transferee spouse, the property is worth $200,000, then 40 percent of $200,000, or $80,000, will be treated as a taxable transfer by the transferee spouse. If the property

had been worth $50,000 on the death of the transferee spouse then only $20,000 would be treated as a taxable transfer. Similarly, if the transfer in trust provided for a fixed payment to the transferee spouse for life of $2,000 per year, which would be 40 percent of the putative income of the trust at the time of its creation, then upon the death of the transferee spouse, if the property held in trust were worth $200,000, the taxable transfer would be $80,000 but if the property were worth only $50,000, only $20,000 would be taxable. In each case, as indicated in the preceding paragraph, the tax on these transfers would be collectible only out of the trust property. To foreclose the possibility that a transfer by a remainderman might impair the Government's right to a tax collectible from the kind of property discussed herein, the property will be subject at the time of the initial transfer to a lien for whatever tax is determined at the time of the termination of the transferee spouse's interest to be collectible from it. In other words, the lien for taxes, even though inchoate, will have priority over all subsequent liens.

(*c*) *Concurrent interests.*—Where a transfer gives concurrent interests in property to a spouse and to other persons, the respective interests of the transferee spouse and the other persons will be determined by application of the same rules that govern the creation of concurrent interests with the interest transferred to the spouse being treated the same as a retained interest. Thus, if A transfers an undivided one-half interest in Blackacre to his wife and the other one-half interest to his son, the one-half interest passing to the wife will be excludable, and the other one-half interest will be taxable. A transfer by the wife of her interest will then result in a tax on this one-half portion of the property. Similarly, to follow the rules relating to retained interests, if A transfers $10,000 into a joint bank account for his wife and his son, the transfer will be excluded since the wife has right to withdraw the full amount for her own use. If the son withdraws $5,000 that amount will constitute a transfer from the wife to him at that time, and upon the wife's death the full amount remaining in the account will be included in her taxable estate. If a person creates a joint bank account for himself and his spouse that transfer will of course be fully excluded.

(*d*) *Deductions for State and foreign taxes.*—The marital deduction will cover not only the amount transferred, whether during the life or at the death of the transferor, but also the amount of any State or foreign gift or estate tax payable by virtue of the transfer.

(*e*) *Election to be taxed.*—In some instances where property is passed from one spouse to the other and subsequently out of the family unit, it may be more advantageous to have the transfer taxed at the time of the interspousal transfer than at the time of the subsequent transfer by the transferee spouse. An option would therefore be made available to have taxed any portion of any property passing under the marital deduction. The property taxed by election would not be taxed again upon transfer by the surviving spouse, with the burden on the surviving spouse to trace any property to previously taxed "marital deduction" property. The election to be taxed will be exercisable by the transferor and, in the case of a transfer at death, if the transferor makes no election, then by the transferee spouse.

(*f*) *Splitting gifts.*—Because property passing to a spouse by gift will also be excludable, a couple could arrange to have taxed to either husband or wife the full amount, or any portion, of gifts to third persons, by use of prior transfers between themselves. To make such artificial circuity unnecessary, an option will be available to have any portion of any lifetime gift taxed as a transfer by the nondonor spouse, if the nondonor spouse consents. This rule will apply to transfers at death as well as during life.

(*g*) *Delayed enjoyment.*—In the case of a transfer by reason of death, the application of the unlimited marital deduction will not be defeated by a requirement that, in order to take or enjoy any property or interest therein, the surviving spouse must survive the decedent by a period of not more than 6 months, provided that such spouse does in fact take or enjoy the property (or interest therein) within such period. Any other condition precedent to immediate beneficial enjoyment will bar qualification for the unlimited marital deduction unless such condition is in fact satisfied within 6 months of the decedent's death. Nonetheless, a cash legacy will qualify for the unlimited marital deduction even if interest for delay of payment does not begin to run for a period not in excess of 1 year. In addition, property that in fact passes to the surviving spouse within 1 year of the death of the decedent spouse as a result of a court decree (e.g., as a widow's allowance) will qualify for the unlimited marital deduction.

(*h*) *Definition of spouse.*—The marital deduction applies to transfers to the transferor's legally recognized spouse at the time of transfer. In addition, the following transfers will be regarded as transfers to a spouse:

(1) A transfer made to the other party in a divorce proceeding as a part of any property settlement, even though the transfer is made after the marriage has been dissolved by a final decree.

(2) A transfer made to a person who would be the transferor's spouse if all decrees of divorce rendered by a court of record are assumed to be valid.

(3) A transfer made to a person who would have been the transferor's spouse but for an annulment of the marriage which occurred subsequent to the transfer.

(4) A transfer made to a person to whom the transferor is married before the date on which any transfer tax on the transfer would be due (a transfer in contemplation of marriage).

In the case of a transfer with a retained income interest, the transfer will qualify if the transferee was the transferor's spouse (or is regarded as the transferor's spouse under the above rules) on the date of the initial transfer by the transferor spouse, regardless of a dissolution of the marriage before the date on which the transferor spouse's interest terminates.

(*i*) *Delayed effective date in respect of certain dispositions using formula clauses.*—While the unlimited marital deduction will generally be applicable to all transfers occurring after the date of enactment, it will not be effective until 2 years after the date of enactment in the case of any transfer pursuant to a provision of a will executed before the announcement date of these proposals if the amount passing to the surviving spouse is described in terms of the

maximum allowable marital deduction under the Internal Revenue Code (and not determinable without specific reference to the code). For the purpose of this rule the execution of a codicil will not change the date of execution of the will unless the codicil specifically refers to the marital deduction provision of the original will.

*4. Transfers to orphan children*

A transfer at death to any child of the decedent under 21 years of age will be nontaxable to the extent that it does not exceed $3,000 multiplied by the difference between 21 and the child's age in years at the date of decedent's death, if the child does not have another parent (including parents by adoption) living at the time of death.

*5. Transfers to charity*

In general, under the unified transfer tax, a transfer of a property interest to a charity is tax free if the amount of the interest transferred to charity can be measured with certainty at the time of the transfer. Thus, outright transfers to charity will not be subject to the transfer tax.

However, where a transfer creates split interests (e.g., a trust to pay the income to the transferor's son for life, with the remainder to the X charity or vice versa), the portion going to the charity will qualify for the exemption only if:

(1) The income beneficiary receives an outright annuity (stated in terms of a fixed annual dollar amount or a fixed percentage of the fair market value of the property at the time of the transfer); or

(2) The governing instrument provides that the transferred property is to be valued annually, and a fixed percentage of the fair market value of the property on each valuation date is to be distributed to the income beneficiary. The required distribution is to be made first from income and then from corpus. To insure that fair market values will be determined objectively, in the case of lifetime transfers the donor will be subject to a 10-year waiver of the statute of limitations with respect to assessment of tax on the transfer. In the case of deathtime transfers, the trustee or other person determining fair market value must be independent of the beneficiaries of the transfer.

Only split interest transfers satisfying one of the above tests will qualify for the charitable exemption. All other types of split interest transfers will be subject to the transfer tax even though a charity may be a potential beneficiary. Thus, for example, if there exists any contingency which could result in the defeat of the charitable interest, or a power to divert the property to or for the benefit of someone other than the charity, the above tests are not met and the transfer does not qualify for the exemption. Also, in cases where the charity has only an income interest, and the period of the charity's interest is measured by the life of any person, no charitable exemption is allowed. The purpose of these rules is to insure that the charity will in fact receive a specified and determinable amount.

As a final guarantee of the integrity of gifts of income interests to charity, a rule will be provided that the exclusion will not be available if the value of the income interest passing to charity exceeds 60

percent of the value of the property transferred. This rule is intended to deny the exclusion in cases where the remainderman's interest is so small that there would be a tendency to invest the principal speculatively in order to increase the remainder interest at the primary risk of the charity's income interest.

The rules for treatment of transfers to charity under the unified transfer tax basically follow the proposal setting forth the rules for deductibility of charitable contributions for income tax purposes.

*6. Transfers for consideration*

Transfers for consideration normally are excluded transfers not subject to the transfer tax, even if it be established that the value of the property transferred exceeded the value of the property received as consideration. However, where a transfer for consideration is not the product of a bona fide arm's length arrangement free of donative intent, such excess will be taxed.

The transfer is not for a consideration unless the alleged consideration is reducible to a value in money or money's worth. Thus, a transfer for a consideration such as love and affection, or a promise of marriage, is not excludable. A transfer to a spouse in return for relinquishment of dower or curtesy, a statutory estate created in lieu of dower or curtesy, support rights, or any other rights which the spouse may possess by reason of the marriage will not be considered a transfer for consideration under the unified transfer tax, whether or not such transfer is made pursuant to a divorce settlement. However, any such transfer to a spouse would qualify for the unlimited marital deduction. This rule represents, in part, a change in present law under which transfers of property to a spouse pursuant to a written agreement relative to the settlement of marital and property rights are deemed to be transfers made for a full and adequate consideration in money or money's worth if divorce occurs within 2 years thereafter.

*7. Transfer by a corporation or trustee*

A transfer made by a corporation or a trustee is an excluded one. If a transfer which is in form made by a corporation or a trustee is in fact made for an individual, the transfer will be regarded as made by the individual, and such transfer is not an excluded one. These rules do not change present law.

*8. Deductions*

Present law provides certain deductions in determining the adjusted gross estate of a decedent. These are specified in present sections 2053 and 2054, and include funeral expenses, administration expenses, claims against the estate, casualty losses occurring during administration, et cetera.

Generally, these deductions will be retained. But two areas which have given rise to problems will be clarified. These involve (1) the double deduction of certain items of expense for both estate and income tax purposes; and (2) the election afforded an executor to take some items of expense either as an estate tax deduction or an income tax deduction.

Although section 642(g) generally prohibits double deductions of items of expense, some items are expressly permitted this treatment

and other items receive this benefit by implication. Section 691(b) deductions [8] in respect of a decendent are specifically excepted from the double deduction prohibition. And since section 642(g) specifically denies double deduction treatment only to those expenses set forth in section 2053 and 2054, other deductions have been accorded the double deduction treatment.[9] (These latter deductions apply to the fiduciary return and the estate tax return, whereas the section 691 deductions are reported on the decedent's final return and the estate tax return.)

Under the capital gain at death proposal, section 691 would cease to have application after December 31, 1969. All items of income and expense formerly treated under section 691 would be accounted for in the decedent's final return. Also, the income tax liability determined on the decedent's final return would be a deduction from the decedent's gross estate for transfer tax purposes. With the abolition of section 691, it would no longer be appropriate for section 691(b) deductions to be allowed also as deductions from a decedent's gross estate. Hence, after December 31, 1969, items formerly treated as deductions under section 691(b) would be deductible only on the final income tax return of the decedent, and would not be allowable as deductions on the transfer tax return filed by the executor.

The proposal would attempt to eliminate the problems which have arisen because of the election under which the executor has to take certain expenses as deductions either against estate income or against the gross estate. This option often places the executor in a conflict of interest position between the interests of the income beneficiaries and the remaindermen, or between the surviving spouse taking property under the marital deduction and the residuary legatees. This option also produces structural dislocations in that estate income is reduced by deductions which have no relation to the production of that income.

To solve these problems, the election granted to the executor to take items of expense as either (or, in some cases, both) income or estate tax deductions will be eliminated. Expenses must be taken as either income or transfer tax deductions under the following rules:

(1) The following expenses must be taken only as estate tax deductions:

(*a*) Funeral expenses.
(*b*) Executor's commissions.
(*c*) Attorney's fees.
(*d*) Miscellaneous administration expenses, such as court costs, surrogate's fees, accountant's fees, appraiser's fees, etc.
(*e*) Claims against the estate (except medical expenses of the decedent), including alimony.
(*f*) Casualty losses occurring during administration.
(*g*) Any of the foregoing attributable to the administration of assets not subject to probate.

(2) The following expenses occurring during administration must be taken only as income tax deductions (or credits) by the executor: [10]

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[8] These include accrued business and nonbusiness expenses, predeath interest, taxes, etc.
[9] These include selling expenses, repayments under the sec. 1341 claim of right provisions, postdeath interest.
[10] Present law rules are retained to permit any excess deductions in the final income tax return of the executor to be carried forward as deductions to the beneficiary of the estate.

(*a*) Interest.
(*b*) Taxes.
(*c*) Trade or business expenses.
(*d*) Selling expenses (in the form of reduction of sales proceeds).
(*e*) Section 1341 credits or deductions.

(3) Medical expenses of the decedent may be deducted only on the decedent's final return. (Under present law section 213(d), the executor may, at his option, take such expenses either as an estate tax deduction or as an income tax deduction on the decedent's final return.)

The foregoing rules will provide certainty for the executor in the handling of deductible expenditures, and will relieve him of the pressures from competing interests that presently arise solely because of the operation of the tax laws.

### TRANSFERS WITH CURRENT OR FUTURE INTEREST RETAINED

*1. In general*

Persons sometimes transfer property but retain the current beneficial enjoyment or provide that the beneficial enjoyment will revert to them at some future date. Under the present dual tax system, it is not possible to treat many of these transfers as completed for tax purposes until the death of the transferor. Under the unified tax system, many more lifetime transfers of this type will be treated as completed for tax purposes. As outlined below, the timing of the imposition of the tax varies with the type of arrangements created.

*2. Transfers with current beneficial enjoyment retained*

Under present law, an irrevocable transfer under which the transferor retains the right to current beneficial enjoyment for some limited period of time, such as his life, is treated as a transfer of a future interest which may be subjected to a gift tax.If the transferor still has the right to the current beneficial enjoyment when he dies, the full value of the property in which the retained interest existed is includible in his gross estate for estate tax purposes (§ 2036), with a credit against the estate tax for the gift tax previously assessed (§ 2012).

The unified transfer tax would simplify existing law by providing that a tax would be imposed only once, when the current beneficial enjoyment terminates. Thus, a transfer under which the transferor retains or grants to his spouse the current beneficial enjoyment is treated as an excluded transfer. An included transfer would occur when the retained current beneficial enjoyment terminated by death, lapse of time, transfer, or the occurrence of some contingency. For example, if A transfers certain property to A for life, remainder to B, the transfer would be an excluded transfer since A has retained beneficial enjoyment. When A dies there is an included transfer from A to B, the property being valued as of A's death (or alternate valuation date). (Similarly, if the transfer were from A to A's spouse for her life, then to B, there would be no tax upon the spouse's taking beneficial enjoyment, but when she died there would be an included transfer from the spouse to B.) However, if A's life estate is sold dur-

ing his lifetime, an included transfer of the remainder interest(s) would occur on the date of sale of the life estate. If A's retained life estate were conveyed as a gift instead of being sold, there would be an included transfer of the entire value of the property on the date of the gift of the life estate.

The transferor would be treated as having retained current beneficial enjoyment of the transferred property if he is entitled to whatever income the property produces (but there need be no obligation to produce income) and if the right to physical beneficial enjoyment of the transferred property is not given to someone else.

Where the transferor retains the beneficial enjoyment in only a portion of the transferred property, then only the determinable portion in which the enjoyment is retained would be an excluded transfer. The portion of the transferred property in which current beneficial enjoyment has been retained may be specified in terms of some designated fractional share of the income, or in terms of some specified annual sum. The rules for determining the amount to be excluded in such cases are the same as the rules under the marital exclusion provisions for valuing partial interests. (If the retained interest of the transferor is only limited by some nonmonetary standard, such as the right to use the income for his maintenance and support, the transfer would be an included one.)

If the remainder interest following the retained current beneficial enjoyment is an indefeasibly vested one, the remainderman conceivably might dispose of the same for a consideration and come into spendable cash without any tax having been paid. This, however, does not appear to open the door to any serious tax avoidance because of the unlikelihood that the remainderman can find a purchaser for his interest, since such interest is reachable by the Government to pay any tax due when the retained current beneficial interest ceases. The remainderman makes an included transfer of an indefeasibly vested remainder interest at his death if the retained current beneficial interest is then still outstanding in the transferor.

The transferor may at his option pay the transfer tax on the basis of the entire current value of the property by electing to have the transfer, which would be treated as an excluded transfer by reason of the retention of current beneficial enjoyment, be treated as an included transfer.

If at the time a transfer is made with current beneficial enjoyment retained a State or foreign gift tax must be paid out of the transferred property, a transfer tax will not be payable on the amount of such gift tax.

*3. Transfers with reversionary interest retained*

The treatment of transfers with a reversionary interest retained will depend upon whether or not the reversionary interest is certain to become possessory. If it is not certain to become possessory (e.g., A gives to B for life, then to A for life, remainder to C and his heirs) then the full value of the property transferred will be taxed as an included transfer. If the reversionary interest is certain to become possessory (e.g., A gives to B for 10 years, remainder to A and his heirs, then only the interests which precede the retained reversionary inter-

ests will be treated as included transfers. The reversionary interest and all interests which follow it will be excluded transfers at the time of the initial conveyance. A transfer tax is imposed upon the interests which follow the reversionary interest when the reversionary interest is transferred, or if it has become possessory in the original transferor, when the current beneficial enjoyment in the original transferor ceases.

This represents a change from present law. Under present law a lifetime transfer with reversionary interest retained results in a gift tax upon the date-of-gift value less the value (if determinable) of the reversionary interest. If, at the time of the donor's death, the value of the reversionary interest exceeds 5 percent of the value of the property and beneficial enjoyment of the property is conditioned upon survival of the decedent, the entire value of the property at death is included in the decedent's gross estate, with a credit allowed for the gift tax previously paid.

It may be argued that the value of a defeasible reversionary interest should be excluded from the taxable transfer, as under present law. However, such interests are difficult to value. Furthermore, if the transfer of the reversionary interest is excluded, an additional tax on the transferor would have to be imposed as and when it turns out that the defeasible interest will not become possessory, since otherwise it would be possible to make a transfer of what turned out to be the complete interest in the property transferred without the full value of the property being subjected to transfer tax.

Since the value of a transfer is not reduced by the value of a retained defeasible future interest, a subsequent transfer by the transferor of his retained interest before it has become a present interest is an excluded one. However, if a reversion is acquired from someone else and then transferred, the transfer is an included one. If the transferor retains a defeasible reversionary interest and the reversion in fact takes place, the transferor is thereafter regarded as owning what reverted to him. Thus, any further transfer of the interest received upon the reversion may be subject to transfer tax—without any credit for tax previously paid on the original transfer.

*4. Transfers with power of appointment retained*

Such transfers would be treated in a manner comparable to the proposed treatment of transfers with reversionary interest retained. Thus, a transfer with power of appointment retained will be a completed gift (i.e., an included transfer) except to the extent that the transferor will be certain to be treated as the owner of the transferred property (under the rules described hereinabove) when the power is exercised, released, allowed to lapse, or terminated. Many lifetime transfers that are not completed ones under present law would be completed ones under this proposal. For example, under present law a transfer under which the transferor retains the power to designate who may enjoy the benefits of the transfer, even though he cannot benefit himself by any exercise of the power, is not a completed gift for Federal gift-tax purposes. This change can be made under a unified tax system because regarding lifetime transfers as completed ones does not permit any significant tax avoidance. The change eliminates the present law complexity as to powerholders, which turns the significance

of certain powers upon whether they are held by the creator of the power or by one other than such creator.

*5. Transfers to acquire future interests previously transferred*

In cases where a transfer tax is "deferred" because the transferor has retained either current beneficial enjoyment, an indefeasibly vested reversionary interest or a power of appointment, an opportunity for tax avoidance exists if the transferor is permitted to deplete his assets tax-free by repurchasing from his transferee a future interest which was previously transferred without tax then being imposed. For example, assume A transfers Blackacre to B for 10 years, then to A for 10 years, then to C for 10 years, remainder to D and his heirs. Since A has an indefeasibly vested reversionary interest, only the 10-year intervening interest in B would be an included transfer. During B's 10-year term, A repurchases from C, C's 10-year term for cash. Thus, A has managed to deplete his estate by the amount of cash paid to "reacquire" an interest previously transferred tax-free. This potential avoidance would be prevented by a special rule treating as included transfers amounts paid by the creator to reacquire future interests which were treated as excluded transfers at the time such interests were created.

## DISCLAIMERS

Rules governing disclaimers of transferred interests will be more specifically detailed than in existing law. A transferee will be entitled to disclaim all or part of an interest within 15 months after the transfer, or within 6 months after he learns of the transfer, whichever period ends later, if he has not knowingly accepted any benefits from or exercised control over the property. No tax will be incurred as the result of a disclaimer satisfying these tests. The property interest will be treated as having passed from the original transferor to the person taking by virtue of the disclaimer, which person may be named by the transferor or by local law, in the absence of direction by the transferor. The disclaiming party, in the absence of a controlling provision in the governing instrument, will be permitted to disclaim in favor of a person to whom the original transferor could have made an excluded transfer; i.e., the surviving spouse or an orphan of the original transferor, or a qualified charitable organization. In such cases the property interest will be treated as having passed from the original transferor to the person taking by virtue of the disclaimer.

A disclaimer may be made by a transferee's legal representative.

## EFFECTIVE DATE AND TRANSITION RULES

The rules of the unified transfer tax will become effective on January 1, 1970. Each individual will be entitled to a $60,000 lifetime exclusion which may be applied against any transfers made after December 31, 1969, regardless of his age or the total lifetime gifts made under present law prior to that date.

For purposes of determining the rate bracket applicable to transfers after December 31, 1969, all included transfers after December 31, 1968, will be counted as transfers for purposes of the new unified tax even though such transfers will be taxed under the rules of present law.

# VIII–C. GENERATION-SKIPPING TRANSFERS

## General Explanation

### BACKGROUND

Normally, a family's accumulated wealth is passed from parent to child and is subject to a transfer tax at each generation. This represents an orderly and equitable application of a transfer tax system. However, under present law it is possible to escape this progressive aspect of the transfer tax system by transferring property in a way so that it can be obtained by the transferor's grandchildren or great-grandchildren without a transfer tax being paid by the intervening generation or generations. This does not involve any reduction of tax at the time of the original transfer; but having paid this tax, the transferor can transfer the property in such a way as to avoid future taxes.

This result can be accomplished by outright gifts. For example, an outright gift to a grandchild enables the family to completely skip a transfer tax at the generation represented by the son or daughter of the transferor.

Moreover, by use of highly complex devices generally in the form of trusts, a transfer tax can be avoided even where the skipped generation has substantial enjoyment of the property and, in some cases, virtual control over it. Thus, for example, an individual can transfer property in trust with the income therefrom payable to his son for life, with provision for the distribution of part of the corpus to the son in the event of need, and with the remainder payable to a grandchild on the son's death. There is no transfer tax on the son in this situation. In fact, even the disposition of the remainder interest may be left to the discretion of the son [1] without the imposition of the transfer tax on him.

Although these devices for avoiding one or more steps in the transfer tax system are theoretically available to all, only the wealthy really have the necessary flexibility to take advantage of them. This fact is borne out by the evidence bearing on generation-skipping transfers summarized in table 1.[2] For the 2 years covered by the data, decedents whose gross estates were under $300,000 made 9.4 percent of the amount of their noncharitable transfers in a generation-skipping form. On the other hand, among the wealthiest decedents, those with gross estates of $1 million or more, 25.4 percent of the amount of noncharitable transfers were generation skipping, 6.6 percent outright, 18.8 percent in trust. The concentration of generation-skipping transfers in the high-income classes, particularly in trust, can be further illustrated by this comparison: Among husbands with estates below $500,000 who established family trusts on their death, 77 percent set up trusts which involved no generation skipping; but among husbands with estates over $2 million who established family trusts, only 25 per-

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[1] However, to avoid a transfer tax on the son, the son must be prohibited from directing the disposition of the property to his estate, his creditors, or the creditors of his estate.

[2] Extensive analyses of transfers during life and at death made by decedents for whom an estate tax return was filed either in 1957 or in 1959 have been completed by Prof. Carl Shoup and others in studies published by the Brookings Institution as well as by the Treasury. Summary analysis of the data has been published in "Federal Estate and Gift Taxes," by Prof. Carl Shoup, and in "Trusts and Estate Taxation," by Dr. Gerald Jantscher.

cent set up trusts which involved no generation skipping, and 60 percent made their trust bequests entirely in generation skipping form.

TABLE 1.—PROPORTION OF TOTAL NONCHARITABLE TRANSFERS SKIPPING A GENERATION, BY ESTATE SIZE AND TYPE OF DISPOSITION

[Dollar amounts in millions]

| Gross estate size (in thousands of dollars) | Gross transfers [1] (1) | Transfer tax (2) | Noncharitable transfers (1–2) | Generation skipping transfers [2] | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Total | | Not in trust | | In trust | |
| | | | | Amount | Percent of noncharitable transfers | Amount | Percent of noncharitable transfers | Amount | Percent of noncharitable transfers |
| Under 300 | $4,574 | $219 | $4,355 | $410 | 9.4 | $158 | 3.6 | $252 | 5.8 |
| 300 to 1,000 | 3,649 | 470 | 3,179 | 533 | 16.7 | 157 | 4.9 | 376 | 11.8 |
| 1,000 and over | 4,502 | 1,089 | 3,413 | 868 | 25.4 | 225 | 6.6 | 643 | 18.8 |

[1] Total value of noncharitable transfers made during life and at death plus the amount of transfer taxes paid.

[2] A special study prepared by IRS identified remaindermen of trusts as children, grandchildren, great grandchildren, other relatives and nonrelatives (as well as additional categories not here relevant such as charity, brothers and sisters, etc.). Thus, the bequests to lineals could be clearly distinguished between generation skipping and others. For other relatives and nonrelatives it was necessary to look to dispositions to lineals to estimate the likely portion of bequests to other relatives and nonrelatives that were generation skipping. With regard to direct bequests to lineals the portion that was generation skipping was 5 percent below $300,000, 10 percent from $300,000 to $1,000,000, and 15 percent above $1,000,000. For trust remaindermen the portion generation skipping among lineals was 33 percent below $300,000, 50 percent from $300,000 to $1,000,000, and 75 percent above $1,000,000.

Source: IRS, Special Tabulation on Estate and Gift Tax Returns, 1957–59.

The ability to skip generations causes an inequitable distribution of the transfer tax in that some families are required to pay a transfer tax at each generation as the family wealth moves from generation to generation in the normal fashion, while other families avoid the tax at some generations. This situation unfairly discriminates against those persons of relatively modest wealth who cannot avail themselves of the opportunity to skip a tax, as well as against all persons regardless of wealth who for personal family reasons do not desire to make use of these generation-skipping arrangements despite the tax savings. It leads to all individuals, in determining how to distribute their wealth and care for their survivors, having to choose between personal and family considerations, on the one hand, and tax savings on the other. A fair tax system would not demand this choice.

## PROPOSAL

The basic objective of the proposal is to obtain a transfer tax with respect to each generation regardless of whether that generation receives the property or is skipped in favor of a succeeding generation. Thus, a substitute tax would be imposed if property is transferred, by gift or bequest, so that it will be received by the transferor's grandchild, or any other person who is more than one degree in family relationship below the transferor, without the payment of a transfer tax by the intervening generation under the normal procedure. In the case of a transfer to a person unrelated to the transferor, the transferee would be considered more than one degree below the transferor if he is more than 25 years younger than the transferor. The substitute tax would apply whether the transfer is in the form of an outright gift or through a trust.

(1) *Tax liability may be elected by intervening generation.*—In a generation-skipping situation, the alternative would be open for the family to treat the transaction as though it followed the normal pattern; that is, the property was first transferred to the skipped generation and then retransferred by him to the next generation. The transfer tax payable on the constructive retransfer would constitute the substitute tax.

More specifically, if an individual bequeaths property, for example, to a grandchild, who is a child of a living son or daughter, the son or daughter could elect to treat the transaction for transfer tax purposes as though the property were actually transferred to him by the original transferor and then retransferred by him to his child. The constructive retransfer would be the taxable event and would be treated like any other transfer by the individual making the election. Thus, the normal rules as to when the return and the tax are due would apply. The election would be made on the electing individual's transfer tax return. The actual transferor could, of course, provide the electing individual with the funds needed to pay the tax.

Setting a date as of which the retransfer is considered to have occurred is, of course, an essential ingredient in applying the election procedure since it triggers the transfer tax and the various dates by which action must be taken. In the case of an outright gift or bequest, the intervening generation will be considered to have received and retransferred the property on the day that the original transferor made the transfer. Thus, if an individual makes an outright gift of $10,000 to a grandchild on July 1, 1970, the grandchild's father or mother could elect to treat the transaction as though the $10,000 were first given to the father or mother on July 1, 1970, and on the same day retransferred by him to his child. If the father or mother made this election, he would reflect on his transfer tax return for 1970 a transfer of $10,000 and would compute and pay the tax just as though he actually made the transfer.

As to gifts in trust, it is often impossible to tell, at the time the trust is created, to what extent there will be distributions which will involve skipping a generation. For example, if an individual establishes a trust which provides that the income and, to the extent necessary, the corpus is to go to his son, with any amount remaining at the son's death to go to the son's children, it will not be certain until the son's death as to whether any amount will actually go to the transferor's grandchildren, thereby skipping a generation. Thus, in a trust situation, the intervening generation (in this case, the son) would not be required to make his election to be treated as an intervening transferor at the time the trust is created. Instead, he would be given an election, at the time the trust is established or as of the first day of any subsequent calendar quarter up until the date of his death, to treat the property then in the trust as if it were distributed to him and then retransferred to the trust. If the son makes this election, he would be considered the transferor; that is, the creator of the trust, for purposes of determining whether future distributions involve generation skipping. For example, if instead of naming his grandchildren as recipients of the remainder interest in the trust, the transferor had named his great grandchildren, then even though the son

elected to pay a transfer tax, there still would exist a skipped generation in the person of the transferor's grandchildren. They in turn would be eligible to elect to treat the property as flowing through them to their children.[3]

In sum, one alternative open to a family in meeting the proposed requirement that a substitute tax be imposed on a generation-skipping gift or bequest of property to compensate for the avoided transfer tax is for the skipped generation to elect to be treated as within the chain of distribution of the property. This alternative will produce a tax treatment comparable to that under the normal transfer pattern of from father to son.

However, it does not seem practical to impose this type of a tax on a mandatory basis since to do so would, in effect, result in the tax treatment of the intervening generation being controlled by the actions of the transferor, whose interests may be entirely different. For example, not only would the intervening generation be subject to a tax on the basis of a transfer over which he may have had no control, but also each succeeding transfer he makes may be taxed at a higher rate because of the progressive and cumulative nature of the transfer tax structure. Therefore, the alternative of having the intervening generation pay the substitute tax would be at the election of this individual.

(2) *Substitute tax when no election is made.*—In the event of a generation-skipping transfer where there is no election by the intervening generation to assume the tax liability (either because the eligible individuals did not choose to so elect or because those who would have been eligible are deceased), the substitute tax would be imposed on the transferor, or his representative where appropriate. As a general rule, the substitute tax would be measured by reference to the transferor's transfer tax rate bracket instead of that of the intervening generation and would be imposed in addition to the normal transfer tax on the transfer involved. However, to reflect the fact that the transfer tax bracket of the intervening generation, the transferor's children, may be less than the tax bracket of the transferor, the substitute tax would be determined by taxing the amount transferred at 60 percent of the marginal transfer tax rate applicable to the transferor after taking into account all his transfers, both during life and at death.

As indicated above, this method of calculating the substitute tax is intended to roughly approximate the tax that would have been paid by the skipped generation. This imprecision is necessary for simplicity. If the result is thought unfair in a particular case, the election is open to obtain precision by having the skipped generation pay the tax as though he received and then retransferred the property. Further, in a case where there are no living members of the intervening or skipped generation who may elect to pay the substitute tax, the tax, though payable by the transferor or his representa-

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[3] In general, therefore, a tax would be payable each generation. This would not be true in all cases, however. Outright gifts to great grandchildren would trigger only one substitute tax as would trust distributions to such persons during the life of the transferor and his children. While the proposal could be amended to require a tax each generation, it seems that the possibilities of avoidance are not serious enough to require this complication.

tive, may be determined on the basis of the intervening generation's marginal transfer tax rate bracket.

In the case of an outright gift or bequest, the substitute tax would be payable by the transferor or his executor on the transfer tax return relating to the transfer itself.

When the generation-skipping gift or bequest is by trust, there would be generally the same options as to when the tax must be paid as would be available to the skipped generation had he elected to pay the tax. Thus, the transferor or his representative (*i.e.*, executor or trustee) [4] may elect to treat the taxable event as occurring at the time of the original transfer or as of the first day of any calendar quarter thereafter. In no event, however, may the tax be postponed beyond the date of the death of the last survivor among the group consisting of the transferor, his children, and any beneficiaries under the trust who are not within the category of individuals to whom a gift would be considered a generation-skipping gift. At this time, it becomes certain that there is a generation-skipping transfer involved and no reason to further defer the tax.

The substitute tax would be computed on the value of the trust corpus as of the effective date of the election or the date of the taxable event. Thus, if an individual put $10,000 in trust, with the income payable to his son and the remainder to his grandchildren, and elected to pay the tax at the time he established the trust, he would be subject to a substitute tax on a transfer of $10,000. If, however, no election to pay the tax was made prior to the death of the transferor and his son, then at that time, a tax would be due computed upon the value of the trust corpus at that time. Since the transferor would be deceased at this time, the substitute tax in this case would be paid by the trustee out of the trust property. Any trust distributions prior to this time which skip a generation would also be subject to the substitute tax as applied to the amount of the distribution.

Once the substitute tax has been paid on the value of trust property, the substitute tax would be further applied as if the intervening generation was the transferor. Thus distributions to persons two degrees below the original transferor would not involve an additional substitute tax, but distributions to persons three or more degrees below (*e.g.*, great-grandchildren) would be subject to a second substitute tax.

### EFFECT OF PROPOSAL

The proposal would achieve more equitable distribution of the transfer tax and would eliminate the tax differences now inherent in alternate methods of distribution of property. The proposal is not intended to imply that long-term trusts or other generation-skipping arrangements are unnatural or wrong from the standpoint of dispositions of family wealth. It merely suggests that those who use such arrangements should bear their fair share of the tax burden as compared with those who do not use such arrangements. The estate tax—and the possibility of its avoidance—should not be a factor which forces family dispositions in one direction rather than another.

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[4] To avoid the possibility of having to choose between the conflicting interests of income beneficiaries and remaindermen, an executor or trustee could so elect only if directed to do so by the transferor.

EFFECTIVE DATE

The generation-skipping proposal, like the unified transfer tax, would apply to transfers on or after January 1, 1970. However, safeguards would be provided against avoidance by generation-skipping transfers while the legislation is being considered. Thus, the substitute tax would also be applicable to distributions on or after January 1, 1970, from *inter vivos* trusts created on or after January 1, 1969.

## VIII–C. GENERATION-SKIPPING TRANSFERS

### Technical Explanation

In order to obtain a transfer tax with respect to each generation a substitute tax would be imposed to compensate for the regular transfer tax that is avoided on generation-skipping transfers.

#### 1. WHAT IS A GENERATION-SKIPPING TRANSFER

Any transfer of property (either by gift or bequest) to a person (or his spouse) more than one degree in family relationship below the transferor would be considered a generation-skipping transfer subject to a substitute tax to compensate for the fact that the normal transfer tax is avoided by the intervening generation. Thus a transfer to a grandchild, a grandnephew or a more distant relative of the same degree would be a generation-skipping transfer. In the case of a nonrelative, a generation-skipping transfer would be deemed to occur if the donee were more than 25 years younger than the transferor. The substitute tax would apply whether the transfer is in the form of an outright gift or through a trust.

#### 2. ELECTION BY SKIPPED GENERATION TO PAY TAX

The objective of this proposal is to compensate for the tax that is avoided when property is passed from the transferor to an individual who is more than one generation removed from the transferor so that tax is skipped in one or more generations. For example, if an individual leaves property in trust with income to his children for life, and the remainder to his grandchildren, the grandchildren would obtain the property without a transfer tax being paid by the transferor's children.

Thus an election would be provided when property is transferred to an individual more than one degree below the transferor, who has a living mother or father who is not more than one degree below the transferor. The mother or father (for example, the son of the transferor) may elect to be taxed as if the property were first transferred to him and then retransferred by him to the ultimate transferee. If the election is made, no additional tax would be imposed under the proposal.

In all cases this would be treated the same as an actual transfer by the electing parent in measuring the amount of his tax and the effect on the tax payable on future transfers. If the transferor pays the tax due from the electing parent the amount of the constructive gift from

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the transferor to the electing parent would be increased by the amount of tax paid on the latter's behalf by the transferor.

For example if an individual makes a gift of $10,000 to his grandchild, the transferee's father, the transferor's son, may elect to treat the $10,000 as if it were first transferred to him and then retransferred to his son on the day the gift was made. The individual making the election would report a gift of $10,000 on his transfer tax return in the same manner as if it were an actual gift.

The original transferor would also pay the normal transfer tax on a $10,000 transfer to his son. However, if the son's transfer tax liability on the constructive transfer to the grandchild is paid by the original transferor, the amount of his gift to his son would be increased by the amount of this tax. For example if the son's tax liability were $2,000, the total amount of the gift to the son would be $12,000.

An election would be made on a transfer tax return for the period for which the election is applicable as though a transfer actually took place during such period. The election must be made on or before the due date of such return unless the transfer was on death in which case the election could be made until the due date of the return to be filed by the transferor's executor. If the parent of the transferee dies before the return on which the election is to be made is filed, this election could be made by his executor.

In the case of an outright gift or bequest, the intervening generation will be considered to have received and retransferred the property on the day that the original transferor made the transfer.

A transfer in trust would not be considered a generation-skipping transfer on a nonelective basis until the death of the last survivor of the group consisting of the transferor, all of his children, and any beneficiaries of the trust who can receive a distribution which would not be a generation-skipping distribution.

Accordingly the intervening parent could elect to be treated as the transferor with respect to trust property at the time the trust is established or as of the first day of any subsequent calendar quarter up until the time of his death. The amount of the property in the trust at the time of the election would be considered for the purpose of computing the transfer tax, to have been distributed to the intervening generation and then retransferred by him to the trust. An election with respect to a trust corpus would be allowed only as to such portion of the trust property as is vested (both as to income and principal) in the electing person and his descendants. However, the possibility of a contingent remainderman will not preclude an election.

Following such election, the electing parent would be treated as the donor of the trust property for purpose of determining whether future distributions are generation-skipping. For example, assume an individual transferred $25,000 in trust with the income payable to his son for life, then to his grandson for life and on his grandson's death the remainder is to be transferred to his grandson's issue. The son may elect to treat the $25,000 as a gift to him and a retransfer to the trust at the time the trust is created. He may make a similar election as of the beginning of any subsequent calendar quarter but

if the value of the corpus had increased to $30,000 at the time of the election, the son's gift would be $30,000. If the son makes an election, distributions to the grandson would not involve generation-skipping because the son would be considered the transferor of the trust. Distributions to the grandson's issue, however, would involve generation-skipping unless the grandson made a similar election.

If no election were made by the son, distributions to the grandson would be subject to the substitute tax. If, however, the trust provided for such distributions during the son's life, the son could elect to treat the distribution when it is made as if it had been made to him and then retransferred to his son (the transferor's grandson) on the day of the distribution. For transfer tax purposes this would have the same effect as an actual gift by the son.

### 3. SUBSTITUTE TAX IN ABSENCE OF AN ELECTION BY TRANSFEREE'S PARENT

If the intervening parent does not elect to assume the tax liability the substitute tax would be imposed at 60 percent of the transferor's marginal rate or if both parents of the transferee are deceased, and the person liable for the tax so elects, at the marginal rate applicable to property transferred at the death of the last parent to die.

In the case of an outright gift the substitute tax would be shown on the same return and be payable by the transferor or his executor at the same time as the basic transfer tax.

In the case of a bequest the executor in addition to the regular transfer tax would pay the substitute tax at 60 percent of the transferor's marginal rate on the total amount of generation-skipping transfers grossed up for the substitute tax. For example, if an individual whose marginal transfer tax rate at death is 40 percent made an outright bequest of $15,200 to his grandchild, the executor in addition to the regular transfer tax would pay a substitute tax at a 24-percent rate (60 percent × 40 percent = 24 percent) of $4,800 ($20,000 − $4,800 (24 percent × $20,000) = $15,200).

If a transfer subject to the substitute tax occurs during the transferor's lifetime, the substitute tax would be imposed by requiring the transferor to increase the amount of his taxable gifts for the current period by an amount equal to 60 percent of the amount of the transfer subject to the substitute tax (grossed up at 60 percent of the transferor's current marginal rate). For example, if an individual in the 50 percent transfer tax bracket makes a net gift subject to the substitute tax of $50,000 he would compute a transfer tax on the basis of a net taxable gift of $92,857.14 computed as follows:

| | |
|---|---|
| Net gift | $50,000.00 |
| 60 percent of net gift | (30,000.00) |
| Gross up for generation—skipping tax at 60 percent of current marginal rate or 30 percent (60 percent × 50 percent) [1] | 42,857.14 |
| Taxable transfer | 92,857.14 |

[1] $42,857.14 − $12,857.14 (30 percent × $42,857.14) = $30,000.

The resultant tax would meet both his regular transfer and substitute tax liability.

If the generation-skipped gift or bequest is by trust, there would be generally the same options available to the transferor or his representa-

tive [2] as to when the tax must be paid as would be available to the skipped generation had he elected to pay the tax. However, the tax could not be postponed beyond the date of death of the last survivor among the group consisting of the transferor, his children and any other trust beneficiaries who are not more than one degree below the transferor.

Trust distributions which skip a generation would also trigger a substitute tax. Thus, if an individual created a trust for a period of 20 years with the income payable to any of his children or grandchildren, as the trustee may direct, a tax on the value of the trust property could be postponed while the transferor or his children are alive. However, a distribution to a grandchild would trigger the substitute tax.

Whether a trust distribution is a generation-skipping distribution depends upon whether or not a substitute tax has been paid. Thus, once the tax has been paid, the category of people to whom distributions would not be generation skipping would be expanded. As stated above, if the intervening generation elects to pay tax as if the property were transferred to him and then retransferred to the trust, the determination of what is a generation-skipping distribution would be made on the same basis as if there had been an actual transfer by the person making the election. If a substitute tax were paid distributions to relatives not more than two degrees below the transferor and to unrelated persons not more than 50 years younger than the transferor would not be generation-skipping distributions.

While the transferor is alive, an election, following the year of the original transfer, to pay tax on the value of trust property, which could be effective as of the beginning of any calendar quarter, or a generation-skipping distribution from a trust would result in the inclusion on his return of an amount equal to 60 percent of the amount of the generation-skipping transfer (grossed up), the regular transfer tax having been paid in connection with his earlier return.

In case of distributions from either an inter vivos or testamentary trust after the transferor's death or a tax at such time on the value of trust corpus the liability for the substitute tax would be imposed on the trustee. An election to pay tax on the value of trust corpus after the donor's death could be made by the trustee only if directed by the transferor. If an election is made or if the tax is due on a distribution or otherwise it would be paid by the trustee at 60 percent of the donor's marginal rate. The tax would apply to the gross amount of the distribution or corpus without any reduction for the tax. Therefore, if a trustee is instructed to distribute a particular amount net of tax, it will be necessary to gross up the amount for purposes of computing the substitute tax. For example, assume a trust distribution of $7,000 (after tax) and an applicable tax rate of 30 percent. The substitute tax payable would be $3,000 since $3,000 withheld out of $10,000 would produce a net distribution of $7,000 as directed.[3]

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[2] The executor could not elect to pay tax on the value of a trust bequest, which is not due on a nonelective basis, unless directed to do so by the transferor.

[3] For the purpose of income taxation of the trust and its beneficiaries, this would be treated as a $7,000 distribution.

4. EXAMPLES

The following examples illustrate the application of the generation-skipping tax. For convenience the transferor is referred to as GF (grandfather) the transferee as GC (grandchild) and the intevening generation, GC's parent and GF's child, as C (child).

*Example 1.*—GF makes a net after tax bequest of $50,000 to GC. GF's top bracket on the transfer tax return filed at his death is 40 percent.

*Substitute tax*

The substitute generation-skipping tax would be applied at 60 percent of GF's marginal transfer tax rate, or 24 percent (60 percent times 40 percent), to the gross before tax bequest. The substitute tax would thus be $15,789.47 out of a total bequest of $65,789.47 ($65,789.47 minus $15,789.47 (24 percent times $65,789.47) equals $50,000). The tax would be payable by the executor.

*Election by C*

If either of the grandchild's parents (C) were alive, at the time the transfer is made, C could elect to treat the $50,000 as a bequest to him and an immediate retransfer by him to GC. In such case, in view of the elective tax that is paid no substitute tax would be payable. C can make this election by filing a transfer tax return on or before the due date of the transfer tax return due on GF's death. Assuming C so elects and at that time is in a 20 percent transfer tax bracket, the tax would be $12,500 to produce a net gift of $50,000 ($62,500 minus $12,500 (20 percent times $62,500) equals $50,000). This could be paid out of C's own funds or, if provision is made therefor by GF, out of GF's estate. Whether or not C paid the tax, he would be treated as if he made a gift of $62,500 for the purpose of computing his tax on his future transfers.

*C is deceased*

If both parents of GC were deceased at the time of the transfer, GF's executor would have the option to pay the substitute tax at the marginal transfer tax rate attained by the last parent (C) to die. If C's top rate were 20 percent, the tax payable to make a net bequest to GC of $50,000 would be $12,500. The option would be exercised by GF's executor because the substitute tax otherwise due is $15,789.47.

*Example 2.*—Assume the same facts as in example 1 except that GF makes a net lifetime transfer of $50,000 to GC a at time when he is in the 40 percent transfer tax bracket.

*Substitute tax.*—In this situation the substitute tax is in effect merged with the regular transfer tax. GF's total transfer tax (including the substitute tax element) is computed by increasing the net gift by 60 percent of the actual amount ($30,000) grossed-up for the substitute tax at 60 percent of GF's marginal rate or 24 percent ($9,-

473.68)[4]. Thus, GF's gift of $50,000 would be increased by $39,473.68 to $89,473.68, and GF's transfer tax would be computed as follows:

| | |
|---|---|
| Total gift | $89,473.68 |
| Total transfer after gross-up for 40 percent tax | 149,122.80 |
| Tax at 40 percent | 59,649.12 |

This would be a regular transfer tax of $43,859.65 (40 percent multiplied by the amount of property transferred—($50,000 gift plus $59,649.12 tax) and an immediate generation-skipping tax of $15,789.47 (40 percent times $39,473.68).

The amount of the generation-skipping gift after gross-up for the substitute tax is $65,789.47 ($65,789.47 minus $15,789.47 (24 percent times $65,789.47) equals $50,000). The substitute tax payable currently is equal to 60 percent of the current marginal rate (24 percent) multiplied by the total amount of the gift but it is expressed as the marginal rate (40 percent) multiplied by 60 percent of the gift ($39,473.68 *i.e.* 60 percent times $65,789.47).

For purposes of determining the transfer tax rate to be applied to the remaining gifts and bequests made by GF, the present transaction would be considered to consist of a transfer of $149,122.80, although the actual transfer was $109,649.12. Thus, all future transfers would be taxed at a point $39,473.68 further along the rate scale than they would be if only actual transfers were considered. Therefore, in the end, the total additional amount paid by reason of the substitute tax will equal the top attained rate multiplied by 60 percent of the amount of transfers subject to the substitute tax (grossed-up by 60 percent of the marginal rate at the time of the gift). This approximates 60 percent of the marginal rate multiplied by total transfers.

*Election by C*

Either of GC's parents (C), could elect to treat the $50,000 as a gift by C to GC following a gift from GF to C. If the tax on the constructive transfer by C to GC is paid by C, the transfer by GF to C is $50,000 and the total tax on the transfer assuming C is in the 30 percent bracket is $54,761.90 computed as follows:

| | | |
|---|---|---|
| Grossed-up gift by GF to C | $83,333.33 | |
| Tax at 40 percent | 33,333.33 | $33,333.33 |
| Net transfer to C | 50,000.00 | |
| Grossed-up gift by C to GC | 71,428.57 | |
| Tax at 30 percent | 21,428.57 | 21,428.57 |
| Net transfer | 50,000.00 | |
| Total tax | | 54,761.90 |

If GF arranges to pay C's tax, GF's gift to C is $71,428.57 ($50,000 gift to GC plus $21,428.57, C's tax) and the total tax would be $69,047.62 determined as follows:

[4] $39,473.68—$9,473.68 (24 percent × $39,473.68) = $30,000.

| | | |
|---|---|---|
| Grossed-up gift by GF | $119,047.62 | |
| GF's tax at 40 percent | 47,619.05 | $47,619.05 |
| Gift from GF to C | 71,428.57 | |
| C's tax at 30 percent | 21,428.57 | 21,428.57 |
| Net transfer to GC | 50,000.00 | |
| Total tax | | 69,047.62 |

*Election if C is deceased*

If both of GF's parents (C) are deceased at the time the transfer is made, GF could elect to compute the substitute tax on the basis of a constructive transfer to C in lieu of the method illustrated above. If C's marginal rate were 30 percent, GF's total tax burden would be $69,047.62 as determined above. In contrast to the method described above, for purposes of determining the transfer tax rate to be applied to the remaining gifts and bequests made by GF the present transaction would be considered to consist of a transfer of $119,047.62 rather than $149,122.80. Thus, although the $69,047.62 is more than the tax payable on the alternative method earlier described, an estimate would have to be made of future transfers to be made by GF to determine whether it was preferable to choose this means of computing the tax. In other words the substitute tax payable currently at 24 percent is less than the tax at C's marginal rate of 30 percent, but if GF's marginal rate were to exceed 50 percent, the ultimate substitute tax would exceed the tax based on C's rate.

*Example 3.*—GF creates a 10-year *inter vivos* trust with income payable to his grandchild (GC) and the principal to be distributed to GC, at the end of the 10-year period. There is no election by GF to pay tax on the creation of the trust and there is no election by GC's parent (C) to pay tax as if there were a transfer by him. An income distribution is made to GC in the amount of $2,000 when GF is alive and in the 40 percent bracket.

*Substitute tax*

GF is liable for a transfer tax at 60 percent of his marginal rate or 24 percent. The tax on a net gift of $2,000 would be $631.58 ($2,631.58 −$631.58 (24 percent × $2,631.58)=$2,000). If GF had so provided in the governing instrument this amount, $631.58, could be paid out of trust assets. GF would show a transfer on his return of 60 percent of the total gift, $1,578.95 (60 percent × $2,631.58). This would produce an immediate tax liability of $631.58 (40 percent × $1,578.95), paid out of the trust, and an eventual substitute tax of GF's final marginal rate × $1,578.95.

If GF paid the tax himself, his total liability would be $1,052.63 and he would be considered to have made a gross transfer of $2,631.58 leaving a net transfer of $1,578.95.

If GF were deceased at the time of the distribution, the trustee would be liable for the tax and would withhold $480 (24 percent (60 percent of GF's marginal rate) × $2,000) from the distribution to GC who would receive $1,520. If the net distribution was to be $2,000, the tax would be $631.58 as computed above. If both of GC's parents were

deceased the trustee could elect to pay tax at the marginal rate of the last one to die and would do so if this rate were less than 24 percent.

*Election by C*

If C were alive, he could elect to be treated as if the $2,000 were transferred to him and retransferred. Assuming such an election and that C is in the 20-percent bracket, the tax would be $400 if paid out of the distribution (20 percent × $2,000) $500 if paid by C (20 percent × $2,500 equals $500, leaving a net distribution of $2,000) and $833.33 if paid by GF (GF in the 40 percent bracket pays a tax of $333.33 to transfer $500 to C to pay C's tax of $500).

*Example 4.*—GF, by will, creates a discretionary trust to pay the income, and under certain circumstances the corpus to any of his issue. The trust is to last until 21 years after the death of the last survivor within the group consisting of GF's children and grandchildren, living at his death. At that point, the trust corpus is to be distributed to GF's surviving issue per stirpes.

*Creation of trust*

No generation-skipping tax is payable at GF's death unless an election to pay is made. If GF so provides in his will, GF's executor could elect to pay a substitute tax on the value of the trust corps. This would be computed in the same manner as the tax on outright bequests. A tax could be paid by the trustee out of the trust corpus at 60 percent of GF's marginal rate if GF directs the trustee to elect to do so. If no election is made, distributions to GF's children would be free of the substitute tax but any distributions to GF's grandchildren or greatgrandchildren would be generation-skipping transfers subject to the substitute tax.

If an election is made to pay a substitute tax on the value of trust property, future distributions to GF's children or grandchildren would not be subject to a generation-skipping tax, but a second substitute tax would be imposed on any distribution to GF's great-grandchildren.

*Death of GF and C*

Under the assumed facts, the trust will not terminate upon the last to die of GF's children. Thus, if when this occurs no substitute tax has been paid, a tax would be payable based upon the value of the corpus as of the date of the death of the last surviving child of GF. The tax would be paid by the trustee at 60 percent of GF's marginal transfer tax rate. Thereafter, distributions to GF's grandchildren would be tax free, but distributions to great-grandchildren would continue to be taxable unless an election is made by the trustee (under directions provided in the trust instrument) to pay another tax on the full value of the corpus.

Similarly, upon the death of the last grandchild, if no such election had been made, a second substitute tax would be payable on the whole value of the corpus as the date of the death of the last surviving grandchild of GF. No tax would be payable on further distributions from the trust unless they are made to great-great-grandchildren of GF.

#### 5. EFFECTIVE DATE

The generation-skipping tax would become effective on January 1, 1970. However, for purposes of determining the rate bracket applicable to transfers after December 31, 1969, 60 percent of the amount of all generation-skipping transfers after December 31, 1968, would be counted as prior transfers even though such transfers will be taxed under the rules of present law and will not be subject to a substitute tax. Thus, if an individual on January 31, 1969, made a $50,000 gift to his child, he would be moved $50,000 up the rate scale in computing the rate on future transfers. If the gift were to his grandchild, he would be moved $80,000 up the scale.

The generation-skipping tax would not be applicable to distributions from inter vivos trusts created before January 1, 1969, or to trusts created by will of decedents dying before January 1, 1970.

## VIII–D–1. LIBERALIZATION OF PAYMENT RULES

### General Explanation

#### BACKGROUND

Estates which contain farms or closely held family businesses sometimes encounter difficulty in finding the cash needed to pay the Federal taxes which become due shortly after death. This problem can arise as a result of improper estate planning, rapid appreciation in the value of an asset, or reluctance to sell an asset for sentimental or business reasons. The inability to pay death taxes in a timely fashion is here referred to as the "liquidity problem."

Careful business and estate planning can help to eliminate the liquidity problem. Moreover, the Internal Revenue Code already provides installment payment privileges for use in situations in which an estate contains a farm or other closely held business. However, experience has shown that little use of these installment payment privileges is presently being made, partly because certain other provisions of the Internal Revenue Code create barriers to the use of these privileges. The following proposals include both general and specific relief for estates which encounter liquidity problems.

#### PROPOSALS

*General relief*

It is expected that the proposal to allow an unlimited marital deduction will substantially ease liquidity problems by postponing the death taxes which would otherwise be payable on assets transferred to a surviving spouse. This will give the surviving spouse more time to plan for the disposition of an illiquid asset at the best possible price or, alternatively, more time to accomplish business and estate planning to insure the availability of funds when death taxes eventually become due with respect to the asset. Moreover, the unlimited marital deduction will help to insure the security of a surviving widow, because it

will not usually be necessary to raise funds to pay taxes with respect to a family farm or business until after the death of the widow herself. It is expected that these benefits will be of special help in connection with estates of moderate size.

In addition, the proposal to decrease transfer tax rates will help to ease liquidity problems, by lowering the amount of tax due with respect to any given asset.

*Specific relief*

In addition to the proposals outlined above, which will generally assist all estates, specific proposals are included which are designed to ease liquidity problems in the case of estates containing farms and closely held businesses. Additional relief in these cases seems appropriate, because such estates tend to encounter more severe liquidity problems than do estates containing other types of assets. These specific proposals are:

Changes will be made in present rules to make it easier for estates containing farms or other closely held businesses to qualify for installment payment of death taxes over periods of up to 10 years. The installment payment privileges will be made available not only in the case of transfer taxes imposed at death but also in the case of income taxes imposed on appreciation in assets transferred at death.

Executors, and certain fiduciaries will be able to obtain a discharge from personal liability for taxes on illiquid assets, when the time for payment of those taxes has been extended, provided that the executor or fiduciary pays those taxes which are not subject to the extension and furnishes adequate security for payment of the remaining taxes. In general, subject to normal business safeguards, a security interest in the illiquid asset will constitute adequate security in such cases. Accordingly, the Government will not only permit deferral of taxes, but will bear part of the risk that the illiquid asset may decline in value during the deferral period.

Executors will be permitted to enter into security agreements, in lieu of bonds, when extensions of time for payment of taxes are requested. A modified bonding requirement would be retained for use in those situations in which the security agreement provisions are not utilized. In general, the security agreements permitted would resemble those authorized by State law under the Uniform Commercial Code.

More realistic rates of interest will be established for use in situations in which the time for the payment of death taxes has been extended. In general, the Secretary of the Treasury would be authorized to establish a rate of interest which approximates the market rate of interest at any given time. Consequently, use of the installment payment provisions will not entail an interest penalty or subsidy, and the rate of interest charged at any given time will more accurately reflect the charges which would be made if an estate were to borrow from a commercial institution to pay death taxes.

Additional time will be provided for making redemptions of closely held business stock at capital gains rates to pay death taxes attributable to the inclusion of that stock in the gross estate. At the same time, steps will be taken to insure this relief is made available only to the extent that funds are needed for the purpose of paying the taxes imposed at the time of death with respect to stock in a closely held business.

Postdeath accumulations of earnings for the purpose of making such redemptions will be permitted. This provision, taken together with the additional time provided for making postdeath redemptions, will permit death taxes to be paid in many cases out of the postdeath earnings of a closely held business. However, amounts accumulated in this fashion must actually be used within a reasonable period of time for making redemptions to pay death taxes.

It is expected that these specific relief provisions, taken together, should make it possible for the owners of any viable farming operation or closely held business to generate the resources needed to pay the transfer and capital gains taxes which become due at the time of death with respect to such assets.

## VIII–D–1. LIBERALIZATION OF PAYMENT RULES

### Technical Explanation

#### A. THE PROVISIONS OF EXISTING LAW

The Internal Revenue Code presently contains four provisions which assist in solving liquidity problems. These are:

1. The provisions of section 6161, which permit the time for paying estate taxes to be extended for a period of up to 10 years in instances in which timely payment would result in undue hardship. On May 27, 1967, the regulations under section 6161 were amended to indicate more clearly that the sale of a small business at a sacrifice price to pay estate taxes constitutes "undue hardship" for purposes of section 6161.

2. The provisions of section 6166, which permit the time for paying estate taxes to be extended automatically for a period of up to 10 years in instances in which an estate contains a farm or closely held business interest the value of which exceeds either 35 percent of the gross estate or 50 percent of the taxable estate of a decedent.

3. The provisions of section 303, under which capital gains treatment is accorded to certain redemptions of corporate stock to pay death taxes, or funeral and administration expenses. In order to qualify for this favorable treatment, the redemption must be accomplished by a corporation whose stock comprises more than 35 percent of the value of the decedent's gross estate, or more than 50 percent of the value of the taxable estate.

4. The provisions of section 6601(b) which provide that interest on unpaid estate taxes accrues at a rate of only 4 percent per year in

instances in which the tax is not timely paid. The applicable rate of interest in the case of other unpaid taxes—such as income or excise taxes—is 6 percent.

### B. THE PROPOSED REVISIONS

*1. Revision in Section 6166—The Automatic Extension of Time Provision*

Under the existing provisions of section 6166 of the Internal Revenue Code, an estate containing a farm, partnership interest, or stock in a closely held corporation may elect to pay the estate taxes attributable to such interest in up to 10 annual installments. However, this relief is not available unless the value of the interest in a closely held business exceeds either 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent.

It is proposed that liberalization be made in the percentage limitations of section 6166. Installment payments of capital gain and transfer taxes (including taxes on generation skipping transfers) will be permitted if the value (as finally determined for Federal estate tax purposes) of an interest in a closely held business—as defined in section 6166(c)—exceeds 25 percent of the taxable estate of a decedent. In addition, the extension of time privilege will be available if the taxed gains in connection with an interest in a closely held business are more than 25 percent of all gains taxed upon the death of the decedent.

In addition, the shareholder limit in section 6166 will be raised to 15. Similarly, the "voting stock" requirement of existing section 6166(c)(3)(A) should be eliminated. A minor proposed change in section 6166 involves shifting from annual to quarterly installment payments. This conforms with existing collection practice in connection with estimated taxes and certain other taxes which are paid in installments. This change will also provide earlier notice of possible delinquency on the part of the estate.

A similar extension of time will be permitted in the case of the income tax imposed on gains taxed at the time of death in connection with an interest in a closely held business. Installment payments of taxes on death-time capital gains are to be elected not later than the time for filing the decedent's last income tax return. The amount pay able in installments may not exceed an amount which bears the same ratio to the total tax imposed on capital gains at death as the gains so taxed in connection with a closely held business bears to the total gains of the decedent at death.

*2. Revision of Section 6165*

Under existing section 6165, District Directors may require, as a precondition to the granting of an extension of time to pay taxes, that the taxpayer furnish a bond for up to double the amount with respect to which an extension is granted. Administrative practice under section 6165 varies widely and the procedure may be expensive to taxpayers.

It is proposed that section 6165 be revised to permit the use of security arrangements, in lieu of bonds, when extensions of time for payment of taxes are requested. The bonding requirement would be retained for use in those situations in which a satisfactory security

agreement is not furnished. The bond would be in the amount of unpaid tax, plus any anticipated additions thereto, including the interest which may reasonably be expected to accrue on the unpaid tax during the extension of time for payment.

The major proposed revision in section 6165 would authorize use of security arrangements such as mortgages, pledges, and escrow agreements, in lieu of bonds. The precise form of security interest which will be required in a specific situation is left to the discretion of the District Director. These provisions would also establish the method of creating security interests in property in accordance with the terms of a security agreement, the furnishing of collateral which is to be subject to these security interests, the standards for determining the necessary amount of collateral, the way in which security agreements become effective, the method of terminating security agreements and interests, and the rights of the District Director in the event of default in the payment of taxes. These proposed provisions of section 6165 follow the basic pattern and terminology established by the Uniform Commercial Code, which has now been adopted in a majority of the States.

When determining the amount of collateral to be furnished to secure the payment of taxes, when an extension of time has been granted under section 6166, the proposed revision of section 6165 will provide that the decedent's interest in a closely held business (including farms) shall, in all cases, constitute adequate collateral to secure the payment of taxes imposed with respect to that business interest. Such collateral will normally be adequate to secure the Government's interest, since the tax with respect to a closely held asset will always be smaller than the value of the asset itself. However, an exception to this rule may be made in situations in which the closely held business is encumbered by prior liens. In such cases, the District Director may demand enough additional collateral to give reasonable assurance that he will ultimately collect the unpaid tax and any additions thereto.

In instances in which the decedent's closely held corporate stock has been furnished as collateral subject to a security interest, the District Director will be entitled to all the rights granted to stockholders by local law, including notice of corporate actions which might impair capital. In addition, in order to provide for instances in which local law does not provide adequate safeguards, section 6165 will specifically provide that the District Director is entitled to 90 days notice of sales of corporate assets of a value greater than $1,000 (other than sales in the ordinary course of business), to notice of the declaration of a dividend, and to notice of any other action calculated to have a substantial effect upon the liquidation value of a firm, including changes in the salaries of officers or directors. Failure to furnish such notice will constitute a default, which will authorize the District Director to enforce his security interests.

*3. Revision of Section 2204*

Section 2204 relieves the executor of personal liability for subsequently determined estate tax deficiencies only in those instances in which the executor pays in full the amount of the estate tax which has already been determined to be due. Consequently, a section 2204 discharge cannot be obtained when an extension of time to pay estate

taxes has been requested. A related problem arises in instances in which trust assets are includible in the estate. In such instances, fiduciaries administering the trust may find themselves liable as transferees for unpaid estate taxes, even though the executor of the estate may have been discharged under the provisions of section 2204.

To deal with these problems, section 2204 will be revised to permit an executor to be discharged from personal liability if two conditions are met. First, the executor must pay all taxes and additions, including deficiencies, which have been assessed prior to the date of discharge and for which *no* extension of time for payment has been requested. Second, the executor must enter into a section 6165 security agreement (or furnish an adequate bond in lieu of a security agreement) to assure payment of taxes in those instances in which an extension of time has been requested.

Similar rules will apply to fiduciaries who hold assets which are includible in the gross estate. If such a fiduciary makes a timely application for a certificate of discharge from personal liability for unpaid estate taxes, and if the executor fulfills the two conditions outlined above, the fiduciary will also be relieved from personal liability for those taxes.

Another minor change in section 2204 would give the Service up to 18 months from the date of filing of a deathtime transfer tax return, to issue a certificate of discharge to an executor or fiduciary. This conforms with the Service's normal estate tax audit cycle.

*4. Section 303 revisions*

Under present law, capital gains treatment is accorded to certain redemptions of corporate stock to pay death taxes, or funeral and administration expenses. In order to qualify for this favorable treatment, the redemption must be accomplished by a corporation whose stock comprises more than 35 percent of the value of the decedent's gross estate, or more than 50 percent of the taxable estate.

It is proposed that section 303 be revised to conform to the revised provisions of section 6166. Section 303 redemptions will be permitted to extend over a period of 10 years—but the use of notes or similar devices to avoid these time limitations would be ended. Thus, the maximum time period for section 303 redemptions would match the 10 year maximum time period for payment of taxes set forth in section 6166.

In addition, section 303 will be changed so that redemptions will be permitted only to the extent necessary to pay taxes on closely held businesses as defined in section 6166. Accordingly, only those persons liable for payments of taxes with respect to a closely held business would be allowed to make use of the provisions of section 303. Taxes on capital gains at death and deathtime transfer taxes could both be taken into account for purposes of section 303, but not State taxes or other expenses incurred by an estate. Because section 303 relief will be limited to closely held businesses, as defined in section 6166, there is no need for retention of the percentage limitations set forth in existing 303(b)(2)(A), since the percentages set forth in the definition of the term "closely held business" in section 6166 would determine the applicability of section 303 relief.

*5. Amendment of tax on unreasonable corporate accumulations*

Under present law, there is some uncertainty as to whether the earnings of a closely held corporation can be accumulated for the purpose of making redemptions under the provisions of section 303. Consequently, a new paragraph will be added to subsection (c) of section 535 of the Code to permit post-death accumulations by a closely held business for the purpose of making section 303 redemptions. Predeath accumulation of funds for this purpose will not however be permitted.

Under the revised provisions of section 535, the amounts accumulated in a given year must be utilized to redeem section 303 stock not later than the close of the year following the year of accumulation. Thus, a corporation will have not less than 12 nor more than 24 months in which to make a redemption of a decedent's stock. This provision will insure that funds accumulated to make section 303 redemptions are actually used for that purpose within a reasonable period of time.

The revision in section 535, taken together with the revisions in sections 303 and 6166, should permit death taxes to be paid in many cases out of the post-death earnings of a closely held business. Thus, in a case in which the time for paying death taxes with respect to a closely held business has been extended for 10 years, a corporation could accumulate earnings during that period to make periodic redemptions of stock under section 303, thereby permitting the executor or beneficiaries of the estate to make timely installment payments of taxes.

*6. Revision of section 6161*

The provisions of this Code section, as presently drafted, apply only to extensions of time to pay estate taxes, where hardship can be shown. These hardship extension provisions will be revised to apply not only to transfer taxes imposed at death, but also to taxes on capital gains taxed at the time of death.

*7. Rate of interest on deferred payments of death taxes*

At present, section 6601(b) of the Internal Revenue Code provides that interest on estate taxes accrues at a rate of 4 percent per year in instances in which the tax is not timely paid. When interest rates are high, this provision constitutes an incentive to delay payment of estate taxes. During periods when interest rates are low, this provision may impose a slight penalty on estates which are unable to borrow elsewhere and which find themselves forced to apply for extensions of time to pay death taxes. The applicable rate of interest in the case of other unpaid taxes—such as income or excise taxes—is 6 percent.

To achieve interest neutrality so far as decisions regarding payment of taxes are concerned, a provision is proposed, similar to section 483, giving the Secretary or his delegate discretionary authority to establish the rate of interest at any given time in light of market conditions. To facilitate this exercise of discretion, and to ease administrative difficulties, the following guidelines for the exercise of this power would be followed: (1) The rate of interest should be adjusted only on January 1 of any given year, and should remain constant throughout that year. (2) Adjustments to interest rates should be made in whole point units, rather than in fractions of a percent.

(3) Adjustments should be made in light of market conditions, determined by adding 2 percentage points to the Federal Reserve System's recommended rediscount rate. (4) The rate of interest applicable on the date on which a tax becomes payable will remain the same for that tax liability until it is paid. For example, if a tax becomes payable on December 31 of a given year, when the rate of interest under section 6601 is 5 percent, that rate of interest will remain applicable, even though the interest rate is raised a few days later by the Commissioner.

## VIII–D–2. PAYMENT OF ESTATE TAXES WITH GOVERNMENT SECURITIES

### General Explanation

#### BACKGROUND

Under the provisions of existing law, certain designated Treasury securities enjoy special estate tax payment privileges. These securities can be redeemed at par in payment of estate taxes, even though the securities may be selling on the date of redemption for a price which is substantially below par. For example, if an issue of securities which carry such redemption privileges has a coupon rate of 3¼ percent and is selling for 86 so as to yield 4½ percent, the Treasury ordinarily must redeem these securities at their par value of 100 if the securities are offered in payment of estate taxes. The effect is the same as selling the securities for 100 and realizing a 14-point tax-free profit.

At the time when estate tax payment privileges were written into the law, during World War I, it was believed that inclusion of these privileges in the terms of issue of Treasury securities would make it possible to market those securities more readily and at lower rates of interest. However, experience has shown that the tax losses sustained when such securities are redeemed at par prior to maturity considerably outweigh any possible benefits realized at the time when such securities are issued. Moreover, the inclusion of tax payment privileges in the terms of issue of Treasury securities tends to obscure the actual cost of carrying the national debt. Finally, the benefits of these securities are conferred in a very haphazard fashion from one year to another and from one taxpayer to another. For example, the benefits conferred by existing law are usually available only to those taxpayers who have the cash or other liquid assets needed to buy such securities and who die during periods when interest rates are high. There does not appear to be any reason for preferring such taxpayers over those whose estates are illiquid, or those who die during periods when interest rates are low.

#### PROPOSAL

The statutory provisions which require the Treasury to include estate tax payment privileges in the terms of issue of certain Treasury securities should be repealed prospectively. Adoption of this proposal will gradually reduce the substantial tax losses caused by the provisions of present law. In addition, the cost of carrying the national debt

will be made clearer, and there will be greater equity in the treatment of similarly situated taxpayers. This proposal would *not* alter the redemption features of any outstanding Treasury securities. To the extent that existing issues of Treasury securities carry estate tax payment privileges, those securities will continue to be redeemable at par in payment of estate taxes.

## VIII–D–2. PAYMENT OF ESTATE TAXES WITH GOVERNMENT SECURITIES

### Technical Explanation

#### PRESENT LAW

Under the provisions of 31 U.S.C. 765, United States Treasury bonds which bear interest at a rate of more than 4 percent must be made redeemable in payment of estates taxes. If an estate owns securities which carry tax payment privileges, and if such securities were held by an individual at the time of his death (or, in the case of certain securities, for at least 6 months prior to his death), the securities may be redeemed in payment of Federal estate taxes, even though the securities have not yet matured. Upon redemption, such bonds are valued at the higher of par or the mean selling price on the valuation date, and the securities must be included in the estate at the same valuation.

#### PROPOSED AMENDMENT

It is proposed that section 14 of the Second Liberty Bond Act, as added by section 6 of the Third Liberty Bond Act, 31 U.S.C. 765, be amended by adding the following sentence at the end of existing section 765: "This section shall not apply to any bond or other security issued after [enactment date]." This proposed revision would repeal, prospectively, the provisions of 31 U.S.C. 765.

#### RELATED MATTER

Under a related provision, 31 U.S.C. 752, the Treasury has discretionary authority to establish the terms of issue of Treasury securities, and, in the past, this discretionary authority has sometimes been used to confer estate tax payment privileges on certain issues of securities. No amendment to section 752 has been proposed because, consistent with its proposed section 765 amendment, the Treasury Department will refrain from using its discretionary authority to issue additional bonds or other similar securities (except bona fide tax anticipation certificates) which are subject to a term or condition permitting such bond or security to be received in payment of taxes imposed by the United States.

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# IX. SUPPLEMENTARY MATERIAL

# IX–A.—SUPPLEMENTARY MATERIAL: TAX TREATMENT OF MINERALS

*Introduction*

This paper is a statement on some of the effects of the tax treatment relating to minerals. The detailed statistical analysis relates to oil and gas. This concentration on oil and gas statistics is undertaken for several reasons:

1. Depletion on oil and gas constitutes three-fourths of the total dollar amount of depletion allowed under the tax law.
2. The statistical data relating to oil and gas are far more adequate than is the case for other minerals.
3. Historically, the first percentage depletion provision, and the largest, was accorded to oil and gas. The others were extended to some extent by analogy to oil and gas.

These reasons do not necessarily imply that the economic effects of the present tax treatment would be the same for other minerals as for oil and gas. The reasons do suggest that pending the development of such other analyses there is a basis for using the analysis of oil and gas as a case study that should have important implications on the tax provisions relating to minerals generally.

This paper does not attempt to reach a conclusion as to what should be done about the present tax provisions respecting oil and gas. This is something that would have to be decided as a matter of overall policy. This paper considers predictions of how much oil and gas reserve additions, prices, and production would change under different tax treatments. If it were concluded that these changes would be very small, it could be suggested that the present effects of the existing treatment is not worth the cost of the present tax benefits (that is, the additional taxes now imposed on other taxpayers to permit the present tax reduction for oil and gas producers). If the indicated changes are very large, it is still a question whether the present effects are desirable from a national standpoint.

*Outline of paper*

Chapter 1 describes the tax provisions relating to oil and gas from the standpoint of whether they constitute a special benefit and how much of a benefit they offer. In general, it is not particularly controversial that the provisions relating to oil and gas constitute a special benefit, although there has been a good deal of discussion of this aspect. The chapter refers to some relatively recent material on the size of the special benefit accorded oil and gas.

Chapter 2 comments on the literature as to the impact of these tax benefits on oil and gas reserves, prices, and production. It will be seen that the early discussions of the depletion issue were replete with nonquantitative assertions to the effect that the impact was either negligible or enormous. In recent years there has been some significant



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attention directed to quantitative studies, particularly by Franklin Fisher, Edward Erickson, and a project undertaken by the Consad Research Corp. of Pittsburgh, Pa., under contract with the Treasury Department. A careful review of this literature suggests some general area of agreement. Some other discussions of price output effects from the technical literature are also considered.

Chapter 3 articulates some issues relevant to evaluating the kind of effects discussed in chapter 2. It is suggested that technical analysis will help clarify some of the issues and permit a more rational expression of individual preferences regarding those issues.

Chapter 4 comments briefly on the general set of resource policies open to and to some extent utilized by the United States as they bear upon the goals sought by the tax provisions.

## Chapter 1.—The Principal Present Tax Provisions Relating to Oil and Gas

As a general tax rule, the capital costs of business operations are spread over the expected life of the capital assets involved and deducted from the business income. In the main, oil and gas well operators obtain different treatment in two ways:

(*a*) Most capital costs (intangibles) are deducted immediately rather than being deducted over the life of the asset.

(*b*) The annual deduction for depletion is measured by reference to income and thus can exceed the actual cost of the assets used up, often by many times.

### INTANGIBLES

The costs of developing oil and gas productive capacity can be described as falling in one of four categories of tax treatment:

(*1*) *Charged off as incurred*

(*a*) Intangible drilling costs (all costs of drilling except for the cost of depreciable property used in drilling). This charge-off treatment is allowed whether the hole is dry or producing.

(*b*) Lease rentals.

(*c*) Costs of general exploration studies not related to an area of interest.

(*2*) *Capitalized but charged off when property is abandoned*

(*a*) Lease acquisition costs and exploration costs on nonproductive properties. (Exploration expenses include costs of things like geological and geophysical studies.)

(*3*) *Capitalized and taken as depreciation (in addition to depletion)*

(*a*) Costs of drilling equipment.

(*4*) *Capitalized and taken as cost depletion (unless percentage depletion is used)*

(*a*) Exploration costs and lease acquisition costs on productive properties.

### DEPLETION

The taxpayer is permitted to deduct each year the greater of cost depletion or percentage depletion:

*Percentage depletion.*—This is computed as the lesser of 27½ percent of the gross value of oil (or gas) at the well or 50 percent of the net income from the property.

*Cost depletion.*—This is computed by combining the capitalized cost of the property, that is, the lease acquisition cost plus the specific property exploration costs less prior depletion (cost or percentage), and taking a portion of this each year equivalent to the ratio of oil (or gas) extracted to the estimated recoverable reserve on the property.

In general, the percentage depletion exceeds the cost depletion except on a property that was purchased when it was already a successful producer.

The problem surrounding oil and gas tax treatment is that only in the natural resource businesses is a taxpayer's deduction for wasting capital permitted to exceed his actual unrecovered capital cost. This arises because such a large part of the actual capital cost is permitted to be deducted as incurred, and then depletion is allowed as a percentage of receipts without regard to the remaining unrecovered cost.

An example will clarify this:

| Item | Total cost | Tax treatment |
|---|---|---|
| 10 exploratory wells dry at $10,000 each | $100,000 | $70,000 deduct currently.<br>$30,000 deduct as depreciation. |
| 1 exploratory well successful with value of deposit in the ground of $220,000. | 10,000 | $5,000 deduct currently or as depreciation.<br>$5,000 lease cost not deducted. |
| Well income cumulative over lifetime | 800,000 | $800,000 in gross income.<br>$220,000 deduct as percentage depletion. |
| Lifting costs over well lifetime | 200,000 | $200,000 deduct currently. |

Looking at the whole operation, the taxpayer will have enjoyed net income of $490,000 when he has used up the successful well ($800,000 gross income less $110,000 exploration cost and $200,000 lifting cost). However, taxable income is only $275,000 as his tax deductions come to $525,000, adding $220,000 of percentage depletion to the $305,000 of costs deducted currently.[1] Thus, the taxable income is only $275,000 in an operation in which the gain was clearly $490,000.

This example not only makes clear that percentage depletion can exceed costs, but it also brings out an issue that has been much discussed in the nonquantitative debates on depletion. When our illustrative driller hit oil in his 11th exploratory hole, he suddenly became the owner of a valuable asset, viz., leasehold rights to oil in the ground worth $220,000. Prior to 1927, the treatment of oil and gas income was to calculate this "discovery value" on the successful well and then take this as a depletion deduction allocated over the well life. When percentage depletion was adopted in 1927, the rationale was to skip the calculation of discovery value and approximate the result of deducting discovery value depletion by taking 27½ percent of gross income. Implicitly, this estimated that the value of an oil deposit in the ground is about 27½ percent of the estimated well-head price of the recoverable oil.[2]

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[1] The $5,000 lease cost on the successful well is not deducted because it would go into cost depletion which is less than percentage depletion.

[2] It has been asserted by some industry spokesmen that at current prices the value of oil in the ground is about 33 percent of the expected gross, and on this ground they assert that the acceptance of the discovery value theory would imply a 33-percent percentage depletion rate for oil.

Even though one might use phrases such as "$220,000 of the well owner's proceeds are not income but only a recovery of the capital that was represented by the value of the successful well before production started," the deduction of $220,000 with respect to this asset is clearly inconsistent with general rules of income taxation. A close analogy would be to a builder who puts up a building for his own account which cost him $110,000 to build and which was worth $220,000 when it was completed. At that point, it could be said that the builder has capital of $220,000; but, if he continues to operate the building himself, his future deduction for capital wastage (depreciation) is limited to the previous undeducted cost. Using the figures in the driller example, the deduction should be limited to $35,000.[3] The oil operator with the same overall experience as a builder gets extra deductions of $215,000.

This analogy brings out another point, viz., that even apart from the extra $215,000 of deductions from percentage depletion, the oil well driller is favored in that his basic capital costs are recovered more quickly because of the writeoff of intangibles. In the example, $75,000 of the $110,000 capital costs were written off at the outset. For a builder only about 10 to 15 percent of the costs would be deductible at the outset.

The extent of the special preferences given the mineral industry has been detailed in a number of recent studies.[4]

In 1960, individuals reported $1.17 billion of gross income from mineral properties. Against this, they claimed deductions of $0.24 billion for exploration and development expenses and $0.38 billion for percentage depletion. The combined net income after deducting these amounts and other costs was $0.53 billion. Of the $0.38 billion of percentage depletion $0.37 billion was taken with respect to oil and gas.

Partnerships reported $0.55 billion of gross income from mineral properties, $0.05 billion of exploration and development deductions and $0.08 billion of percentage depletion, of which $0.065 billion was from oil and gas.

Corporations reported $8.8 billion of gross income from mineral properties. Their exploration and development deductions were $1.1 billion and their percentage depletion deduction was $2.9 billion. The figure of $2.3 billion of the percentage depletion and almost all of the exploration and development was on oil and gas. Of the $2.9 billion of depletion, $0.75 billion was on foreign properties.

Among corporations that were classified as in the mining industry the depletion allowed was $0.88 billion of which $0.84 billion was allowed to corporations with assets over $1 million, but $0.30 billion was allowed on returns with no income. (A taxpayer is limited to a depletion deduction of 50 percent of the net income from the property. If exploratory drilling is extensive on other properties, the net income can be "drilled up".)

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[3] This amount is the sum of the undeducted depreciation of tangible drilling costs which the oil operator also takes as depreciation and the lease cost on the successful well which would have been cost depletion to the oil operator.

[4] Effects of Special Federal Tax Provisions on Selected Aspects of the Oil and Gas Industry, a special report of the CONSAD Research Corp. to the U.S. Treasury.

Depletion Survey, 1958–60, Treasury Department, Feb. 6, 1963. Parts of this were published in Hearings on Tax Revision, vol. 1, Committee on Ways and Means, 1963.

Statistics of Income, 1960, Supplementary Volume, Depletion Allowances, Internal Revenue Service.

It is estimated that if percentage depletion were disallowed completely in 1968 the tax increase would be $1.5 billion. This figure recognizes some growth in the base since 1960 plus the fact that lower percentage depletion on foreign operations would in large measure be offset by larger foreign tax credits. If percentage depletion had never been allowed, the cost depletion in 1968 would have been higher; and the revenue gain might have been about $1.3 billion.

If exploration and development expenses were required to be capitalized, the revenue gain in 1968 would have been about $0.75 billion; but this would fall in the future to perhaps $0.3 billion as cost depletion deductions were taken.

In total then the current special tax advantages of depletion and current expensing of intangibles result in loss of revenue to the Treasury of $2.25 billion annually in 1968. If percentage depletion and expensing of exploration and discovery costs had never been permitted, cost depletion deductions would be larger than at present and the long-run revenue cost at 1968 levels of activity would be $1.6 billion. Under present law, the revenue cost would tend to grow with the growth of the industry.

## Chapter 2.—The Effect of the Special Tax Provisions on Oil and Gas

The problem of the effects of the special tax provisions on oil and gas is a complex one. This chapter undertakes to identify several distinct elements of the effects problem and to comment on the available literature in each area. A summary evaluation is attempted at the end. To survey the ground to be covered, we first give attention to three assumptions, viz., that the increased tax from a change in the tax provisions could be absorbed by reduced royalties, or met by increased product prices, or offset by lower costs. (To the extent that these changes occur, the profit position of the oil and gas producer is unchanged.) Following this, attention is given to the questions of how the investment policy of the producer might change if the tax revision should be absorbed by lower profits and how the financial methods of operation might change to minimize the tax effects.

### A. THE PRICE ASPECT

Oil and gas producers sell their products under various degrees of competition. Natural gas is subject to public utility type rate regulation and is sold principally to regulated interstate pipelines who in turn sell the gas to local distributors (also regulated) who sell the gas in competition with electricity and fuel oil. Crude oil is sold subject to a field price system where prices are not directly regulated but are conditioned by the decisions of several key States with respect to production controls which tend to support the price posted by the major integrated oil companies. The largest final product is gasoline, which has a highly inelastic demand. Other products are fuel oil and petrochemicals, both of which involve competitive pressures.

It is plausible, *a priori*, that a major effect of reduced tax benefit provisions would be to raise crude oil prices which would offset in

whole or in part the loss of profitability of the drillers. There is no completely satisfactory analysis of what would happen along this line.[5] Given the present crude oil price of around $3 per barrel, a price increase of $0.70 would be necessary to completely compensate drillers for the loss of percentage depletion, and probably another $0.25 (less in the long run) to compensate for the loss of deductibility of intangibles. If this increase were spread over all products, the price of gasoline might rise by 2½ cents per gallon.[6] Since the demand for gasoline is more inelastic than some of the other products, the gasoline price might rise more than this (and other oil products less). This kind of a price increase would involve some small drop in volume of gasoline sold.

Such a potential price increase might result in tipping the scale of comparative economics to liquefication of coal or shale oil production so that crude could be supplied from these domestic sources at a price lower than from drilling for new oil. It could be argued that the present tax laws thus result in a misallocation of resources which, among other effects, is inhibiting the development of our vast coal and shale resources.

A constraint on any price increase is the import situation. Crude oil already sells in the United States at a price nearly $1.25 above the price of Mediterranean oil delivered in the United States,[7] a result maintained by import controls. In principle, U.S. crude oil prices could probably be increased further as a result of reduced special tax provisions with little impact on sales by U.S. producers if import quotas were maintained at current levels. A larger disparity between the U.S. price and the world price would no doubt add to the pressure for increased import quotas and thus make U.S. producers reluctant to raise prices. In effect, the price of crude oil in the United States is being underwritten by import controls, by State controls on production, and by favorable tax provisions. It is legitimate to investigate what would be the impact on U.S. drillers if the tax provisions were changed without any price increase. Separately, we can offer some speculation about the effect of possible price changes.

The case of natural gas is somewhat different. Because of the price regulation process it is highly plausible that the effect of the loss of tax benefits from natural gas would be fully reflected in the price. An offsetting increase in natural gas prices would be 5 cents per 1,000 cubic feet at the wellhead. This would amount to only a 10-percent rise in the average delivered price if passed on equally to all consumers. No doubt such an increase would tend to price gas out of some uses or markets where it is now marginally competitive with coal. But if so, this underscores the misallocation of resources under existing law. It can be argued that the Federal tax laws should not be the instrument for giving one form of fuel an advantage over its competitors at the expense of the taxpaying public.

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[5] The unsatisfactory state of our knowledge of crude oil and oil product prices is referred to in U.S. Energy Policies, An Agenda for Research, Resources for the Future, 1968, p. 27.

[6] Typically a barrel of crude (42 gallons) is refined into 20–22 gallons of gasoline, with the balance going into other products.

[7] Erickson, "Economic Incentives, Industrial Structure and the Supply of Crude Oil Discoveries in the U.S., 1946–58/59," unpublished Ph. D. thesis, Vanderbilt University.

### B. THE ROYALTY ASPECT

Oil producers search for oil prospects and then pay the landowners for the right to drill and extract oil. Typically the payment takes the form of a royalty interest of 12 percent—15 percent and in addition it may include lease bonuses.[8] If the profitability of drilling for oil were reduced, drillers would be less willing to pay for prospects. If one assumes that the supply of potential oil land is homogeneous and perfectly inelastic, the royalties would be reduced dollar for dollar for the loss of tax benefits (until they were near zero).[9] If on the other hand there is an extensive graduation of prospective oil lands, only small changes would occur in the level of royalties as the result of a reduced profitability from drilling (e.g., due to a change in the tax provisions).[10]

To make this point in nontechnical language, oil depletion allowances create initially a prospect for a "windfall" for oil drillers; that is, they would have more income after tax than others earning the same income before tax. If there was an absolutely fixed supply of land with oil possibilities and the probability of finding oil was the same on every tract, then the landowners could charge for this windfall prospect an amount equal to the windfall (the oil drillers would still obtain normal profits, by definition). The fact is, as both Davidson and Campbell agree, the supply of oil land is not competely fixed and uniform; less promising prospects can be explored. There is considerable disagreement, however, on the exact shape of the distribution of oil prospects.

Given that there would still be a range of oil prospects by quality, even if the tax advantages were eliminated, owners of the better prospects could still command royalties. There are no historical data available as to oil and gas royalties in the past during times of better or worse oil market prospects. Hence there is no precise method of judging how much a reduction in tax preferences would be offset, so far as drillers were concerned, by lower royalties. This could be as high as 60 percent.[11] An offset as low as 14 percent would simply involve dividing the tax loss between producer and royalty recipient proportionately.

### C. THE COST ASPECT

There is a possibility that the effect of loss of tax benefits could be largely offset by decreases in costs which could leave the profit incentives to drilling relatively unchanged. Two cost reduction circumstances may be noted. Under presently used technologies, only 33 percent of the estimated oil in place in known reserves is considered recov-

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[8] Henry Steele refers to the figure 14.5 percent for the average royalty as "frequently used by petroleum industry economists." C. F. Steele, "The Prospects for the Development of a Shale Oil Industry," Western Economic Journal, 1963, p. 60.

[9] Paul Davidson, "Policy Problems of the Crude Oil Industry," 53 American Economic Review 85, March 1964.

[10] D. R. G. Campbell, Comment on Davidson article, op. cit., 54 AER ¼ March 1965. Also, cf., reply by Davidson loc cit.

[11] If a barrel of crude is $2.93 at the well, the value of percentage depletion over cost depletion considered at 23.5 percent, that is, the difference between 27.5 percent and a cost depletion of 9 percent is worth, after a 48-percent tax, $0.33. A 14.5-percent royalty deducted is worth $0.204. Thus elimination of the royalty could compensate for 60 percent of the elimination of percentage depletion.

erable by the Interstate Oil Compact Commission. There is considerable opinion by industry engineers that with improving technology this recovery rate can be doubled, either gradually as technology improves or by more intensive use of these methods at a higher cost.[12] Existing State conservation practices result in significantly higher oil prices, through encouraging unnecessary drilling and through increasing the share in output of high-cost wells.[13] Revision of conservation practices could reduce costs.[14]

In the specific task of forecasting the effects of price changes, it does not seem sensible to predict that reducing the benefit of percentage depletion will cause a cost reduction, since these matters are not really in the control of individual companies. It would be better to regard this as an area of possible alternative Government policies. One particular connection is noteworthy, however. Under present tax law, the large integrated companies benefit from higher prices for crude oil since higher prices would cause more of their income to be from mining, rather than refining, and they mainly are producing their own crude. These companies probably gain little from regulatory policies. If percentage depletion were removed, this factor itself might cause the integrated producers to move more aggressively to achieve production cost economies.[15]

### D. IMPACT OF CHANGES IN THE TAX PROVISIONS IF NOT OFFSET BY ROYALTY, PRICE, OR COST CHANGES

To complete the analysis of the effects of the tax provisions on oil and gas, it remains to say something about what could be expected to happen in the unlikely event that the tax benefits were removed and no offset through lower royalties, lower costs, or higher prices were available to producers. There is no basis for a direct empirical examination of this problem because the tax provisions have not been significantly changed for decades. There has been investigation, however, of the reactions within the oil industry to changes in price and changes in cost. Since the import of percentage depletion and the expensing of intangibles can be converted into equivalent increases in the prices received by oil producers. or into equivalent reductions in cost of production, these analyses provide some basis for evaluating the tax question.

A path-breaking study in this area was undertaken by Franklin Fisher.[16] Fisher examined the short-run effects of changes in wellhead prices of oil on the annual rate of new discoveries measured in barrels. On the basis of data for the period 1946–55, he concluded that a 1-percent increase in wellhead price resulted in a 0.3-percent increase in barrels of new discoveries. An extension of Fisher's analysis by Edward Erickson, which incorporated additional data and methodological refinements, also concluded that changes in barrels of new discov-

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[12] CONSAD. p. 4.18

[13] J. W. McKie and S. L. McDonald, "Petroleum Conservation in Theory and Practice," Journal of Political Economy, February 1962, p. 115.

[14] M. A. Adelman estimates the cost of wasteful practices due to current State regulatory practices in the neighborhood of $0.80 to $1 per barrel of domestic crude, at current output. M. A. Adelman, "Efficiency of Resource Use in Crude Petroleum," 31 Southern Economic Journal 105, 122 (October 1964).

[15] Erickson, op cit. p. 87.

[16] "Supply and costs in the U.S. Petroleum Industry Two Econometric Studies" (for Resources for the Future), Johns Hopkins Press, Baltimore, 1964.

eries are less than proportional to changes in wellhead prices.[17] According to Erickson's findings, a 1-percent increase in price resulted in a 0.89-percent increase in the annual rate of new discoveries. Both writers attributed the nonproportionality of discovery response to price change largely to the fact that, in the short run, increases in discovery can be obtained only from drilling less attractive prospects and this increases the discovery cost per barrel of oil and tends to discourage the expansion of discovery activity.

Another study, which was undertaken by the CONSAD Research Corp., examined the effects of changes in wellhead oil prices and changes in the cost of replacement (discovery and development) of oil reserves on the levels of reserves which oil producers would wish to hold.[18] This study found that, holding the cost of replacing reserves constant, a 1-percent change in wellhead prices would result in a corresponding change of 0.27 percent in the level of reserves producers desire to hold; and, holding wellhead prices constant, a similar 1-percent change in the cost of replacing reserves would result in a change of 0.27 percent in desired reserve levels, but in the opposite direction.

In the long run, then, elimination of the percentage depletion option, which is equivalent to a reduction of nearly 12 percent in the wellhead price of oil from the point of view of oil producers, would lead to a 3-percent reduction in the level of reserves producers would wish to hold; and since a discontinuance of the privilege of expensing intangibles would be the equivalent of a 15-percent increase in the cost of replacement reserves, this would lead to a further reduction of 4 percent in the reserves producers would wish to hold.

Thus, according to the CONSAD results, the longrun effect of removing the differential tax treatment of oil would be approximately a reduction of 7 percent in the level of reserves held by oil producers. If, under present conditions, oil producers hold reserves equal to 12 times current production, under normal income tax treatment, they would strive to hold only slightly more than 11 times current production.

The Fisher-Erickson and the CONSAD analyses examine the past behavior of oil and gas companies to see how they have modified their behavior as oil and gas market conditions varied. They use different technical approaches. Fisher separates three elements of drilling; that is, he estimates the relation of price and cost factors separately to (1) additional wells. (2) the success ratio, and (3) the average yield of successful wells. This pattern can take into account that, when oil market conditions are such as to encourage more drilling, less promising prospects are developed because the best prospects are used first. Similarly, when poor market conditions develop, the marginal prospects are not drilled so that reserve discoveries do not go down as much as drilling. Erickson builds on the same analytic technique as Fisher

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[17] Economic Incentives, Industrial Structure, and the Supply of Crude Oil Discoveries in the United States 1946–58/59." unpublished thesis, Vanderbilt University, 1968. Erickson argued that there were "significant errors" in Fisher's data and he acknowledged Fisher's help in tracing down these errors (p. 17). In fitting Fisher's equations to the revised data, he got nonsignificant results. The main part of Erickson's paper involves a respecification of Fisher's equations, still using the general form of Fisher's analysis.

[18] "The Economic Factors Affecting the Level of Domestic Petroleum Reserves," a research study prepared for the Office of Tax Analysis, U.S. Treasury Department, by CONSAD Research Corp., Pittsburgh, Pa., Dec. 27, 1968.

but introduces several refinements, such as regional disaggregation of the data.

The CONSAD study accommodates the "Fisher effect" by relating oil reserves discovered to market factors in one equation; but in the one equation they treat the cost and price factors in a more sophisticated way, following the user cost of capital definition as defined by Jorgenson,[19] and others. The CONSAD study also finds a more satisfactory explanation of oil market behavior by looking at the combined United States and Canadian markets. Also the CONSAD approach uses a smoothing technique to deal with time lags and intercorrelations which appears to be an improvement.

For specific comparison of results, we may assume that Erickson's work replaces that of Fisher and the question arises as to what the differences in results amount to.

It is important first to realize that Erickson tries to calculate the difference in *current drilling for new reserves* that can be associated with various factors, including the current price of crude oil. CONSAD tries to calculate the difference in the *level of reserves held* that is associated with current and recent past factors, including the price of crude oil.

The significance of this difference can be seen by recognizing that each year oil companies undertake drilling at a level that finds new reserves large enough to replace the reserves used up by current production and to provide a reserve margin for the increase in output. Since World War II the output has grown about 3 percent a year, and the ratio of known reserves has fluctuated around 12 times annual output. This is consistent with new reserve discoveries each year of about 136 percent of output to cover the output used up and to provide the 12-to-1 margin against the 3-percent increase in output.

The difference in the two analyses is that Erickson looks at current drilling, the 136 percent, and CONSAD looks at the reserve level, the 12 to 1. Assume that the oil business becomes less profitable so that operators are less willing to explore for reserves. They may decide, for example, that reserves are so much less valuable than they were before that they only want to carry an 11-to-1 multiple of reserves to output. This is a reduction of only 8.3 percent in the reserve *level* (the variable which CONSAD estimates), but it would be achieved by a larger reduction in drilling (the variable which Erickson estimates). For example, to cut the reserve level from 12 to 1 to 11 to 1 in 3 years, the companies could reduce drilling so as to reduce the annual level of new reserves discovered from 136 percent of output to 100 percent for 3 years, a reduction of 26½ percent. There is no evidence as to how rapidly oil companies would adjust their reserve planning to new levels, and the 3-year period used above was somewhat arbitrary. The important thing, whether the transition would be 1 year or 4 years, is that it could be expected that the Erickson technique of explaining the change in drilling would show a higher price coefficient than would the CONSAD technique.

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[19] D. W. Jorgenson, "Capital Theory and Investment Behavior," 53 American Economic Review 247 (May 1963), also R. E. Hall and D. W. Jorgenson, "Tax Policy and Investment Behavior," 57 American Economic Review 391 (June 1967).

The CONSAD technique appears to be preferable as a method of analyzing the long-run effect of changes in the tax provisions on the level of oil reserves, which presumably is the principal concern of the provision. A further reason for preferring the CONSAD technique is that the Erickson's technique handles only indirectly an important long-run aspect of the problem. If the price of oil should turn unfavorable so that reserve drilling is reduced relative to current production, and if this continues to prevail for several years, then this will itself mean that the stock of known reserves will fall relative to current output and thus reserves will become more valuable, creating an improved incentive to go looking for them. This factor tends to reduce the initial decline in drilling and again to suggest that Erickson's way of formulating the problem, which shows short-run effects, should reflect a higher price effect than CONSAD's way. Granted the different approaches, the results seem broadly consistent.

### E. INCREASED SALES OF SUCCESSFUL WELLS

A further possible reaction to the removal of the favorable tax provisions relating to oil and gas is that oil drillers would sell successful wells and the proceeds would be realized at capital gains rates.[20] This is a different kind of effect than the three discussed earlier since this implies that drillers can change their financial operations, that is, realize capital gains, so as to reduce the dollar impact of removing percentage depletion.

To evaluate this possibility we need to estimate the net receipts that the oil driller will obtain if he operates the well with percentage depletion, operates the well with only cost depletion, or sells the well and realizes a capital gain.

*1. Operation with percentage depletion*

Assume a successful well with estimated reserves having a discounted wellhead value of 100, a life of 20 years, and estimated discounted lifting costs of 23.[21] The discounted value of percentage depletion would be 27.5.

*Operation with percentage depletion*

| | |
|---|---|
| Discounted gross income | $100.00 |
| Less discounted lifting cost | 23.00 |
| Less discounted percentage depletion | 27.50 |
| Discounted before tax net income | 49.50 |
| Less tax (48 percent) | 23.76 |
| Discounted after tax net income | 25.74 |
| Discounted net receipts (25.74+27.50) | 53.24 |

If the oil driller operates the well with percentage depletion, the discounted net receipts would be the sum of the discounted after tax net income plus the discounted percentage depletion, or $53.24.

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[20] This is emphasized by A. Harberger, "Taxation of Mineral Industries," in Federal Tax Policy for Economic Growth and Stability, Joint Economic Committee, 1955, pp. 439–448 and by P. Steiner, "Percentage Depletion and Resource Allocation," in Tax Revision Compendium, Committee on Ways and Means, 1959, pp. 949–966.

[21] The estimate of discounted lifting cost of 23 is obtained by dividing the estimated lifting cost per barrel of $0.68 for the period around 1960 from Adelman by the constant dollar average field price per barrel of $2.93 from the Bureau of Mines, Adelman, M. A., "Oil Production Costs in Four Areas," Proceedings, Council of Economics, American Institute of Mining Engineers, 1966.

*2. Operation with cost depletion*

Further assume that the true cost depletion base is $5.50.[22] If the oil driller operated the well with cost depletion, the discounted value of the depletion deduction would be less than $5.50. Since cost depletion is calculated by the unit of production method and since oil wells typically produce a large proportion of total life-time output in the early years of the well, it is assumed that the discounted value of the cost depletion is $4.00.

*Operation with cost depletion*

| | |
|---|---|
| Discounted gross income | $100.00 |
| Less discounted lifting cost | 23.00 |
| Less discounted cost depletion | 4.00 |
| Discounted before tax net income | 73.00 |
| Less tax (48 percent) | 35.04 |
| Discounted after tax net income | 37.96 |
| Discounted net receipts (37.96+4.00) | 41.96 |

If the oil driller operates the well with cost depletion, the discounted net receipts of $41.96 would be significantly less than the $53.24 under percentage depletion, the difference of $11.28 representing the tax benefit of percentage depletion.

*3. Sale of well*

If the oil driller sells the producing well, he will realize a capital gain represented by the difference between the sale price and the true cost basis of $5.50. The dollar magnitude of the capital gain depends on how much a willing buyer would pay for this producing well. If the well is sold under competitive conditions, the sale price will just equal the discounted net receipts of the buyer. In short, the sale price will equal the discounted gross income minus the discounted lifting costs minus the discounted taxes. The discounted taxes depend on the discounted cost depletion which in turn depends on the sale price.

*Sale of well (and operation with cost depletion based on sale price)*

| | |
|---|---|
| Discounted gross income | $100.00 |
| Less discounted lifting cost | 23.00 |
| Less discounted cost depletion | 44.78 |
| Discounted before tax net income | 32.22 |
| Less taxes (48 percent) | 15,47 |
| Discounted after tax income | 16.75 |
| Discounted net receipts (16.75+44.78) | 61.53 |

The sale price is equal to the discounted net receipts, or $61.53. This cost can be depleted over the life of the well. If the discount factor is the same as assumed above in discounting the $5.50 of true cost depletion for the oil driller; that is, 4.00/5.50 equals .727, then the discounted cost depletion for the new owner would be $44.78 (.727×61.53).

Thus, a competitive buyer would be willing to pay up to $61.53 for a producing well expected to yield $100 discounted gross income with $23 of discounted lifting costs and cost depletion based on the selling price. If the well is sold, the cost basis for depletion is stepped up from $5.50 to $61.53.

---

[22] G. Stigler's estimate of the excess of depletion claimed over true cost depletion is 80 percent. Therefore, one-fifth of the percentage depletion would be equal to true cost depletion. Thus in the example above where discounted gross income is assumed to be $100, true cost depletion would be $5.50 (.20×27.5). The cost basis would be higher if expensing of intangibles were not allowed.

*Calculation of capital gain*

| | |
|---|---|
| Sale price | $61.53 |
| Cost basis | 5.50 |
| Capital gain before taxes | 56.03 |
| Less taxes (25 percent) | 14.01 |
| Capital gain after taxes | 42.02 |
| Net receipts (42.02+5.50) | 47.52 |

From these examples it appears that discounted net receipts of the oil driller will be $53.24 if the well is operated by the oil driller with percentage depletion, $41.96 if the well is operated by the oil driller with true cost depletion, and $47.52 if the well is soid and capital gain realized.[23] Therefore, if the percentage depletion were not allowed, there would be an incentive to sell producing wells.

The conclusion that the removal of percentage depletion would lead to increased sales of successful wells can be utilized in several directions:

(*a*) The effect of complete removal of percentage depletion on enterprises engaged in exploration and development will be moderated by the opportunity to convert discoveries into capital gains. As much as half the apparent increase in taxes resulting from restricting drillers to cost depletion could be recouped by them were they to sell and realize capital gains.

(*b*) In order to effectively eliminate any tax preference to this industry, the tax law would have to consider that gains from the sale of successful wells by a driller be considered ordinary income, since he is in the business of selling oil wells, or that gain from the sale of successful wells is ordinary income to the extent of previous deductions of drilling expenses.

The calculations above made a particular assumption about the sales price in relation to the expected gross income. If selling prices typically run lower than this, the capital gain prospect would be less attractive relative to continued operation.

### F. OVERALL COMMENTS ON EFFECTS

The most completely worked out estimates of the effects of removing the special benefits for oil and gas, assuming no price, royalty, or cost offsets, are those of CONSAD, which suggest a longrun decline in known oil reserves of 3 percent from repeal of percentage depletion and 7 percent from elimination of both percentage depletion and the immediate deduction of intangibles.

On its own terms the CONSAD estimate is too high in that it assumes zero offset through higher prices, lower royalties, or cost reductions. While none of these possible offsets can be estimated precisely, a judgment that they would reduce the profit impact by a half would seem modest.

On the other hand, the CONSAD study, given all the practical difficulties that beset statistical studies, may involve either an underestimate or an overestimate of the tax effect under the assumption of no price, royalty, or cost offsets. The issue is uncertain. It may be pertinent to observe that judging the effects of percentage depletion is

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[23] In this last case where the well is sold and the capital gain realized and the new owner obtains a high basis for cost depletion, the tax revenues total $29.48 (the sum of $14.01 on the capital gain and $15.47 by the buyer who operates the well), midway between the $23.76 tax in case 1 with percentage depletion and the $35.04 tax in case 2 with cost depletion.

hard because the provision has not been changed in the period for which we have data regarding the industry. If one is impressed with the uncertainty of any estimate, this would not suggest doing nothing but rather changing percentage depletion, either up or down, to see what happens.

This chapter dealt only with direct effects on the oil and gas industry. The significance of these effects to the United States is dealt with in the next chapter.

## Chapter 3.—Evaluation of the Results of Decreasing Tax Incentives to Oil and Gas Drilling

Chapter 2 described several possible economic effects of a major change in the tax provisions relating to oil and gas. It remains to say something about the importance of these effects from the standpoint of national policy.

### 1. PRICE AND ROYALTY EFFECTS

On balance the United States does not gain by tax provisions which increase the income of royalty recipients. Already royalty rates on oil and gas far exceed royalty rates on other minerals. It must be noted, however, that the U.S. Government is the largest recipient of lease bonuses from its ownership of naval and Continental Shelf oil lands.

It would also appear that the United States has nothing to gain by continuing tax provisions which merely reduce the price of gasoline, petrochemicals, or natural gas. The whole logic of the free market system argues for the users of gasoline and other forms of energy paying the full price. In a free market economy consumers can best make rational choices if they are confronted by prices that cover full costs. Considered from the standpoint of possible price effect, the present situation can be regarded as unfairly favoring oil and gas over competing forms of energy and thus inhibiting the market in performing its function of the rational allocation of resource development.

### 2. IMPLICATIONS OF THE FISHER-ERICKSON AND CONSAD ESTIMATES

The longrun implications of the CONSAD estimates of tax changes on the level of longrun annual reserve development are rather small. Presently, known recoverable oil reserves are about 12 times the annual output (reserves about 36 billion barrels, output 3 billion). Output has been rising at the level of about 3 to 4 percent a year (if we ignore the bulge in output associated with Suez). Oil companies have maintained a level of exploration and development, such as to increase known reserves each year by an amount equivalent to the reserves used up by production plus an amount about 12 times the increased production. (Since World War II the ratio has fluctuated between 13 and 11.) With growth at 3 percent a year, the longrun average level of new reserves developed would have to be about 1.36 times annual production.[24] If the desired reserve stock fell by 8.3 percent from 12 times annual production to 11 times annual production (which is slightly higher than the 7 percent decline predicted by CONSAD

[24] That is 1.0 times production for replacement plus 12 times .03 to cover growth.

from repeal of both percentage depletion and expensing of intangibles), the longrun annual increase in reserves would be 1.33 times annual production, a decline of 2.3 percent. Roughly the decline in drilling expenditures would be about the same level.

In addition to this long-run effect there would be a one-time reaction to the lower level of desired reserves when the multiple of reserves to production drops.[25] Theoretically, a drop of about 8.3 percent in the level of reserves to output (i.e., a multiple of 12 to a multiple of 11) could be accomplished by stopping all exploration for a year. This is hardy likely to happen since companies would want to keep their "exploration teams" intact, would not want to lose good prospects to competitors, etc. An indication of this adjustment is given by the experience since the boom in drilling during the Suez crisis left oil companies with a reserve level of about 13 times output, and it took them about 5 years to reduce this to a more normal 12 times. If an adjustment from 12 to 11 were spread over 5 years, the decline in drilling would be about 20 percent for 5 years and then about 2.3 percent below the levels that could be expected without any change in the tax provisions.

These are merely numbers and thus are hard to interpret. It is useful, therefore, to consider the favorable tax provisions relating to oil and gas as equivalent to a subsidy and then examine the question of how the cost of the subsidy pays off in additional reserves.

In these terms we should use the longrun estimates of the revenue cost of the provisions, $1.3 billion for percentage depletion and $0.3 billion for expensing intangibles. (This means putting aside the additional transition effect of removing the tax provisions, which effect would be due to the fact that taxpayers would have virtually no tax basis on current investments.)

An estimate that the percentage depletion deduction reduces the desired reserve level by 8.3 percent (which, as explained above, means a 2.3-percent difference in the long-run annual reserve finding level) means that the annual outlays on exploration and drilling would be lower by about 2.3 percent. Since the annual outlays at current levels are about $4.5 billion, then the reserve finding expenditures resulting from the tax provisions should be below $0.15 billion. This can be compared wtih the revenue cost of $1.6 billion for the combined tax benefit—that is, one-tenth of the revenue loss goes to additional drilling.

This result is not inconsistent with an observation that could be made by an oil driller that he uses most of his present tax saving in investment. The point would be simply that the resulting investment *in oil and gas reserve finding* is only $0.15 billion higher than it would have been. The rest of the tax saving could be invested in refining or general diversification, or it could serve to make the industry less dependent on outside capital sources than would normally be expected.[26]

In any case the indicated result suggests a rather low payoff for the revenue foregone, and the payoff would be low even if it were three or four times larger than the indicated $0.15 billion.

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[25] This is the same point that was referred to in the comparison of the Erickson and CONSAD estimates in the last chapter.

[26] The oil industry is generally less dependent on outside capital sources than other industries because of its higher cash flow.

Another way of putting this in comparative terms is to utilize a current industry figure that reserves in the ground sell at about 33 percent of the expected wellhead value of the reserves as they are drawn out.[27] Since new reserves developed annually are about 4.5 billion barrels and the current oil wellhead price is about $3, this implies a market valuation of the addition to reserves of $4.5 billion. This suggests that the Federal Government is paying, in tax benefits, about $1.6 billion for resources which the market values at $0.15 billion (3.3 percent of $4.5 billion). Even if the supply response was considerably higher than the CONSAD and Fisher-Erickson estimates, the market value of the extra oil reserves developed would be less than the revenue foregone.

The foregoing has compared the loss from total percentage depletion with additional oil reserves despite the fact that some of the depletion goes to gas well drilling. The procedure is followed because (1) the CONSAD report estimates no drilling response from gas tax benefits and (2) general market considerations suggest that gas tax benefits are completely reflected in gas prices.

### 3. POSSIBLE TAX STRUCTURE BIASES OPERATING ON OIL AND GAS WELL DRILLING

The literature on oil and gas taxation includes discussion of various ways in which the tax structure may, by itself, be distorting oil and gas well-drilling decisions. One argument suggests that oil and gas well-drilling would tend to be discouraged by the existence of a nonintegrated corporate tax and thus some compensating allowance is called for. The other argument suggests ways in which the tax structure tends to overstimulate exploration and development even apart from the general percentage depletion effect analyzed by Fisher, Erickson, and CONSAD.

#### *a. The capital intensity of oil and gas*

An argument developed by McDonald holds that oil and gas well drilling is a high-risk capital intensive industry and that the existence of a nonintegrated corporate tax imposes a penalty on various industries according to their risk and capital intensity. He concludes that unless offset by some special allowances this would tend to distort downward the investment in oil and gas well drilling compared to what it would be in a neutral tax system.[28] In his latest article [29] McDonald appears to conclude that for the domestic oil industry his argument suggests a percentage depletion rate of 14 percent. He further indicates that various criticisms of this modified position have "some validity," and that the importance of his argument also rests on an assumption that the general corporate income tax is not shifted forward in price.

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[27] Cited in the recent Interior Department study on oil reserves

[28] This thesis was advanced by Stephen McDonald in "Percentage Depletion and the Allocation of Resources: The Case for Oil and Gas," 14 "National Tax Journal 323" (December 1961). There ensued an extensive debate with critical views expressed by Musgrave, Steiner, and Eldridge. A detailed bibliography on this literature is provided in S. McDonald's "Percentage Depletion, Expensing of Intangibles, and Petroleum Conservation" in "Extractive Resources and Taxation," Mason Gaffney, Editor 1967, in which McDonald sums up his views and makes some concessions to his critics.

[29] In the Gaffney volume at p. 284.

The debate on the McDonald thesis itself has not given adequate attention to the possibility that an opposite bias arises from the treatment of immediate expensing, discussed below in *b*.

*b. The expensing of intangibles on exploration*

The risk character of oil and gas well drilling introduced a peculiar tax advantage to this activity which has been recognized in the literature.[30] On general economic grounds, and abstracting from taxes, one would expect relative investments in different industries to proceed until the rate of return at the margin was equal (or reflected the preferences of investors about risk, etc.). As applied to exploratory oil and gas well drilling compared to, say, a steel plant, this would suggest that resources should be invested in oil and gas exploration until the marginal return on resources invested was the same as the marginal return on building steel plants. Exploratory oil and gas well drilling has the peculiarity that about 1 in 10 wells is successful so that some kind of marginal equivalence would come about in this fashion: the expenditure of $100,000 in drilling 10 exploratory wells would, on the average, produce one successful well which would have a value of $110,000, and the expenditure of $100,000 in building a steel plant would create a business prospect worth $110,000.[31] But the technological feature that tends to favor drilling is that the cost of the nine dry holes would be immediately written off, even though in the large the expense of nine dry holes is part of the cost of one producer. The rule of permitting deduction for dry hole costs, therefore, indicates that in oil and gas well drilling 90 percent of the capital cost is written off as incurred while the capital cost of the steel plant would only be recovered through depreciation over its life. Ample tax literature supports the point that a 90-percent writeoff in 1 year is an enormous advantage under a tax rate of 48 percent. This argument is not advanced to recommend denying the deduction for dry hole costs but only to note that this feature alone causes a tax system without any other special benefits for oil and gas to favor these activities. This early write-off advantage for exploration tends to offset the effect of McDonald's point about capital intensity. In exploration activity, the *unrecovered* capital investment is small.

*c. A note on risk*

In the literature favoring percentage depletion the argument is sometimes advanced that the allowance is necessary "because of risk." The problem involved is highlighted by the previous discussion which at least suggested the risk feature.[32] Even if one in 10 exploratory wells is successful, one driller of 10 or 20 wells could have no successes. This would be irrelevant if businessmen were completely unemotional about risk, that is, if they regarded an outlay of $100,000 on 10 wells each with a one in 10 chance of a payoff of $110,000 as exactly equivalent to a sure thing payoff of $110,000 on an outlay

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[30] A. Harberger, "Taxation of Mineral Industries," supra and P. Steiner, "Percentage Depletion and Resource Allocation" in "Tax Revision Compendium" vol. 2, Committee on Ways and Means, 1959, pp. 949–966.

[31] We assume that there would be an excess of value over cost to provide a normal return.

[32] An extensive analysis of the risk problem is presented in C. Jackson Grayson, Jr., "Decisions Under Uncertainty—Drilling Decisions by Oil and Gas Operators." The techniques for spreading and thus reducing risk which Grayson describes are numerous.

of $100,000. Presumably businessmen are willing to pay something to avoid risk, or equivalently, that they would want a better payoff on a risky investment than one which would on the average cover the risk plus normal return. One question on this asks why the Government should deliberately set out to offset this risk. If businessmen are reluctant to undertake risk, the price of the product produced under risk conditions ought to reflect this, just as it would reflect any other circumstances that made businessmen reluctant to enter a particular line.[33]

Another comment is that if percentage depletion were concerned with the risk problem it should apply at a lower rate for large firms since risk can be reduced by large repetition of the risky event. If the probability of success of a well is one in 10, then for a driller of 20 wells the probability of having only one or no successes (half the expected number) is about .29 (29 chances out of 100). For a driller of 500 wells, the probability of 25 or fewer successes (half the expected number) is less than one in a thousand.[34]

A final comment is that if risk were the problem this would not justify the present percentage depletion provision because it pays off only on success; that is, the reward it bestows has the same risk attached to it as the reward of a successful venture and would also be undervalued by investors. A more rational approach would be to reduce risk by making unsuccessful ventures less expensive; for example, by paying some dry hole costs.

*d. The significance of a higher reserve*

Percentage depletion obviously does not put more oil below the ground. What it does is induce more drilling so that a larger amount of oil at any time is in the category of known (and thus more or less available) reserves. It was indicated that the market value of this increment to known reserves is less than the cost of getting it. What other value does it have to the Nation?

Potentially, this margin of known reserves may have value for defense purposes. This would appear limited since the capacity of presently existing wells considerably outstrips current production rates and refinery capacity. The question is whether more useful ways could be found to produce things of defense potential with a Government expenditure of $1.6 billion per year. It would seem, for example, that this amount spent directly on reserves, transportation, and refinery capacity keyed to defense needs might be more useful. Further, the increasing importance of nuclear fuels, possible synthetic oil from coal or shale, and rocket fuels raises questions about oil needs in the future for defense.[35] In fact the percentage depletion allowance for oil and gas by encouraging petroleum development and thus indirectly handicapping efforts toward development of shale oil and liquefication of coal may be slowing the development of these enormous supplementary fuel sources which could more than meet our strategic needs.

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[33] Note the McDonald thesis discussed above does not say that the risk should be offset but that the extra burden of an unintegrated corporate tax on the extra premium for risk taking constitutes an *added deterrent* to risk taking. We have commented on the literature surrounding this point in section *a*.

[34] This point is developed at greater length in Grayson, op. cit., pp. 270–276.

[35] The authors of "U.S. Energy Policies, Agenda for Research." (Resource for the Future, 1968), argue that the specific national security objective in resource policy has not been seriously formulated and analyzed, pp. 45, 143–144.

*e. General oil "needs" and output*

Some writers have extrapolated oil and gas consumption at rates faster than current growth of supply and have concluded that the resulting "shortage" demands special incentives for production and finding reserves.

From an economic point of view this is illogical. If demand tends to outspace supply, the proper market adjustment is an increase in price. This leaves it to free market choice whether the excess demand will be eliminated by some buyers shifting to substitutes (in view of the higher price) or by producers increasing output (in view of the higher price). In any case a free market can make the proper output adjustments, and Government management of the oil supply is unnecessary. It could be said that in the light of potential shortages a free market will underinvest in research and technology (especially on substitutes) because any one producer who could spend money on research may believe that it is not worthwhile to him because he will not recover much of the benefit. It is conceivable, for example, that a million dollars spent on experiments in hydrogenation of coal would produce in the aggregate a gain of many millions to the society, but each single coal producer may be reluctant to spend this money because even if he is successful he may think that he will increase the value of his coal by less than a million dollars. If analysis of liquid fuel "needs" and supplies indicate this possibility of underinvestment in research, the appropriate response is to introduce Government subsidies for research, or other devices to let coal companies undertake the research collectively. While a free market may in some circumstances underinvest in research, preferential tax treatment of one fuel source would seem to further impede development of substitutes.

## Chapter 4.—Other Government Policies Relating to Oil and Gas

The previous analysis has been directed at the specific question of how prices, exploration, and development in the oil and gas industry might change, given changes in the distinctive tax provisions applicable to this industry, but assuming other Government policies with respect to oil and gas are unchanged. Further, chapter 3 raised some questions as to whether the effects of the provisions were of sufficient value to the United States to be worth their cost.

One could, of course, argue that the effects of the tax provisions on oil and gas exploration and development are higher than the estimates cited; and, whether or not the effects have been underestimated, one could argue that on balance the effects are favorable to U.S. policy interests even after considering the cost of the provisions. These arguments would not by themselves demonstrate that the special tax provisions relating to oil and gas were desirable. The question would remain, "Can these benefits be achieved, at less cost to other taxpayers, by means of some other Government policy?"

With regard to these broad issues of alternative oil and gas policies, the Treasury Department is not in a position to offer final answers. We can, however, raise questions which suggest, at least, that there are alternative polices that could be pursued. A brief survey would

suggest four main areas in which alternative policies might come about. These are:

(1) Management of presently known oil and gas reserves in private hands.

(2) Management of oil and gas reserves in the hands of the Federal Government.

(3) Policy with regard to oil imports.

(4) Policy with respect to alternative liquid fuel sources.

We will comment on each briefly.

### 1. MANAGEMENT OF PRESENTLY KNOWN OIL AND GAS RESERVES IN PRIVATE HANDS

Several commentators have suggested that two effects of State regulation, under which oil wells are operated, are to increase the average cost and to maintain the price. For example:

> An outstanding technical fact about proration is a systematic bias toward producing oil from the less productive wells. Production from flush, low-cost sources is kept severely in check. The limits placed on total production support the price structure under which the high-cost producers can continue to exist, instead of being forced into early abandonment.[36]

Without presuming to say just how State regulations might be changed it is pertinent to note that on balance the profitability of petroleum investment could be enhanced if more efficient production were permitted. Some of the specific directions in which this might be achieved are through wide spacing requirements in wells, revision of proration formulas to assign higher quotas to efficient wells, more encouragement to unitization, etc. (Cf. "U.S. Energy Policies," pp. 37–38.)

It is plausible to expect that revisions in regulation that permitted lower cost operation would enhance profit and thereby provide some stimulus for exploration. The R.F.F. report states "* * * * to a degree the State regulatory systems embody a pattern of disincentives for exploration" (p. 49).

### 2. MANAGEMENT OF OIL AND GAS RESERVES OWNED BY THE FEDERAL GOVERNMENT

Some of the most prolific deposits of crude oil are located in areas that the Federal Government owns or controls. The particular way in which the Federal Government manages its stewardship with regard to these resources will have some effect on the general situation of availability of petroleum production.

The R.F.F. study suggests that there is good reason to review Federal Government policy with respect to both the western lands and the Outer Continental Shelf. The aim should be to investigate ways in which leasing policy could be modified to require more efficient operation and to provide more incentive for exploration. Specifically, it appears possible for the Federal Government to exclude lands on public domain from State regulation. This opens up the possibility that the Federal lands could be used as a laboratory to develop efficient production methods. Such a development would in the long run have

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[36] "U.S. Energy Policies, An Agenda for Research," R.F.F. op. cit., p. 34.

a constructive influence on State systems. (Cf. "U.S. Energy Policies," p. 48.)

If it is thought that a larger backlog of known reserves is needed for potential defense needs, the oil under the Outer Continental Shelf could be managed from a national security standpoint, for example, by providing for exploration but discouraging production.

### 3. POLICY ON OIL IMPORTS

It is said of the oil import policy, as it is often said of the tax provisions relating to oil and gas, that the purpose of the policy is to strengthen the national defense. The cost of the import restrictions to the American public was estimated by a 1962 Report of the Office of Emergency Planning to be around $3.5 billion a year.[37] In the very short term an increase in oil imports might have some implications for the balance of payments. For the longer run it is, nevertheless, a possible policy, that should not be overlooked, that the U.S. could economize significantly by relying more on imported sources for current petroleum needs. From a long-run standpoint, insisting on using U.S. sources to meet current needs reduces oil underground in the United States. The R.F.F. study suggests the desirability of doing research on the possibility of using the savings from increased imports to subsidize exploration in the United States to develop known-reserve stockpiles (p. 46). (Possibly the relaxation of oil import controls could be associated with reciprocal reduction of controls affecting some U.S. exports.)

### 4. POLICIES WITH REGARD TO ALTERNATIVE SOURCES

At least two alternative sources for liquid fuel appear to be near the level of economic feasibility. One process is called hydrogenation of coal, in which hydrogen is added to the hydro carbons in coal in order to make the molecular structure closer to that of petroleum. Another is the retorting of so-called oil shale to produce kerogen. Both of these processes have been conducted experimentally. In both cases the supply of the raw material is very large so that an economical process would assure a very great addition to the supply of liquid fuel. An alternative to present policies would be a massive Federal effort to underwrite large-scale pilot operations in both areas. "U.S. Energy Policies" describes the Government expenditures on shale research as "very small" (p. 126) and on coal research as "exceedingly small" (p. 77).

### 5. CONCLUSIONS ON ALTERNATIVE POLICIES

Other natural resources policies besides the tax provisions have major effects on oil reserves, prices, and utilization. Various policy changes and combinations of changes offer promising possibilities for meeting all our needs, including national security. These various policies and combinations should be the subjects of careful research and consideration.

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[37] Cited in U.S. Energy Policies, p. 45.

# IX–B. SUPPLEMENTARY MATERIAL: TAX TREATMENT OF TIMBER

## 1. Present Treatment of Timber Income

Income derived from the increase in the value of standing timber is, in general, taxed as capital gains. Prior to 1944, only the taxpayer who sold his timber in a lump sum or sold his timber and land outright was entitled to pay tax on the increase in value of the standing timber at the preferential capital gains rates. In contrast, the taxpayer who cut his own timber or sold it under a cutting contract in which he retained an economic interest, such as a so-called pay-as-cut contract, paid tax on the increase in value at ordinary income tax rates. The Revenue Act of 1943 extended capital gains treatment to the taxpayer in either of these latter two situations. (Sec. 631 (a) and (b) of the 1954 code.)

One result of the present capital gains treatment of income derived from the increase in the value of standing timber is a significant revenue loss to the Treasury. In 1965, corporations in the lumber and paper industries reported $443.4 million of long-term capital gains. This represented a tax savings for the corporations of $102 million.[1] The capital gains provisions lead to an effective tax rate of 29.6 percent for the lumber industry, and 39.9 percent for the paper industry as compared to a 44.4 percent effective rate for all manufacturing except the petroleum and lumber industries.[2]

Partnerships and individuals also report timber capital gains. The 1962 Statistics of Income, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns indicated that in 1962 $114 million gross capital gain was claimed by individuals for timber and coal. These data give no breakdown between timber and coal. The supplemental report does break down capital gains claimed by broad AGI classes. Using estimates of the differential in marginal tax rates between these broad AGI classes, it is estimated that the individual revenue loss in 1962 for coal and timber was $29 million, most of which was for timber.

The total revenue loss to the Treasury in 1965 for corporations, individuals, and partnerships is probably greater than $125 million ($100 million on corporate returns and $25 million on individual returns). This should be compared to the 1966 fiscal year expenditures for forest resources by the Forest Service and Bureau of Land Management of $406 million. The tax subsidy to timber through capital gains in 1965 is at least 25 percent of the direct expenditures for forest resources in the 1966 fiscal year.

The tax advantage of capital gains treatment of timber accrues mainly to large corporations and high-income individuals. Small corporations with taxable income less than $25,000 do not benefit from the capital gains provision. In 1965 there were 13,251 corporate returns filed in the lumber and paper industries. Of these, the 16 corporations with assets over $250 million reported 64.8 percent of the long-

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[1] The statistics of income data do not separate timber capital gains from other capital gains. The assumption is that almost all of the capital gains reported by the lumber and paper companies are in fact from timber. In addition, some corporations not in the lumber and paper industries do report timber capital gains.

[2] The effective tax rate is the actual tax, both domestic and foreign, as a percent of taxable income.

term capital gains. The 63 corporations with assets over $50 million reported 80.4 percent of the long-term capital gains. In fact, five companies reported 51.3 percent of the long-term capital gains. The table below gives the capital gain reported as a proportion of taxable income for the years 1962–66 for "an average large firm" distilled from four of these large corporations and for the lumber and paper industries.

TABLE 1.—PERCENTAGE OF TAXABLE INCOME LONG-TERM CAPITAL GAIN, 1962–66

[Dollar amounts in millions]

| Year | Taxable income | Capital gain | Capital gain as percentage of taxable income |
|---|---|---|---|
| Average large firm: | | | |
| 1962 | $33.2 | $29.2 | 88.0 |
| 1963 | 34.7 | 31.4 | 90.5 |
| 1964 | 50.0 | 45.9 | 91.8 |
| 1965 | 50.4 | 49.6 | 98.4 |
| 1966 | 47.5 | 48.9 | [1] 102.9 |
| Industry: | | | |
| Lumber: | | | |
| 1962 | 304.8 | 177.8 | 58.3 |
| 1963 | 367.6 | 181.5 | 49.4 |
| 1964 | 438.5 | 225.8 | 51.5 |
| 1965 | 540.5 | 275.6 | 51.0 |
| Paper: | | | |
| 1962 | 976.3 | 113.7 | 11.6 |
| 1963 | 945.6 | 111.8 | 11.8 |
| 1964 | 1,033.7 | 139.8 | 13.5 |
| 1965 | 1,223.8 | 167.8 | 13.7 |

[1] The possibility of capital gains component being larger than total taxable income is explained below.

The individual returns filed in 1962 with timber and coal capital gains reveal that a disproportionate share of the tax benefit goes to the high-income individuals. Of the 43,977 taxable returns with net capital gain or loss from timber and coal, 3,427 returns or 7.8 percent had adjusted gross income of $25,000 or more. These returns reported 25.4 percent of the gross gains.

### 2. Justification of Present Treatment of Timber Income

Capital gains treatment was provided timber in lieu of an explicit averaging technique and as an incentive device for good conservation. It can be argued that there are alternative ways of handling the lumpiness problem (averaging) and either that the incentive for conservation is not (or no longer) needed or that there are better ways of giving the incentive (for example, through direct expenditures or at least tying the incentive to conservation expenditures).

### 3. Problems of Capital Gains Treatment of Timber Income

There are four main problems associated with the capital gains treatment of timber income:

(*a*) *Inequity between individuals or corporations owning timber and those with other income sources which leads to a misallocation of investment*

The basic economic argument against the present tax treatment of income from timber growing is that investment in business assets should be treated neutrally. The favorable tax treatment of timber in-

creases the profitability of investing in timber and leads to a distortion of investment away from other industries to the timber industry. However, the increased investment in timber does not necessarily imply increased conservation expenditures. Under present law, capital gains treatment is allowed regardless of whether the taxpayer practices conservation. In fact, fast liquidation operations to make a quick profit at favorable tax rates may be encouraged. This is just the opposite of good conservation practices.

In the long run, a part of the tax advantage might be shifted forward in the form of lower prices for timber products and part of the tax advantage might be shifted backwards in the form of higher prices for land suitable for timber. Therefore, in the long run, after-tax profits in timber might be no higher, given the risks, than after-tax profits in other industries.

(*b*) *Distortion of timber ownership within forestry*

Small corporations with taxable income of less than $25,000 do not benefit from the capital gains provision because the tax rate on capital gains is 25 percent whereas the tax rate on ordinary net profits is 22 percent. To the extent that integrated firms are successful in shifting manufacturing profits to timber growing to gain the advantage of capital gains over ordinary income tax treatmnt, timberlands will become even more valuable to them. For individuals there is an increasing advantage to timber ownership as taxable income increases because the differential between ordinary and capital gains tax rates increases with taxable income. Therefore, the capital gains treatment of timber income leads to a shift in ownership of timberland away from small corporations and low-income individuals to large or integrated corporations and to high-income individuals.

(*c*) *Inherent difficulty in determining fair market value when the timber owner logs and processes such timber*

When the timber owner cuts his own timber, the determination of the fair market value of the standing timber essentially divides the total taxable income between capital gain and ordinary income. This point is illustrated by several examples.

Let us suppose that a corporate taxpayer in the 50 percent [1] marginal tax bracket cuts its own timber and sells the logs and that the cost basis of the timber is $5 million, the logging costs are $7 million and the selling price of the logs is $20 million. In absence of capital gains treatment of timber income, the taxpayer would have $8 million of income taxed at ordinary tax rates ($8=$20--$7−$5). It thus would have a tax liability of $4 million.

However, under section 631(a), the difference between the fair market value of the standing timber on the first day of the taxable year in which it was cut and the cost basis of the timber is considered for tax purposes a capital gain. Thus let us further suppose that an estimate of the fair market value for the timber is $11 million. The taxpayer would then have a capital gain of $6 million ($6=$11−$5). It has ordinary income of $2 million ($2=$20−$7−$11). The $8 million of taxable income in the first example has been divided between

[1] The 50-percent marginal tax rate was chosen so as to simplify the exposition.

$6 million of capital gain and $2 million of ordinary income. The tax liability is 25 percent of the $6 million plus 50 percent of the $2 million or $2.5 million. The capital gain provision has decreased the tax liability from $4 million to $2.5 million.

Except as noted below, it is to the taxpayer's advantage to claim as high a fair market value as possible.[1] This increases the capital gain which is taxed at the preferential capital gains tax rates and decreases the ordinary income which is taxed at the ordinary tax rates. For example, if the taxpayer had claimed a fair market value of $12 million instead of $11 million, it would have $7 million of capital gain ($7=$12−$5) and $1 million or ordinary income ($1=$20−$7−$12). Its tax liability would be $2.25 million ($2.25=.25×$7+.50×$1).

The taxpayer can minimize its tax liability if all its taxable income is capital gain. To do this our taxpayer would need to claim a fair market value of $13 million. It would then have $8 million of capital gain ($8=$13−$5) and no ordinary income ($0=$20−$7−$13). All its taxable income would be taxed at the preferential capital gains tax rates. Thus, the tax liability would be 25 percent of the $8 million capital gain or $2 million.

In the extreme situation where the capital gain exceeds taxable income, the taxpayer can decrease its tax liability by decreasing its capital gains. For example, suppose the fair market value is $15 million. If the taxpayer reports its income using that value, it has a capital gain of $10 million ($10=$15−$5) and ordinary loss of $2 million ($−2 =$20−$7−$15). Under the alternative tax computation, the taxpayer receives no tax savings as a result of the ordinary loss and the tax liability is 2.5 million (2.5 million=.25×10 million). The taxpayer's tax liability has been increased by 0.5 million as compared with the prior case where the capital gain was just equal to taxable income. Thus, if it were to report its income claiming a fair market value of only 13 million, its tax liability would be $2 million computed as in the prior case. Obviously in such a case there is an inducement to report fair market value so as to minimize the tax liability.

It is not unknown for two different taxpayers to claim very different fair market values for similar timber on adjacent tracts. A large integrated corporation with high profits from later manufacturing may claim a high fair market value to minimize the proportion of taxable income taxed at ordinary rates. In contrast, a single product corporation, for example, a lumber producer, with low profits from later manufacturing may claim a lower fair market value for the standing timber. If this lumber producer claimed as high a fair market value as the integrated corporation, it would end up in the extreme situation where the capital gain is greater than the taxable income. Thus, the fair market value which minimizes the tax liability of the large integrated corporation does not minimize the tax liability of the lumber producer. Therefore, it is not surprising that these two taxpayers claim very different fair market values for similar timber.

An examination of table 1 indicates that the average large firm has nearly minimized its tax liability by having almost 100 percent of its taxable income taxed at the preferential capital gains rates. It pre-

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[1] For estate tax purposes, an individual taxpayer would want to claim as low a fair market value as possible.

sumably was the intention of Congress in 1943 to provide capital gains treatment only for the income derived from the increase in the value of standing timber. However, it appears that large integrated corporations with income from logging and later manufacturing are able to shift all their income into the lightly taxed capital gain category. This would not appear to accord with the purpose of the special treatment.

In summary, the determination of fair market value is a valuation question with important tax consequences. The taxpayer has a strong incentive to adjust the fair market value claimed so as to minimize the proportion of total taxable income taxed at ordinary tax rates. It is, therefore, not surprising that the Internal Revenue Service has frequent disagreements with the taxpayers on the determination of fair market value when auditing the returns of large lumber and paper companies.

*(d) Inherent difficulty of allocating expenses between those which may be currently deducted and those which must be capitalized*

There are two tax advantages to current deductions. First, current deductions reduce present taxes whereas capitalization will later reduce future taxes. Current deduction thus leads to an interest saving on the postponed taxes. Second, by deducting against ordinary income the costs necessary to produce a capital gain in timber growth, the taxpayer is able to increase the future capital gain which is taxed at the preferential capital gains rates and to reduce the ordinary income which is taxed at a relatively higher rate. The economic and accounting question is, "What expenses should be capitalized?"

Under tax practices prevailing within the timber industry property taxes, interest on a mortgage, premiums for insuring standing timber against loss by fire or other hazards, contributions to fire protection organizations, protection costs incurred for controlling outbreaks of forest insects or disease are now being deducted. Cost of these types would seem to be costs necessary to carry trees to merchantability and in this view should thus be capitalized and added to the cost basis of the stand of timber. If timber is to be considered a capital asset then all costs going into its creation should be capitalized.

Requiring capitalization of these costs necessary to carry trees to merchantability would in general be consistent with the accounting practices of many firms within the timber industry in their financial reporting to stockholders and to the Securities and Exchange Commission.

## IX–C. SUPPLEMENTARY MATERIAL: TAX TREATMENT OF REAL ESTATE

### I. Introduction

The income tax laws now provide preferential treatment in the real estate field which subsidizes commercial and industrial buildings, hotels and motels, shopping centers, office buildings, and rental housing operators. These preferences consist primarily of highly favorable tax depreciation enhanced by thin equity financing and reduced or deferred taxation of gains on the disposition of the investment. These are frequently combined into varying arrangements called the real

estate tax shelter which not only provides tax-free cash flow but may offer syndicated investors an opportunity to apply excess real estate deductions to shelter other income from tax.

The total revenue cost of this system of tax preferences is difficult to estimate because of the limitations of available data on real estate investment activity and the complex interplay of the relevant tax provisions and real estate transactions. Nevertheless, it is conservatively estimated that some $750 million of revenue concessions attributable to accelerated depreciation plus another $100 million due to favorable treatment of gains on real estate dispositions went into the real estate field at 1967 tax and economic levels.

This memorandum examines these provisions and the cost and effect of the existing preferential tax treatment in the real estate field.

## II. Nature of the Real Estate Tax Shelter

The following reviews the highlights of the provisions giving rise to the real estate tax shelter.

### ACCELERATED DEPRECIATION

The income tax law allows accelerated depreciation methods which the Treasury considers unrealistic for investors in buildings, including industrial buildings, even though they may not be heavily debt-financed or involved in the artificial tax shelter arrangements which frequently appear in other real estate areas.

For new buildings, as on machinery and equipment, the law permits the use of the 200-percent declining balance and sum-of-the-years digits methods. The former permits the annual writeoff of the original cost of a building at a rate equal to twice the corresponding straight-line rate. An approximately similar pattern of writeoff is allowed under the sum-of-the-years digits method. For used buildings, the law and regulations permit the 150-percent declining balance method, which provides a rate equal to 150 percent of the corresponding straight-line rate.

The following brief summary indicates the first year, first 5-year, and first 10-year writeoff as a percentage of a building's cost with 25- and 40-year lives and under the four major alternative depreciation formulas:

[In percent]

| | Straight line | | 200-percent declining balance | | Sum-of-the-years digits | | 150-percent declining balance | |
|---|---|---|---|---|---|---|---|---|
| | 25-year life | 40-year life | 25-year life | 40-year life | 25-year life | 40-year life | 25-year life | 40-year life |
| Year 1 | 4 | 2.5 | 8.0 | 5.0 | 7.7 | 4.9 | 6.0 | 3.75 |
| 1st 5-year total | 20 | 12.5 | 34.1 | 22.6 | 35.4 | 23.2 | 26.6 | 17.40 |
| 1st 10-year total | 40 | 25.0 | 56.6 | 40.1 | 63.1 | 43.3 | 46.1 | 31.80 |

### RESALE AT CAPITAL GAIN RATES

After accelerated depreciation begins to run low, the investor may sell the real estate subject to capital gain rates. As a result of the limited recapture rules (discussed later) the gain representing the

excess depreciation is subject primarily to capital gains tax though the depreciation deductions had offset income taxed at ordinary rates. The seller can then repeat the accelerated depreciation process on another new building. The buyer can recommence depreciation with a stepped-up basis on the old property using the 150-percent declining balance method, but with a generally shorter tax life which may give about as favorable a rate as the 200-percent declining balance rate on the original investment.

### ADVANTAGES OF LEVERAGED FINANCING

In combination with leveraging—use of a high ratio of mortgage debt to the property's cost—the accelerated depreciation advantages are concentrated on a relatively thin equity capital commitment, giving rise to the familiar real estate tax shelter. Under this arrangement, depreciation and mortgage interest not only wipe out the taxable rental income, thus permitting tax-free cash flow from the property, but also give rise to depreciation-caused "tax losses" which can be applied against other income.[1] Where the syndicated or limited partnership form of organization is used, the real estate project's "tax losses" may be taken directly as deductions by the individual participants who may purchase "pieces of the action" at $5,000, $10,000, or $50,000 a project.

### CAPITAL GAINS ON RESALE

Gains on resale of the property—including book gains created by the excess of tax depreciation over the fall off of actual value—are taxable at reduced capital gains tax rates (half the ordinary rate for individuals and in no case higher than 25 percent of the gain for individuals or corporations). On the other hand, any net loss on these and similar transactions is fully deductible against income subject to regular tax rates.[1a] The gains created by excess depreciation on real estate, unlike those on machinery and equipment,[2] are subject only to limited, if any, recapture, as outlined under the next heading. These book profits reflecting the artificial writedown of the depreciable investment by accelerated depreciation represents deductions previously taken against ordinary income, so that the whole process represents a conversion of ordinary income into capital gain for tax purposes.

### LIMITED RECAPTURE OF CAPITAL GAIN DUE TO PRIOR OVERDEPRECIATION

Although the Treasury has recommended stronger recapture of capital gains on real estate which reflect prior overdepreciation, the

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[1] Depreciation, in contrast with other expenses of operating real estate such as utilities, State and local property taxes, and janitorial services, is a deduction for tax purposes but is not an out-of-pocket expense constituting an actual cash outflow from the operating activity. On the other hand, mortgage amortization payments represent a cost payment which is not a tax deduction. However, accelerated depreciation allowances in the early years exceeds by far the relatively low element of principal repayment in the mortgage service. Consequently, depreciation deductions, and particularly those in excess of any current actual loss of the property's value, serve to provide a tax-exemption cover for cash flow, enabling the cash flow to be withdrawn by the investor without being subject to individual income tax. Tax-free cash flow of this type is far more attractive to the high-bracket investor than ordinary dividends or profits.

[1a] Section 1231 of the Internal Revenue Code.

[2] Section 1245 recapture rules adopted in the Revenue Act of 1962 provide that gain on disposition of machinery or equipment is taxable as ordinary income to the extent of all prior depreciation taken on the property since 1961.

modified version of depreciation recapture applied to buildings limits the recapture to gains realized on property held less than 10 years and (except for short-term holdings up to 12 months) to a specified sliding scale percentage of the excess of the depreciation taken after 1963 over straight line.[3] Under this provision, for property held for 20 months of less, the applicable percentage is 100 percent. For property held over 20 months, the percentage is 100 percent minus 1 percentage point for each full month the property is held over 20 months. If property is held for 10 years or more (120 months or more) the percentage is zero and no portion of the gain is treated as ordinary gain by reason of section 1250.

#### TAX-FREE OR TAX-DEFERRED DISPOSITIONS

Real estate investors also enjoy advantages of tax deferral on their gains through the tax-free swapping rules,[4] installment sale provisions, and the refinancing to withdraw equity capital growth as tax-free borrowing proceeds.

#### DEDUCTIONS FOR MORTGAGE INTEREST AND PROPERTY TAXES DURING THE CONSTRUCTION PERIOD

Another tax advantage to real estate investors involved in new construction is the fact that they can deduct the interest on construction loans and local property taxes incurred during the construction period. In effect these are paid like other building costs largely out of borrowed money, but offsetting these costs against other income provides a tax savings which benefits the equity owners. As a result, owners of a thin equity may enjoy the ability to obtain an early tax-free return of a major part of their equity commitments almost at the outset through these tax deductions.

## III. Revenue Costs

As previously indicated, it is difficult to estimate the overall revenue cost of the real estate tax shelter in its various forms and arrangements, taking into account the fact that while the capital gains tax provides some, although only partial, recoupment of excess tax depreciation it also encourages repeated cycles of sales to restore tax basis and renew the accelerated writeoff process. The inadequate recapture of depreciation-caused gains represents a conversion of ordinary income into capital gains. The tax-free exchange and installment provisions postpone the collection of even capital gains tax.

### *1. Accelerated depreciation*

Looking at the accelerated depreciation provisions by themselves, it is evident that where allowable tax depreciation exceeds the actual rate at which buildings are used up and become obsolescent, income

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[3] Section 1250 of the Internal Revenue Code, adopted in 1964. A special rule provides that for property held for 1 year or less the recapture rule applies to the entire amount of post-1963 depreciation taken on the property, not just the excess over straight line.

[4] No gain or loss is recognized for income tax purposes upon the exchange of business or investment property solely for property "of a like kind" to be held for use in business or for investment. Under this provision, an exchange of real estate for other real estate qualifies as a "like kind" exchange. Where cash or other "boot" is also involved, the gain is taxable only to the extent of the cash or other boot received. See section 1031 of the Internal Revenue Code.

tax liabilities are deferred resulting in revenue reductions. It is estimated that this involves a current revenue cost of about $750 million, of which $250 million relates to rental residential investments and some $500 million to other kinds of real estate, including industrial and commercial buildings, hotels and motels, shopping plazas, and the like.

In view of the Nation's concern with housing construction goals, it seems worthwhile to examine in more detail the rough estimates of the breakdown of the $750 million revenue cost or "tax expenditure" by destination:

Some $500 million as just indicated is used for tax advantages for motels, office buildings, shopping centers, and commercial and industrial construction of all kinds.

As much as another $100 million is used for continued tax advantages for older housing which is undergoing its second, third, or fourth round of depreciation writeoffs at rates above straight line.

Probably another $100 million goes for relatively recent housing construction in the semiluxury or luxury highrise category.

Only about $50 million feeds directly into the process of rewarding investors who currently or recently have made commitments increasing the low- and moderate-income housing supply.

*2. Capital treatment on gain reflecting prior overdepreciation*

Capital rather than ordinary gain treatment on gains reflecting prior depreciation probably represents annual revenue losses of about $75 million.

*3. Installment payment and other tax deferment procedures*

Still another $25 million annual revenue is probably involved in the continuous (from the social viewpoint) tax deferment arising from the tax rules permitting installment reporting of capital gains on real estate, tax-free exchanges, and mortgage refinancing as a technique for cash withdrawal of appreciated equity in real estate investment.

## IV. Effects of Present Real Estate Tax Rules On Construction

It is virtually impossible in the present state of the economic art to reach reliable quantitative estimates of the effect of the present preferential tax provisions on construction and housing supply. Lacking quantitative measures of these effects of the millions of "tax expenditure" dollars now being spent to assist building generally and housing in particular, what are the qualitative effects?

In broad outline, the effects of the Federal income tax assistance seems to show the following pattern:

The tax assistance provided, through accelerated depreciation and capital gain treatment, for building investors generally and landlords, presumably tends to encourage construction and rental housing supply in the aggregate but by unknown amounts; the a priori effect one would logically expect—after all, millions of tax dollars are being provided annually—cannot be reliably measured either in terms of building in the aggregate, housing generally, or low-income housing.

In the housing field the tax stimuli are probably more effective for luxury and moderate-income rental housing where profitability and appreciation prospects relative to risk are inherently more attractive than in lower income housing.

The "trickle down" supply effect for the lower income rental housing market is apparently slow and uncertain in a growing general housing market.

Capital and other resource demands engendered by the existing tax stimuli probably tend to expand luxury housing, commercial, office, motel, shopping center, and other forms of more glamorous investment, squeezing out lower income housing.

The investor tax stimuli depend on and are sensitive to favorable financial leverage and interest rates relative to rents, so that they are turned on and off abruptly with abrupt changes in monetary policy; as a consequence, investors apparently rank loan-term factors high and ahead of taxes in deciding whether to invest.

The tax benefits are not focused on new construction but are spread over repeated turnover of older properties; this may support the market and prices for older housing, but the beneficial feedback to new construction incentive is probably not proportionate to the revenue cost.

The present treatment seems to create a tax environment favorable to frequent turnover which tends to discourage long-range "stewardship" and adequate maintenance; it also encourages thin equities and unsound financial structures which could topple if the market for real estate and rental housing weakened.

The tax stimuli probably aid new construction more than improvement or remodeling of existing housing since it appears that remodeling of risky low-income projects cannot be conventionally financed as well as new housing.

## V. Other Effects

### A. INCOMPATIBILITY WITH AN EQUITABLE TAX SYSTEM

The cost of tax incentives for building—residential and other—cannot be counted solely in terms of revenue aggregates. It has a compelling significance in terms of its impact on individual taxpayers, on the sharing of Government costs under a system supposedly dedicated to progressive and equitable tax principles, and on the phenomenon which so frequently discredits the American income tax system—the individual with hundreds of thousands or even millions of dollars of income who makes little or no contribution to the Nation's revenue resources.

*1. Real estate operators*

The Treasury recently examined a sample of tax returns of taxpayers (more aptly termed "nontaxpayers") engaged in real estate operations who enjoyed substantial income receipts.

As an illustration of what this examination showed, out of one group of 13 individual returns for the year 1966 depreciation losses reduced the Federal tax liability of nine of them to zero and of two

others to less than $25. In the aggregate, the 13 taxpayers studied—all of whom had substantial gross incomes—reported capital gains on real estate of $1,260,000, depreciation deductions of $462,000, and net rental losses of $370,000 after deducting all expenses and depreciation.

Over a 7-year period one taxpayer had capital gains (chiefly from real estate sales) of over $5½ million, and dividends, management fees, and other income of nearly $2 million—a total income of about $7½ million. Yet because he had real estate losses arising from depreciation deductions, he paid only $800,000 in taxes, an average effective rate of 11 percent. Eleven percent is the effective tax rate paid annually by a married wage earner (two children) with around $10,000 of income.

*2. "Passive" investors in real estate*

The above taxpayers represented individuals actively engaged in real estate operations. What about the larger group of "passive" real estate investors—investment bankers, corporate executives, stockbrokers, and other high-bracket individuals who participate in syndicates leasing buildings of various kinds?

The Treasury has also examined the returns of a number of passive real estate investors for 1964. Almost without exception, the real estate investments were made through syndicates or limited partnerships which leased the property, often to substantial business enterprises.

On the average, these taxpayers showed a wage or salary income of $140,000 and reported real estate deductions in excess of real estate income of $77,500, which offset other income. On the average, these real estate investors paid tax on only 53 percent of what would have been their taxable income except for the real estate losses. This average loss of $77,500 resulted in average tax savings of about $45,000 per taxpayer or 58 percent of the loss. Depreciation and interest expenses amounted to $1.47 for each dollar of real estate income reported.

These investors presumably systematically sought and exploited unreal tax losses from real estate. The unreality of these tax losses is indicated by the fact that the cash rentals exceeded all cash expenses plus mortgage amortization payments so as to provide a favorable cash return to the taxpayers, calculated at over 10 percent on equity, on the basis of reasonable assumptions as to the depreciable base and financing.

*3. Capital gains on disposition*

The Treasury has also studied a number of sales transactions in which gains on real estate were reported. Nearly all of the properties had been depreciated under accelerated methods [1] and had operated at a "loss" for tax purposes during an average holding period of 4 years. The properties were sold at an average price in excess of original cost. Many of the gains reflected pre-1964 depreciation not subject to section 1250 recapture. But even if these section 1250 limited recapture rules had been fully applicable to the gains, about two-thirds of the prior depreciation deductions would not have been recaptured by sec-

[1] A great preponderance of the taxpayers used the 200-percent declining balance method.

tion 1250 at ordinary rates but would have been reported as capital gain. To be more specific, if section 1250 had been fully applicable, about 70 percent of the gain would still have been capital gain and about 70 percent of that capital gain would have been attributable to prior depreciation deductions on the properties.[1] This indicates the inadequacy of the recapture under section 1250.

More detailed tabulations relating to the cases studied by the Treasury relating to passive investors, capital gains on real estate dispositions, and the tax losses and capital gains of real estate operators are presented in the accompanying appendix A.

### B. INCOMPATIBILITY WITH BUDGET CONTROL AND EXPENDITURE ALLOCATION

The present special tax provisions for construction and housing investment have an annual revenue cost of approximately $850 million. This is roughly the amount of tax expenditures—the revenues forgone—due to these special provisions.

The direct expenditures (exclusive of net lending) in the Federal budget to assist private building construction will come to about $500 million for the fiscal year 1969. Thus the amount of budget resources used for buildings in the form of tax expenditures is over one and one-half times as large as comparable direct expenditures.

To sum up on the effects of the present system of accelerated depreciation and related tax treatment of real estate operators and investors—the real estate tax shelter—the system—

is costly and inefficient as a means of getting more housing or other construction;

offers no assurance that construction resources are directed to priority needs; indeed—it may be surmised—it diverts promotional talent, capital, and other resources into forms of building which are less essential than many basic housing needs;

is basically incompatible with the operation of a fair tax system and the important objectives of tax reform; and

is also incompatible with budgetary responsibility since it involves substantial tax-expenditure commitments via the revenue side of the budget which escape the tests and controls of sound modern budgetary procedures.

## VI. Some Historical Background on Accelerated Depreciation

These observations on the wisdom of the present depreciation system for buildings are reinforced by its historical background.

The present accelerated methods were intially adopted in 1954 with industrial machinery and equipment primarily in mind. Acceleration of depreciation for buildings in 1954 appears to have been a happenstance, coming along as an inadvertent appendage to the liberalization directed at machinery and equipment. No conscious decision was made to adopt the present system as a useful device to stimulate building or

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[1] Thus, about 80 percent (70 percent times 70 percent, or roughly half, plus the 30-percent ordinary gain recognized under sec. 1250) would represent prior depreciation.

to provide us with more or better housing, let alone lower income housing. The present tax system for buildings just happened.[1]

This "inadvertency" in the extension of accelerated provision to buildings, however, has created a variety of unanticipated problems. Because of the typically high rates of debt financing in real estate, the advantages of acceleration based on the entire depreciable cost loom much larger relative to a thin margin of equity capital. The availability of the accelerated methods for buildings has thus created a variety of tax problems: Deferral of tax; conversion of ordinary income into capital gain; tax-free dividends; spillover of depreciation losses against other income; the phenomenon of the negative tax on real estate earnings with the result that the after-tax income from real estate is greater than the before-tax income; and the development of all the exaggerated forms of tax avoidance inherent in the debt-financed real estate tax shelter.

## VII. Treasury's Previous Efforts To Correct Accelerated Depreciation for Buildings and Recapture Rules

In his tax message of 1961, President Kennedy recommended that capital gain treatment be withdrawn from gains on the disposition of depreciable property, both real and personal, to the extent of prior depreciation allowances.

It was felt that such gain reflects depreciation allowances in excess of the actual decline in value of the asset and under the proposal would be treated as ordinary income. Any gain due to the portion of selling price in excess of the cost of the asset would still be treated as capital gain. This reform, it was indicated, would eliminate an unfair tax advantage which the law gave to those who depreciate property at a rate in excess of the actual decline in market value and then proceed to sell the property, thus, in effect, converting ordinary income into a capital gain. It was felt that this reform was particularly essential at that time in view of the impending administrative revision of depreciation guidelines.

Under the Revenue Act of 1962, in response to the President's recommendation, gain on the disposition of depreciable personal property and certain other property which is eligible for the investment credit was treated as ordinary income to the extent of depreciation taken after 1961. Initially, the House failed to act on the President's proposal as it applied to real estate, for reasons described in Secretary Dillon's statement before the Senate Finance Committee in April 1962 on the 1962 legislation as due largely to "difficulties in reaching a consensus on the appropriate remedy * * *. There nevertheless appears to be recognition that excessive depreciation in the real estate

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[1] Dan Throop Smith, one of the prime architects of the 1954 liberalization, has said, in commenting on the need for further liberalization for machinery and equipment as of 1961 (prior to the 1962 guideline revision and the investment credit) : "It is not needed for real estate, depreciation allowances on which are probably too liberal. These allowances might even be reduced, though the repeal of the capital gains provision may take care of the worst of the present unfair tax advantages achieved through real estate transactions." Smith's remarks clearly indicate the primary concern in 1954 with liberal tax depreciation on machinery and equipment, in his words "the most important form of depreciable property from the standpoint of industrial productivity." Dan Throop Smith, "Federal Tax Reform," McGraw-Hill Co., New York, 1961, ch. 6, p. 157.

area is a serious problem and that some action is required." [1] He further indicated that it would be unwise to delay action and renewed his recommendation for remedial legislation at that time. Secretary Dillon specifically recommended that depreciation with respect to all real estate hereafter acquired be limited to an amount not in excess of the depreciation allowed under the straight-line method. He indicated that accelerated depreciation applied to real estate is not an appropriate measure of decline in value. Real estate, he said, unlike personal property, does not generally suffer unusually heavy depreciation in the early years of its life.

Secretary Dillon further suggested that, while gain on the sale of all real estate should be treated as ordinary income to the extent of depreciation after 1961, to meet the assertion of real estate investors that such ordinary income treatment would operate peculiarly in the real estate area to lock them into their investments after a long period of time, such treatment could be subject to a sliding-scale cutoff. Under the sliding-scale cutoff recommended by Secretary Dillon in 1962, gain would be ordinary income to the extent of 100 percent of all depreciation taken after 1961 in the case of real estate held for 6 years or less. The cutoff would begin for real estate held for more than 6 years prior to disposition and the percentage of depreciation to be treated as ordinary income would be reduced by 1 percentage point for each month the property was held in addition to 6 years. This reduction would, therefore, accumulate to 100 percent after 8⅓ years, thus providing full capital gain treatment regardless of prior depreciation after a total holding of 14⅓ years.

Since no action was taken by the Congress to provide recapture of excess depreciation on real estate, the administrative revision of depreciation guidelines in 1962 was confined, in effect, to personal property. While guideline lives were provided for buildings, they were essentially the same as those in Bulletin F with the exception of farm buildings.

There the matter rested for a short time, but in President Kennedy's 1963 tax message he specifically referred to necessary definitional changes in the capital gain area. He indicated that details regarding specific proposals in this area, including real estate gains, would be presented by the Secretary of the Treasury. In the list of definitional changes mentioned by the President were "real estate tax shelters, which are giving rise to increasingly uneconomic investment practices and are threatening legitimate real estate developments."

Following the President's message, Secretary Dillon recommended that depreciation on future acquisitions of real property should not exceed that allowed under the straight-line method and that the provisions of section 1245 of the Internal Revenue Code adopted in 1962 with respect to capital gain treatment on the sale of depreciable equipment should be extended with appropriate modifications to depreciable real estate. The technical explanation accompanying Secretary Dillon's statement described a sliding-scale cutoff to provide a special treatment for long-term investments in real estate. The sliding-scale cutoff recommended by the Secretary in 1963 utilized the same 6- and

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[1] Revenue Act of 1962, "Hearings Before the Committee on Finance, U.S. Senate," 87th Cong., 2d sess., p. 1, p. 88.

14⅓-year cutoff periods which he had described in his earlier statement before the Senate Finance Committee on the Revenue Act of 1962. The action taken by the Congress in 1964 watered down the recommendations made by the administration. The House bill and the final legislation in 1964 provided that if a building is sold within 1 year after its acquisition, any gain up to the amount of post-1963 depreciation taken on the building is to be treated as ordinary income. It further provided that if the building is sold during the first 8 months of the second year, gain is to be treated as ordinary income to the extent of the excess of depreciation taken over straight-line depreciation. Beginning with the 21st month after acquisition, the excess of actual depreciation taken over straight-line depreciation which is to be treated as ordinary income would be diminished by 1 percent per month. Thus, after 10 years, any gain would be treated as long-term capital gain except that major improvements were to be treated as having a separate holding period.

It was estimated that this provision would increase revenues by $15 million a year. By contrast, the 6-year, 14⅓-year cutoff plan directed at the entire amount of prior depreciation since the effective date plus limitation of future acquisitions to straight line which had been recommended in 1962 had been estimated as adding about $80 million to tax receipts.

## VIII. Work of the Douglas Commission (National Commission on Urban Problems) on Real Estate Taxation

The Douglas Commission (National Commission on Urban Problems) has devoted considerable attention to the tax treatment of real estate in the form of rental housing property particularly for people of low and moderate incomes and in the urban ghettos. This section of this memorandum gives the highlights of the Douglas Commission work in this area with some of the Commission's findings and recommendations which appear in its recently released report.

One of the Douglas Commission's studies, The Federal Income Tax in Relation to Housing (the Commission's Research Report No. 5),[1] suggested a package tax reform in the real estate investment area which would incorporate the following set of interrelated changes:

Limitation of depreciation on all buildings to a straight-line basis, in order to lessen motives for quick turnover.

Provision of liberalized depreciation guideline lives on buildings, in keeping with the machinery and equipment life system.

Establshment of full recapture rules to backstop the easing of depreciable building lives.

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[1] Prepared by Richard E. Slitor while he was on leave from the Treasury to serve as a Professor of Economics at the University of Massachusetts in Amherst.

Allowance of an investment tax credit for new construction and major structural rehabilitation, suitably tailored to the building life and to the extent of mortgage financing.

In view of the special risks and deterrents to investment in low-income housing and rehabilitation of older residential properties, such a balanced reform package might well include some type of differential benefit for such outlays, if that is feasible without requiring a highly detailed and selective certification procedure.

This proposed approach would tend to equalize tax incentives—now focused heavily upon luxury and highrise development—and distribute the interest of private enterprise more evenly over the whole housing field. It should also eliminate existing tax incentives toward excessive property turnover. Revenue gains in areas where taxpayer advantages now produce little or no new investment could thus be employed to provide tax benefits for desirable housing construction.[1]

The Douglas Commission Research Report No. 5 also recommended a kind of incentive plan called a supplementary allowance approach designed to stimulate the better upkeep and rehabilitation of old rental housing. This plan would permit, subject to some limitation, the current expensing for income tax purposes of all expenditures on improvement and rehabilitation as well as repairs and maintenance on rental housing structures of 30, 40, or 50 years of age and, in addition, would cut back on the depreciation ordinarily allowable on such property unless matched by expenditures for repair and improvements.

The Commission report endorses the objectives of the tax reform package outlined in its research study but indicates that the Commission is not prepared either to endorse this particular plan or to offer a similar plan. It indicates that the whole area needs further careful exploration as promptly as possible. Accordingly, the Commission made as its recommendation No. 1, a U.S. Treasury study, described as follows:

> The Commission recommends that the President direct the Treasury Department to make an intensive analysis and submit explicit findings and recommendations concerning tax law changes best suited to provide materially more favorable treatment for investment in new residential construction (including major rehabilitation) than for other forms of real estate investment.[2]

The second recommendation of the Commission is concerned with tendencies of the tax law to reinforce underlying conditions which inhibit sound maintenance and rehabilitation of old rental housing, especially in deteriorating city neighborhoods. Thus with respect to "tax incentives for upkeep of older rental housing":

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[1] The Federal Income Tax in Relation to Housing, National Commission on Urban Problems, Research Report No. 5, pp. 104–105.

[2] This and the subsequently quoted recommendations of the Douglas Commission appear in its report, part IV, Investment Structure, Finance, and Taxation, chapter 7, "Federal Income Taxation and Urban Housing," pp. 20–22.

The Commission recommends that the Internal Revenue Code be amended to provide specific incentives for adequate maintenance and rehabilitation of rental residential property by allowing, within appropriate limits, for especially generous tax treatment of investor-owners' expenditures for these purposes with respect to structures of more than some specified age, such as 30 or 40 years.

In this regard, the Commission report cites as one specific plan the supplementary allowance approach discussed in its Research Report No. 5.

Although the Commission report earlier pointed out the defects of the tax incentive approach to housing problems and indicated that the Nation's efforts in this area should rely primarily upon direct types of subsidies, it nevertheless recognized an important potential role for the income tax system. This role consists of reinforcing those subsidy programs by which the Federal Government seeks to attract private capital for construction and rehabilitation of low- and moderate-income housing on a limited-profit basis. Accordingly, in its recommendation No. 3, for "tax incentives for low- and moderate-income housing investment":

The Commission recommends prompt revision of the Federal income tax laws to provide increased incentives for investment in low- and moderate-income housing, relative to other real estate investment, where such housing is governmentally subsidized and involves a legal limit upon the allowable return on investors' equity capital. Specifically, we propose that the Internal Revenue Code be amended to provide especially favorable treatment (whether through preferential depreciation allowances or through investment credits) for investments made under governmentally-aided limited-profit programs for the construction and rehabilitation of low- and moderate-income housing.

Still other findings and recommendations of the Douglas Commission are concerned with more effective taxation of the "unearned increment" in land values, both at the State and local property tax level and through various provisions of the Federal income tax laws.[1]

Specifically, the Commission report recommends that the President direct a Treasury Department study of means by which Federal taxation might be used to recoup a materially increased portion of increases in land value along with published findings and specific recommendations on this subject. The report mentions as possible types of Federal action differentially higher taxation of gains in land value and a specially tailored "transactions tax."

In regard to State action the Commission recommends that the State governments vigorously explore the desirability and feasibility of placing new or differentially higher taxation on land values or land value increments.

Supplementary views on the taxation of land values submitted by Chairman Douglas and three other members of the Commission take a stronger position than the Commission as a whole with respect to the

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[1] See pt. IV, chap. 6, of the Commission report entitled "The Need for New Approaches to Land Value Taxation."

taxation of land or location values and make some suggestions which might involve the Federal income tax as well as the State property taxes.

## IX. Contract Studies for Treasury

Studies undertaken under contract with the Treasury by academic economists at the University of California have indicated, among other things, that debt financing leverage and other financial factors tend to be more important than tax factors per se in determining the profitability of real estate investment projects. These studies have also indicated that whatever reduction in the rate of return to investors would be involved in eliminating the accelerated depreciation formulas for real estate could be offset by a combination of somewhat shorter depreciable lives in combination with the straight-line method and a moderate investment credit. There is good reason to believe that a more effective program can be developed along these lines at less cost in terms of revenue and the equity of the tax structure. In particular, it seems desirable to focus incentives more effectively on new construction, thus avoiding the continuing revenue erosion which accompanies the repeated turnover of used real estate properties with step-up of tax basis at capital gains rate and multiple rounds of overliberal depreciation.

Recognizing the importance of the real estate sector of the economy generally and of low and moderate income housing in particular, it is nevertheless evident from the foregoing that the present structure of tax provisions for real estate seem ill-suited and costly. Moreover, it provides individuals with an unwarranted and excessive escape from tax liabilities. Clearly, a new set of tax provisions together with suitable nontax measures that meet proper tests of efficiency and effectiveness are required.

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## APPENDIX A

This appendix consists of three tables with explanatory comments.

Table 1 shows detailed information concerning the group of taxpayers which were classified as real estate operators in the text.

Table 2 gives detailed information on the income position, tax liabilities, and tax savings of the passive investors in real estate discussed in the text.

Table 3 reports information concerning certain sales of real estate included in the cases studied by the Treasury. It is divided into two sections. The first page summarizes cases where sale of improvements was reported with the sale of the underlying land. The second page reports on sales where the taxpayer reported the land sales separately. The final column on this page aggregates all the cases.

TABLE 1.—SAMPLE OF REAL ESTATE OPERATORS FOR 1966

| Taxpayer | Wages and income from non-real-estate investments [1] | Excess of real estate deductions over real estate income [2 3] | Taxpayer's share of excess of deductions over income of real estate partnerships | Capital gains on sales of real estate [1] | Total of all items [1] |
|---|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) | (6) |
| 1 | $37,670 | $18,980 | $2,150 | $44,800 | $61,340 |
| 2 | (60,240) | 94,110 | 0 | 90,380 | (63,970) |
| 3 | 108,840 | 196,250 | 213,620 | 388,270 | 87,240 |
| 4 | 261,080 | 9,350 | 270,300 | 117,520 | 98,950 |
| 5 | 10,150 | 46,610 | 1,560 | 280 | (37,740) |
| 6 | 229,260 | 3,740 | 322,510 | 117,780 | 20,790 |
| 7 | 226,450 | 2,840 | 198,860 | 32,910 | 57,660 |
| 8 | 8,760 | (10,290) | 0 | 14,300 | 33,350 |
| 9 | (800) | 18,110 | 0 | (47,900) | (66,810) |
| 10 | 2,140 | (11,630) | 0 | 56,040 | 69,810 |
| 11 | 169,440 | (8,270) | 264,080 | 72,950 | (13,420) |
| 12 | (18,550) | 6,830 | 0 | 364,030 | 338,650 |
| 13 | 20,890 | 3,110 | 0 | 8,880 | 26,660 |
| Total | 995,090 | 369,740 | 1,273,080 | 1,260,240 | 612,510 |

[1] Negative figures in this column indicate an excess of deductions over income.
[2] Negative figures in this column indicate an excess of income over deductions.
[3] This column does not include any portion of the losses reported by real estate partnerships in which the taxpayer was a partner.

## Real Estate as Business: Commentary on Table 1

The effects of the tax treatment on the real estate holdings of persons actively engaged in the real estate business can be illustrated by examining in detail the returns of a group of 14 taxpayers, 13 of whom were examined for the year 1966 and 1 of whom was examined for the 7-year period commencing in 1960 and ending with 1966.[1] As noted above, these taxpayers were engaged in real estate operations as a business producing a substantial portion, but not all, of their total income.

The findings for the single year may be summarized as follows: In 9 of the total 13 cases, no tax at all was paid, and in 2 other cases the total tax amounted to less than $25.[2] This group thus shows a combination of investment or other business income, real estate capital gains, and excess real estate deductions large enough to permit many of them either to pay no tax or to pay a tax only at capital gains rates. In 11 of the 13 cases, real estate deductions, including a proper share of real estate losses realized by partnerships in which the taxpayers were partners, exceeded ordinary income from real estate. In 5 of these 11 cases, real estate capital gains were more than the excess of ordinary real estate deductions over ordinary real estate income. In the aggregate, aside from real estate partnership losses, these 13 tax-

[1] The one taxpayer whose activities for a seven year period are reported was chosen from a group of returns from which it appeared that real estate activities were the major, if not the only, business in which the taxpayer was engaged. Such operations were not the only source of income, however. The 13 taxpayers examined for a single year were drawn from a group of returns selected only because one source of reported income was substantially greater than adjusted gross income. Seventeen of such returns indicated that real estate activities were a substantial portion of the taxpayer's total activity, but four of the returns contained deficiencies in information which led to their exclusion from this analysis.

[2] Neither tax liabilities nor taxable income is shown in the table. To reach taxable income the amounts in Column 6 would have to be reduced by the deduction for one-half of long-term capital gains, personal itemized deductions, and personal exemptions.

payers reported (1) depreciation deductions on rental real estate of $462,000 (not shown in Table 1), (2) rental deductions in excess of all rental income by $370,000 (Column 3), and (3) real estate capital gains in the amount of $1,260,000 (Column 5).

In addition, as shown in Column 4, 7 of the 13 taxpayers reported partnership real estate deductions in excess of partnership income by more than $1,270,000, just slightly more than the total capital gains on real estate. On the whole the total for these taxpayers of their other income plus their real estate capital gains less their excess real estate deductions, was over $610,000, as shown in the last column of the table. Indeed, only 4 of the 13 had deductions in excess of income when their outside income and real estate capital gains were added to their excess real estate deductions, and of these four only one (Taxpayer 9) reported a net loss greater than his excess real estate deductions.

What was true of the single year remained true over a number of years. For example, the returns of one taxpayer not shown in Table 1 were reviewed for a 7 year period commencing in 1960 and running through 1966. During that time the taxpayer reported total adjusted gross income of $1,700,000 on which a tax of about $800,000 was paid. This adjusted gross income, however, consisted of capital gains from real estate of $4,330,000, other capital gains of $1,220,000, dividends of $1,110,000, interest of $110,000, management fees and miscellaneous income of $700,000, and an excess of real estate deductions over rental income by about $3,000,000. Thus, the total income before the excess real estate deductions was $7,470,000 on which the total tax was $800,000, an effective rate of about 11 percent. Even after taking the excess real estate deductions into account the effective tax rate was less than 18 percent.

In 3 of the 7 years no tax at all was paid although the capital gain income in those years was over $1,500,000 and included capital gains on real estate of about $760,000. In 2 of the remaining years, when capital gain income—including about $445,000 of gains attributable to real estate—was $850,000, taxes totaling less than $5,000 were paid. In these 5 years as a whole, interest, and miscellaneous income exceeded $1,500,000, but was offset by excess real estate deductions from as many as 70 different organizations, sufficient to reduce taxable income for the 5-year period to slightly more than $130,000. The balance of the tax was paid in two years, in which total capital gains exceeded $3,000,000 and consisted entirely of capital gains from real estate except for $55,000.

A better picture of this taxpayer's operations may be gained by examining a single year in detail. In 1962, capital gains were $1,150,000 which was reported as $575,000 since only one-half of long term capital gain is included in taxable income. In addition, dividend and interest income was about $250,000. These amounts were offset by excess real estate deductions of $863,000, thereby also insulating a $38,000 salary and his other dividends, interest and capital gains from any tax liability and permitting the taxpayer to obtain a refund of taxes withheld from that salary.

TABLE 2.—SAMPLE OF PASSIVE REAL ESTATE INVESTMENTS FOR TAX YEAR 1964

| Taxpayer | Business income | Taxable income | Excess real estate deductions [1] | Taxable income without excess real estate deductions | Tax | Tax without excess real estate deductions | Tax savings | Taxes saved as percent of excess real estate deductions |
|---|---|---|---|---|---|---|---|---|
| 1 | $168,207 | $125,722 | $46,680 | $172,402 | $61,285 | $93,095 | $31,810 | 70.4 |
| 2 | 201,460 | 115,007 | 37,194 | 152,201 | 57,785 | 83,443 | 25,658 | 69.0 |
| 3 | 162,187 | 115,034 | 28,911 | 143,945 | 56,750 | 74,670 | 17,920 | 62.0 |
| 4 | 175,000 | 60,909 | 28,131 | 89,040 | 27,003 | 45,750 | 18,747 | 66.6 |
| 5 | 91,808 | 166,402 | 46,680 | 213,082 | 76,886 | 105,529 | 28,643 | 61.4 |
| 6 | 100,000 | 62,827 | 33,168 | 95,995 | 25,124 | 45,024 | 19,900 | 60.0 |
| 7 | 74,906 | 34,178 | 39,915 | 74,093 | 9,127 | 26,567 | 17,440 | 27.6 |
| 8 | 77,399 | 60,877 | 20,734 | 81,611 | 23,586 | 35,339 | 11,753 | 56.7 |
| 9 | 73,507 | 5,944 | 55,418 | 55,117 | 1,069 | 20,946 | 19,877 | 31.5 |
| 10 | 191,983 | 164,839 | 128,122 | 292,961 | 77,002 | 165,139 | 88,137 | 68.8 |
| 11 | 46,797 | 36,172 | 9,860 | 46,032 | 11,082 | 13,159 | 2,077 | 21.1 |
| 12 | 305,866 | 221,371 | 257,103 | 478,474 | 123,970 | 266,009 | 142,039 | 55.3 |
| 13 | 124,452 | 135,051 | 101,488 | 236,539 | 63,000 | 132,536 | 69,536 | 68.5 |
| 14 | 83,985 | 64,480 | 20,441 | 84,921 | 25,733 | 37,546 | 11,813 | 57.8 |
| 15 | 136,908 | 64,393 | 73,892 | 138,285 | 25,375 | 71,197 | 45,822 | 62.0 |
| 16 | 131,158 | 9,488 | 92,062 | 101,550 | 1,830 | 43,911 | 42,081 | 45.7 |
| 17 | 174,549 | 106,340 | 113,951 | 220,291 | 46,296 | 120,027 | 73,731 | 64.7 |
| 18 | 186,204 | 57,806 | 135,046 | 192,852 | 22,451 | 103 551 | 81,100 | 60.0 |
| 19 | 174,042 | 0 | 204,979 | 193,805 | 0 | 108,182 | 108,182 | 52.8 |
| Total | 2,680,418 | 1,606,840 | [2] 1,473,775 | 3,063,196 | 735,354 | 1,591,620 | 856,266 | 58.1 |

| Taxpayer | Depreciation | Interest | Rent | Depreciation as percentage of rent | Interest as percentage of rent | Total expenses as a percentage of rent | Depreciation as percentage of basis | Interest as percentage of basis |
|---|---|---|---|---|---|---|---|---|
| 1 | $57,596 | $55,406 | $66,322 | 86.8 | 83.6 | 170.4 | ---------- | ---------- |
| 2 | 44,154 | 39,485 | 48,447 | 91.1 | 85.6 | 176.7 | ---------- | ---------- |
| 3 | 60,881 | 54,728 | 86,698 | 70.2 | 63.1 | 113.3 | ---------- | ---------- |
| 4 | 57,171 | 66,864 | 95,904 | 59.6 | 69.7 | 129.3 | ---------- | ---------- |
| 5 | 57,596 | 55,406 | 66,322 | 86.8 | 83.6 | 170.4 | ---------- | ---------- |
| 6 | 54,108 | 57,937 | 78,877 | 68.6 | 73.5 | 142.1 | ---------- | ---------- |
| 7 | 49,525 | 49,819 | 61,821 | 80.1 | 80.6 | 164.6 | 7.92 | 7.97 |
| 8 | 33,664 | 24,102 | 38,604 | 87.2 | 62.4 | 153.7 | 8.20 | 5.87 |
| 9 | 44,034 | 73,572 | 63,158 | 69.7 | 116.5 | 187.7 | 6.98 | 11.67 |
| 10 | 159,616 | 210,421 | 241,915 | 66.0 | 87.0 | 153.0 | 6.86 | 9.04 |
| 11 | 18,550 | 14,561 | 24,112 | 77.0 | 60.4 | 140.9 | 7.62 | 5.98 |
| 12 | 516,424 | 408,407 | 694,834 | 74.3 | 58.8 | 137.0 | 7.35 | 5.81 |
| 13 | 148,301 | 137,851 | 184,664 | 80.6 | 74.75 | 155.0 | ---------- | ---------- |
| 14 | 36,663 | 32,857 | 49,956 | 73.4 | 65.8 | 140.9 | 7.56 | 6.78 |
| 15 | 91,394 | 96,883 | 118,920 | 76.9 | 81.5 | 162.1 | 8.58 | 8.27 |
| 16 | 144,035 | 106,750 | 175,237 | 77.1 | 60.9 | 152.5 | 7.62 | 5.65 |
| 17 | 149,231 | 148,598 | 190,337 | 67.9 | 78.13 | 159.9 | 8.14 | 8.11 |
| 18 | 269,476 | 214,161 | 363,219 | 74.2 | 59.0 | 137.2 | 7.68 | 6.11 |
| 19 | 231,891 | 247,959 | 288,736 | 80.3 | 85.9 | 171.0 | 7.45 | 8.62 |
| Total | 2,224,310 | 2,095,767 | 2,938,083 | 75.7 | 71.3 | [3] 150.1 | 8.15 | 7.63 |

[1] When used in column titles, the term "excess real estate deductions" means the excess of deductions attributable to real estate over the real estate income.

[2] The addition of "taxable income" and "excess real estate deductions" will not total to "taxable income witout excess real estate deductions" because (1) in the case of taxpayer 9 the computation of taxable income without the excess deductions would be affected by the changes in limitations on deductible contributions and medical expenses and (2) in the case of taxpayer 19 his negative taxable income is shown as zero.

[3] Total expenses exceed the total of depreciation and interest because a few cash expenses aggregating less than $92,000 have been omitted.

## Real Estate as a Passive Investment: Commentary on Table 2

This table is based on the 1964 tax returns of a number of stockbrokers, investment bankers, corporate executives, and other taxpayers primarily occupied in fields other than real estate. Their real estate investments were passive investments in syndicates or limited partnerships which leased real estate improvements to major corporations

such as department stores, oil companies, grocery stores, automobile manufacturers, and other blue chip organizations under agreements where the lessees paid all cash expenses except interest and principal on the mortgage debt. Aside from minor administrative expenses, the syndicates incurred no expenses except interest and depreciation. Nor so far as can be ascertained was there any risk beyond the initial equity which in the typical situation would amount to a small percentage of cost,[1] since the portion of cost financed by borrowed funds was borrowed on nonrecourse notes and also because the taxpayers were limited partners in limited partnerships.

The cases are individually analyzed in table 2, but in the aggregate they show:

(1) There was an average income of $141,000 from the major economic activity. Reported taxable income averaged just over $85,000. On the average, real estate deductions exceeded rental income by $77,500. Such excess real estate deductions thus averaged 91 percent of the taxable income. Stated another way, the excess deductions sheltered from tax ordinary income equal to 48 percent of the taxpayer's total amount of income. This portion of the ordinary income which was sheltered by the excess deductions otherwise would have been taxed as ordinary income at an effective rate over 58 percent.[2] These excess deductions resulted in an average net tax savings of nearly $45,000.

(2) Depreciation claimed amounted to 75 percent of the rental income reported. Interest paid was over 71 percent of the rental income. Thus, the ratio of the total of these deductions to rental income was nearly 1.47 to 1. In other words, these real estate deductions—for the most part known and computable before the purchase of the property—exceeded rental income, also predictable, by 47 percent.

(3) Despite the fact that real estate deductions exceeded real estate income, the cash rentals appear to have exceeded all cash expenses plus payments on amortization of loan principal. For example, if the depreciable portion of the properties were fully financed by funds borrowed at a 7.63-percent interest rate (the average interest stated as a percentage of average basis)[3] over a 20-year period, the cash rent would be more than all cash expenses plus equal annual payments on principal. Again, making the conservative assumptions that the that the depreciable portion is fully financed and equal to 80 percent of the cost, the equity supplied by the owners would be 20 percent of cost. On these assumptions the cash available to the owners after payment of all cash expenses and principal amortization would annually exceed 10 percent of their equity investment.

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[1] The proportion of interest paid to depreciable basis suggests that the investments were highly leveraged with a minimum of equity capital.

[2] Of the 19 taxpayers, 4 had an effective tax savings of less than 50 percent of the excess deductions; 4 between 50 percent and 60 percent; 10 between 60 percent and 70 percent; and 1 over 70 percent. In the year under review the top tax rate was 77 percent.

[3] It should be noted that these averages are derived from information taken from only 12 of the 19 taxpayers. As to the other 7, the information concerning basis was reported in a manner which precluded an accurate determination of basis and therefore also precluded computing interest as a percentage of depreciable basis.

TABLE 3.—SELECTED CASES OF CAPITAL GAINS ON SALES OF REAL ESTATE FOR THE YEAR 1962 THROUGH 1965

| | Cases in which land sale was not reported separately from improvements | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | Total |
| Sales price | $1,171,000 | $1,275,000 | $3,215,000 | $1,052,000 | $417,000 | $1,265,000 | $1,930,000 | $2,550,000 | $2,120,000 | $14,995,000 |
| Cost | 1,111,000 | 1,202,000 | 3,041,000 | 1,034,000 | 429,000 | 1,160,000 | 1,846,000 | 2,530,000 | 2,210,000 | 14,563,000 |
| Depreciation | 102,000 | 239,000 | 1,030,000 | 170,000 | 76,000 | 75,000 | 316,000 | 620,000 | 830,000 | 3,458,000 |
| Gain | 162,000 | 312,000 | 1,204,000 | 188,000 | 64,000 | 180,000 | 400,000 | 640,000 | 740,000 | 3,890,000 |
| Sec. 1250 gain | 0 | 26,000 | 0 | 34,000 | 0 | 37,000 | 37,000 | 0 | 10,000 | 144,000 |
| Capital gain | 162,000 | 286,000 | 1,204,000 | 154,000 | 64,000 | 143,000 | 363,000 | 640,000 | 730,000 | 3,746,000 |
| Holding period in months | 24 | 48 | 48 | 12 | 18 | 14 | 48 | 60 | 57 | 37 |
| Depreciation method | S/L | DDB | DDB | DDB | DDB | DDB | DDB | S/L | DDB | ---- |
| Operated at a loss | Yes | Yes | Unknown | Yes | Yes | Yes | Yes | Breakeven | Yes | ---- |
| Depreciation as percent of gain | 62 | 76.6 | 85.5 | 90 | 118.8 | 41.7 | 79.0 | 96.8 | 112.2 | 83.7 |
| Net depreciation [1] as percent of gain | 62 | 68.2 | 85.5 | 72.3 | 118.8 | 21.1 | 69.8 | 96.8 | 110.8 | 79.9 |
| Net depreciation as percent of capital gain | 62 | 76.1 | 85.5 | 88.3 | 118.8 | 26.6 | 76.8 | 96.8 | 112.3 | 83.0 |
| Depreciation as a percent of cost | 9.4 | 19.9 | 33.8 | 16.4 | 17.7 | 6.5 | 17.1 | 24.5 | 37.6 | 22.3 |
| Annual average depreciation as percent of cost | 4.7 | 5.0 | 8.5 | 16.4 | 11.8 | 5.5 | 4.3 | 4.9 | 7.9 | 7.2 |

| | Cases in which land sale was reported separately from improvements | | | | | | | | | Total—All cases |
|---|---|---|---|---|---|---|---|---|---|---|
| | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | Total | |
| Sales price | $1,259,000 | $1,328,000 | $456,000 | $839,000 | $1,076,000 | $572,000 | $30,500 | $381,000 | $5,941,500 | $20,936,500 |
| Cost | 993,000 | 998,000 | 491,000 | 866,000 | 983,000 | 553,000 | 29,500 | 382,000 | 5,295,500 | 19,858,500 |
| Depreciation | 89,000 | 124,000 | 134,000 | 109,000 | 177,000 | 204,000 | 3,200 | 105,000 | 945,200 | 4,403,200 |
| Gain | 355,000 | 454,000 | 99,000 | 82,000 | 270,000 | 223,000 | 4,200 | 104,000 | 1,591,200 | 5,481,200 |
| Sec. 1250 gain | 44,000 | 40,000 | 0 | 0 | 11,000 | 5,000 | 1,100 | 2,000 | 103,100 | 247,100 |
| Capital gain | 311,000 | 414,000 | 99,000 | 82,000 | 259,000 | 218,000 | 3,100 | 102,000 | 1,488,100 | 5,234,100 |
| Holding period in months | 18 | 30 | 24 | 30 | 60 | 120 | 24 | 78 | 48 | 42 |
| Depreciation method | DDB | DDB | DBD | DDB | DDB | DDB | DDB | DDB | DDB | ---- |
| Operated at a loss | Yes | Yes | Yes | Yes | Breakeven | No | Yes | Yes | ---- | |
| Depreciation as percent of gain | 25 | 27.3 | 135.3 | 132 | 65.6 | 91.4 | 76.4 | 100.1 | 59.4 | 80.3 |
| Net depreciation [1] as percent of gain | 12.7 | 18.5 | 135.3 | 132 | 61.4 | 89.2 | 50.0 | 98.1 | 52.9 | 75.8 |
| Net depreciation as percent of capital gain | 14.5 | 20.3 | 135.3 | 132 | 64.1 | 91.2 | 67.7 | 100.9 | 56.6 | 79.4 |
| Depreciation as a percent of cost | 9.0 | 12.4 | 27.3 | 12.5 | 18.0 | 37.9 | 10.8 | 27.5 | 17.8 | 22.1 |
| Annual average depreciation as a percent of cost | 6.0 | 5.0 | 13.7 | 5.0 | 3.6 | 3.8 | 5.4 | 4.2 | 3.7 | 6.3 |

[1] Net depreciation is depreciation claimed less the amount recaptured under sec. 1250.

## Gains on Disposition of Real Estate: Commentary on Table 3

This table is based on a study of a number of sales transactions on which gains were reported. The information which follows represents selected examples of such sales transactions. These sales represent (1) instances in which the taxpayers reported the sale of the land and the sale of the improvements on a combined basis, and (2) cases in which the sale of the improvements and the sale of the land were reported separately. In the latter case, the land sale has not been taken into account in the discussion below. These transactions may be summarized as follows:

(1) The taxpayers held the properties an average of 3½ years out of an average useful life for depreciation purposes of 29¼ years. Double declining balance depreciation was used in 15 of the 17 cases and straightline in two.[1] In 13 of the 17 cases, the properties produced deductions in excess of income; two operated at the breakeven point for tax purposes; one produced a small tax profit; and income data concerning one case was unavailable.

(2) Depreciation deductions averaged 6.3 percent of cost [2] per year resulting in an average write-off of 22.3 percent of the cost over the 3½ year holding period. On the other hand the average gain was 27.6 percent of cost.[3] Stated another way, there was no depreciation in value, even though depreciation deductions had been claimed equal to 22.3 percent of the cost. Instead there was an increase in value; and significantly where gain on the land and improvements was separately reported, the reported gains on the improvements averaged a greater percentage of cost than the reported gains where the gain on the land and on the improvements was not segregated.

(3) The aggregate sales price exceeded aggregate cost (basis before adjustment for depreciation) by about 5 percent. In the five cases where the sales price was less than the cost, the sales price averaged 96 percent of cost. Even in these cases, however, the actual decline in value averaged about 1 percent per year over the average 41-month holding period; whereas depreciation claimed in those five cases averaged 29 percent, or about 8.4 percent per year.

(4) Many of the gains reflected pre-1964 depreciation not subject to section 1250 recapture. However, even if section 1250 recapture had been fully applicable to the gains, about two-thirds of the prior depreciation deductions would have been reported as capital gain. Stated another way, even if section 1250 had been fully applicable, about 70 percent of the gain would still have been capital gain and about 70 percent of that capital gain would have been attributable to prior depreciation deductions on the properties. That is, for all the cases in the sample, about one-half of the capital gain would be excess

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[1] It is interesting that the sum of the years digits method was not used in any case. Where useful lives typically associated with new real estate improvements are used, double declining balance produces a larger deduction in the first year. However, by the end of 3 years cumulative depreciation deductions under the sum of the years digits method exceed those under double declining balance.

[2] In cases where land was not segregated from improvements, cost includes land cost.

[3] Since the sales fell into four different years (1962, 1963, 1964 and 1965), section 1250 of the Code was not applicable to all the sales or to depreciation taken before 1964. However, after eliminating the depreciation recaptured as ordinary income by that section, the depreciation amounted to 21.2 percent of cost while the capital gain was 26.4 percent of cost. In other words only slightly more than 1% of the sales price, less than 4% of the gain, and less than 5% of the depreciation was recaptured.

depreciation deductions; just over one-quarter of the gain would have been recaptured as ordinary income; and just under a quarter of the gain would represent price appreciation. Of the cases in which the land and improvements were not segregated, about one-half of the gain would have been excess depreciation converted to capital gain; just over one-third would have been recaptured as ordinary income; and about one-sixth would have been price appreciation. Where the sale of improvements was reported separately, about 40 percent of the gain would be excess depreciation converted to capital gain, about 20 percent would have been depreciation recaptured as ordinary income, and about 40 percent would be price appreciation.

## IX–D. SUPPLEMENTARY MATERIAL: TAX TREATMENT OF FINANCIAL INSTITUTIONS

### 1. Introduction

The average effective rate of corporate income tax on net income, as usually defined for business purposes, paid by commercial banks, savings and loan associations, and mutual savings banks is substantially lower than the average effective rate for all corporations. In addition, the average effective rate for each of these three types of financial institutions differs substantially.

The tax reform program includes a proposal to eliminate one method of computing the deduction for additions to the reserve for bad debts now granted to mutual savings banks and savings and loan associations. If adopted, this proposal is expected to raise the average effective rate of tax on mutual savings banks to approximately the level being paid by savings and loan associations. This reform recommendation does not, however, cover the larger questions of: (1) should mutual savings banks and savings and loan associations continue to be taxed at a lower effective rate than commercial banks; and (2) should commercial banks, as well as mutual savings banks and savings and loan associations, continue to be taxed at an effective tax rate substantially less than the average for all corporations?

The average effective Federal income tax rate (on a broad income base) for all manufacturing corporations, other than those for whom special tax provisions apply, has been about 43.3 percent in recent years (exclusive of the 10-percent surcharge). For commercial banks, the effective rate has been declining, from about 38 percent in 1960 to probably 22–23 percent in 1967. The decrease is much larger than can be accounted for by the rate reductions in the Revenue Act of 1964 and the investment credit provision of 1962.

Mutual savings banks and savings and loan associations paid very little in the way of income tax prior to 1963 when an amendment in the Revenue Act of 1962 came into effect. Even after this change in the law, the effective rate for savings and loan associations averages about 15–16 percent, and for mutual savings banks about 5 to 6 percent (see tables 1 and 1a).

It should be pointed out, however, that the Treasury Department had prepared a study in 1961 on the taxation of mutual savings banks and savings and loan associations which was in the direction of taxing them on the same basis as commercial banks.

Savings and loan associations and mutual savings banks compete with commercial banks and other financial institutions in attracting savings and in lending. As a result of this situation, the 1961 Treasury study of mutual savings banks and savings and loan associations summarized the tax aspects as follows:

> The reasons which have been advanced in the past for special tax treatment of the mutual thrift institutions no longer seem sufficient to justify a special tax treatment amounting to virtual tax exemption, particularly in the context of the national need for appropriate sources of revenue and the financial strength of these institutions. From the viewpoint of a logical and equitable application of the Federal income tax, the mutual thrift institutions should be able to retain corporate earnings tax free only in accordance with a provision comparable to established concepts for computing bad debt reserves. Possible adverse effects on housing, * * * may justify consideration of alternative methods of taxation over a transitional period or a method of partial taxation which later could be reexamined in the light of future developments in the housing industry, but additional tax revenue can be obtained at this time without significant disruption to the mutual thrift institutions or impairment to national housing programs.[1]

The legislation in 1962 resulting from the recommendations included in this 1961 report provided for more effective taxation of these institutions, leading, as just stated, to Federal income tax rates on a broad income base of about 15–16 percent for savings and loan associations and about 5–6 percent for mutual saving banks.

## 2. Effective Rate of Tax (Tables 1, 1a, and 2)[2]

In making this analysis of the tax burden of the financial organizations, an attempt was made to obtain a measure of their income which would encompass what the organizations really earned after payments to depositors (including depositors of mutual savings banks and shareholders of savings and loan associations in the term "depositors"). This concept is designated "economic income." This term constitutes taxable income with the addition of: tax-exempt interest, 85 percent of domestic dividends received, the amount of deductions for bad debts allowed for tax purposes that is in excess of actual bad debt losses, and the net operating loss carryover.

While there may be good reasons for not taxing all income of the organizations at the full corporate rate (e.g., dividends received), it was thought desirable to start out with a definition of economic income because this makes it possible to obtain a full picture of the effect of special tax provisions as they relate to the organizations.

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[1] "Treasury Department Report of July 1961 on the Taxation of Mutual Savings Banks and Savings and Loan Associations," Hearings before the Committee on Ways and Means on Treasury Department Report, etc., 87th Cong., First sess., pp. 14–15 (Washington, D.C., 1961).

[2] While regulatory agencies publish current statistical data on the three types of financial institutions being reviewed herein, these data are used only when necessary. Instead, primary reliance is placed upon the Source Book of Statistics of Income (SOI). While the data in the different sources often are in relatively close agreement, there are a number of specific cases where the regulatory agencies statistics (Federal Deposit Insurance Corporation, Federal Home Loan Bank Board) differ from SOI. Since these differences could not be fully adjusted or coordinated, it was decided that the basic source to be used should be SOI, since SOI figures are collected from income tax returns and we are interested in the effect of the tax laws. SOI data also have the advantage of providing a more detailed breakdown of receipts and expenses in most cases than the regulatory agencies data—except as to actual losses from loans.

Since SOI data become available with a relatively long lag, this study can not be effectively extended beyond 1966. Regulatory agency data are available, however, through 1967. Table 1a, is inserted to supplement the effective rate of tax computations through 1967, using regulatory agency data for the most recent year. Ratios for 1965 and 1966 from both sources show that the effective rate of tax on economic income as computed from both sources did not differ significantly in those years.

The 1962 legislation revising the taxation of mutual savings banks and savings and loan associations continued the policy of taxing the latter two types of institutions at a lower effective rate than commercial banks through the allowance of a more generous bad debt reserve deduction for mutual savings banks and savings and loan associations. While it was intended that mutual savings banks and savings and loan associations should be taxed less heavily than commercial banks, it was expected that the two types of savings institutions would be taxed on a relatively equal basis. This has not worked out as expected.

The Federal income tax paid by mutual savings banks on 1962 income was only $1.5 million. By 1965 this had increased to $8.2 million but dropped to $7.2 million in 1966. By way of contrast, the $7.2 million tax payment of savings and loan institutions on 1962 income increased to $126 million for 1965 income. For 1966 it dropped to $98 million.

The aggregate amount of tax payments, of course, is really significant only when related to the income against which tax is incurred. If income tax is related to income subject to tax as reported on tax returns, there are differences in the effective rate paid by the three types of institutions, as shown below, but nothing as striking as the difference in aggregate tax paid when related to economic income.

INCOME TAX AS A PERCENT OF INCOME SUBJECT TO TAX

| Year | Commercial banks | Mutual savings banks | Savings and loan associations |
|---|---|---|---|
| 1960 | 47 | 31 | 38 |
| 1961 | 45 | 30 | 39 |
| 1962 | 46 | 22 | 36 |
| 1963 | 46 | 33 | 44 |
| 1964 | 44 | 35 | 41 |
| 1965 | 40 | 34 | 40 |
| 1966 | 40 | 33 | 39 |

Source: Table 1.

The effective tax rates on economic income were as follows:

INCOME TAX AS A PERCENT OF ECONOMIC INCOME

| Year | Commercial banks | Mutual savings banks | Savings and loan associations |
|---|---|---|---|
| 1960 (SOI) | 38 | 0.7 | 1.0 |
| 1961 (SOI) | 36 | .6 | .8 |
| 1962 (SOI) | 33 | 1.1 | .9 |
| 1963 (SOI) | 31 | 2.2 | 16.0 |
| 1964 (SOI) | 28 | 2.7 | 14.8 |
| 1965 (SOI) | 23 | 3.3 | 15.2 |
| 1966 (SOI) | 23 | 6.1 | 16.9 |
| 1965 (FDIC and FHLBB) | 24 | 3.4 | 14.3 |
| 1966 (FDIC and FHLBB) | 24 | 5.6 | 13.2 |
| 1967 (FDIC and FHLBB) | 22 | 4.7 | 13.2 |

Source: Tables 1 and 1a.

The above table shows three important facts. The first of these is that commercial banks have been able to significantly reduce their effective rate of tax since 1960, so that they paid only slightly over 22 percent for 1967. The second is that the 1962 legislation succeeded in

raising the effective rate of tax for savings and loan associations from about 1 percent to the 15–16 percent level. Savings and loan associations are now paying tax at about 60 percent of the rate paid by commercial banks.

As to mutual savings banks, the table shows the 1962 legislation has had no really significant effect. Although the effective rate of tax was raised from the pre-1963 level of 1 percent, the increase was only to 3.3 percent for 1965, and perhaps around 5–6 percent for 1966 and 1967.

The difference between what these banking institutions paid in tax and what they would have paid if they had been taxed at the statutory rate on their economic income is shown for 1955–66 in tables 1 and 2. For 1966 the figures are as follows:

[In millions]

| | Actual tax | Tax on economic income |
|---|---|---|
| Commercial banks | $845 | $1,676 |
| Mutual savings banks | 7 | 54 |
| Savings and loan associations | 98 | 266 |
| Total | 950 | 1,996 |

In the aggregate, full taxation of the income of these organizations would have increased their tax for 1966 by $1 billion, or 109 percent. The increase for commercial banks would have been slightly less than 100 percent and for savings and loan associations about 170 percent. Since mutual savings banks paid only a token amount of $7 million, the increase in this case would have been nearly 700 percent.

## 3. Causes of the Low Effective Rates of Tax

### A. BAD DEBT DEDUCTION

(1) *Deductions compared to actual losses (table 3).*—Attention is first directed to the relation of the allowable bad debt deduction to actual losses and the size of bad debt reserves to uninsured loans.[3] [4] The next section (B) then will integrate the bad debt deduction with the other factors which cause taxable income to be much lower than economic income.

Deductions taken by these financial institutions for tax purposes and actual losses on loans are shown in table 3 for the years 1951 and 1955–66.[5]

One of the most noticeable features of the table is that the ratio of actual losses to uninsured loans by mutual savings banks is only one-fifth to one-tenth that of commercial banks, and even relatively less on total loans. Yet, mutual savings banks (and savings and loan associations) are permitted a much higher bad debt reserve ratio.

[3] These financial institutions do not have to use a reserve system, and a few do not. Although the computations reflect the experience of those companies which use the direct charge off, the text, for the sake of convenience, is phrased as though all units used the reserve approach.

[4] Some uninsured loans also are practically riskless due to the credit worthiness of the borrower or the value of the collateral pledged.

[5] Actual loss figures for savings and loan associations are not available. The loss ratio experienced by mutual savings banks is used a a proxy.

This table also shows that in the period 1955–66 commercial banks were deducting each year for tax purposes between three-tenths and four-tenths of 1 percent of uninsured loans outstanding.[6] Actual losses never reached two-tenths of 1 percent. As a result, in the 12-year period, bad debt deductions of $5.7 billion exceeded actual losses by $3.6 billion, or by 167 percent.

Losses by mutual savings banks were extremely low relative to outstanding uninsured loans. In only 2 years in the period did they exceed two one-hundredths of 1 percent. Prior to 1963, the mutual banks were taking a bad debt deduction for tax purposes of 1 to 1.2 percent per year of outstanding uninsured loans. After the 1962 law went into effect (in 1963), the deduction ratio dropped to less than 0.5 percent by 1966. As a result of the low actual loss ratio and extremely generous bad debt deduction, deductions for tax purposes of $1.3 billion in the years 1955–66 were approximately 50 times the losses of $27 million. For the years 1963–66, following the 1962 amendment, deductions for tax purposes have been about 22 times losses.

Savings and loan associations' tax deductions for bad debts relative to uninsured loans outstanding were 10 to 20 percent higher than those of mutual savings banks during the period 1955–62. The changed rules for such deductions effective in 1963 appear to have brought the deduction ratio for savings and loan associations down to the level to which mutual savings banks also were reduced by the 1962 law. Thus, the 1962 legislation restricted bad debt loss deductions for tax purposes relatively more in the case of the savings and loan associations.

If savings and loan associations had the same loss ratio as mutual savings banks, their deduction for bad debts for tax purposes of $6.1 billion in 1955–66 exceeded actual losses by $6 billion, or by more than 50 times.

In the aggregate, these three groups of institutions took bad debt reserve deductions of $10.8 billion more than losses on loans over the 12 year period. In 1966 alone the excess was $860 million.

(2) *Reserves relative to loans outstanding* (*table 4*).—The bad debt reserve deduction system has enabled commercial banks to keep their bad debt reserve as reported to regulatory authorities at about 2–2.1 percent of uninsured loans from 1957 forward. In 1951 the ratio was only 1.6 percent. Since 90 percent or so of loans by commercial banks are uninsured (as defined for purposes of this study), the bad debt reserve ratio to all loans is only slightly lower.

While some figures for reserves for bad debts are shown in the statistics published by regulatory authorities with respect to mutual savings banks and savings and loan associations, the figures have no relation to what has been utilized for tax purposes. The reason for this discrepancy is that the income tax rules permit the bad debt reserve to be kept in a dual set of books, one for tax purposes and one for bank regulatory purposes. Bad debt reserves for tax purposes of these institutions generally show up in their reports as "surplus"

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[6] The term "loans" encompasses all items classified as "Loans and discounts" in the FDIC *Annual Report*. "Uinsured loans" are all loans and discounts other than FHA or VA insured or guaranteed mortgages and loans to farmers directly guaranteed by the Commodity Credit Corporation. "Uninsured loans" as used herein are larger than those qualified for income tax purposes as recently outlined in Rev. Rul. 68–630.

or "reserves." In any case, practically all of the surplus and reserves of these institutions has been built up free of tax.[7]

Surplus and reserves of savings and loan associations have been about 8 percent of all loans outstanding over the 1955–66 period. For uninsured loans the ratio has been 9 to 11 percent.

The ratio of surplus and reserves to uninsured loans of mutual savings banks is of an entirely different magnitude than that of savings and loan associations. While the ratio has been gradually declining from a high of 42 percent in 1951, it still was 22 percent in 1966. Because mutual savings banks have a high ratio of insured loans to total loans (54 percent in 1966), the ratio of surplus and reserves to total loans is much less. In 1966 the ratio was only 10 percent, having declined over the years from 24 percent in 1951.

### B. OTHER DEDUCTIONS, EXCLUSIONS, AND SPECIAL TAX TREATMENT OF SOURCES OF INCOME (TABLE 5)

The excess of tax deductions for bad debts over actual losses is a principal, but not the only, reason for the low effective tax rates for, and the variation in rates between, these groups of institutions. The favorable and nonparallel treatment of capital gains and capital losses, the exemption of interest income on State and local government securities, and the deduction for dividends received are other provisions which reduce the effective rates of tax and which have an uneven impact on the three different types of financial institutions.[8]

The importance of various types of tax exempt income relative to economic income is shown in table 5. Half of net long-term capital gains is included because the 25-percent tax rate on such gains is roughly equivalent to exempting half of them from the rate of tax on ordinary income.

Several facts stand out in this table. In the case of savings and loan associations, practically all tax-exempt income is the result of the excess bad debt deduction. Practically nothing is derived from tax-exempt interest, dividends, or long-term capital gains. While excess bad debt deductions are the principal source of tax-exempt economic income of mutual savings banks, dividends received are quite important and tax-exempt interest and capital gains are of some significance.

Commercial banks in turn have their own tax-exempt income pattern. Beginning with 1957, tax-exempt interest has always been the most important source of such income. This is followed by the excess bad debt deduction. Dividends received but not subject to tax never have been important sources of exempt income for commercial banks.

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[7] The surplus and reserves figures used to calculate the tax free bad debt reserve ratio for mutual savings banks and savings and loan associations should be adjusted to reflect the fact that minor amounts of tax were paid by mutual savings banks between 1952 and 1966 and by savings and loan associations between 1952 and 1962. The amounts of tax are so minor, however, that it is perfectly reasonable to assume that the organizations were really free of tax. The years 1963–66 are somewhat different in the case of savings and loan associations. In these years the organizations paid an effective rate of tax on economic income of 15–16 percent. Consequently, the tax free bad debt reserve ratio of these organizations should be adjusted downward from the 8-percent level shown in table 4 for these years. However, it is not necessary to try to make such a complex adjustment for it is obvious that savings and loan associations have a tax-free bad debt reserve ratio considerably higher than that of commercial banks.

[8] The deductibility of "interest" on "deposits" in mutual savings banks and savings and loan associations is not included in the list. Such deductibility is taken to be equivalent to the deductibility of interest on deposits in commercial banks, although there is an equity aspect to the deposits in the mutual institutions.

Ordinarily, long-term capital gains have not been of any significance, but there was a slight bulge in this area in 1960–63.

A few trends in the tax-exempt income factors show up. Tax-exempt interest shows an upward trend as a proportion of economic income for commercial banks. Starting at 12 percent of economic income in 1955, it reached 33 percent in 1966. This growth has been the primary cause of the declining effective rate of income tax on commercial banks. Excess bad debt deductions dropped from 13 percent of economic income in 1955 to 5 percent in 1960 and then steadily increased to 13 percent in 1965. A new drop to 11 percent was recorded in 1966.

The importance of tax-exempt interest for mutual savings banks has dropped precipitously in recent years. After having risen to 20 percent of economic income in 1960, it was 5 percent in 1965. Dividends received but not taxed have been a somewhat erratic proportion of economic income, but generally have been 20 to 25 percent of such income—in 1965 they were 23 percent. The excess bad debt deduction prior to 1963 was 65 to 70 percent of economic income but reached 92 percent in 1962. After that it dropped and was only 47 percent in 1965. Long-term capital gains were important in 1959–62 but dropped back to 5 to 10 percent of economic income in 1963–65. The 1966 ratios for mutual savings banks are shown in table 5 but not cited here as they differ greatly from those of more normal years. In 1966, these banks distributed much of their tax-exempt income to depositors which caused tax-exempt income to exceed economic income.

In the case of savings and loan associations, excess bad debt deductions were extremely steady at 96 to 98 percent of economic income from 1955 through 1962. The change in the allowable bad debt deduction as a result of the 1962 legislation reduced the excess deduction to a steady 63 to 65 percent of economic income in 1963–66.

## 4. Analysis

### A. Reserve for bad debts

Section 166(c) IRC permits corporations and individuals to take a deduction for a reserve for bad debts.[9] In the ordinary case, it is the practice of the IRS to permit a taxpayer to maintain a bad debt reserve equal to the ratio of the taxpayer's average year's losses to accounts receivable. The average is computed on the basis of data for the current year and the 5 preceding years. Roughly speaking, the formula permits the (expected) losses of year $x$ to be deducted in the prior year.[10] Since the loss ratio is a moving average, it takes into account (with some lag) changes in the nature of a firm's risk exposure and the business cycle. Industrywide ratios are not utilized.

The general bad debt reserve approach does not permit building up a tax-free reserve to meet catastrophic or unusual losses, except to the extent that such situations enter into the moving average formula for some time after they occur.

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[9] Sec. 582 also permits banks (including mutual savings banks and savings and loan associations) to create a reserve for losses on securities (stocks and bonds), but it is understood that few take advantage of this privilege on their income tax returns.

[10] An alternative concept is that the losses determined to have occurred in year $x$ merely represent losses which were inherent in the transactions at the time they originally took place.

Commercial banks, however, are permitted by administrative ruling a much more generous bad-debt reserve than other taxpayers. Rev. Rul. 65–92 (C.B. 1965–1, 112) granted commercial banks on an industrywide basis the privilege of building up a bad-debt reserve equivalent to 2.4 percent of outstanding loans.[11] [12] If banks were subject to the ordinary bad-debt reserve rule, they would (according to the figures in table 3) be allowed on the average to build up a bad-debt reserve of less than 0.2 percent of outstanding loans other than those insured by the Federal Government.

Without going into the long background of Rev. Rul. 65–92, the history of the ruling indicates that the 2.4-percent ratio is roughly three times the annual average of commercial banks' bad-debt loss experience during the period 1928–47 (which included the most devastating bank losses in modern history).

Mutual savings banks and savings and loan associations are permitted by statute (sec. 593, I.R.C.) to set up a bad-debt reserve account for mortgage loans which has no relationship to the bad-debt experience of the two industries as a whole or the individual institutions.[13] Furthermore, the reserve account computation is not limited to uninsured mortgage loans.

Omitting the numerous qualifications in the law so as to simplify exposition, mutual savings banks and savings and loan associations can be said to have two alternative bad-debt reserve systems available to them.[14] First, they may deduct an amount equal to 3 percent of the increase in their outstanding mortgage loans during the year, provided the deduction does not bring the reserve account above 3 percent of total mortgage loans outstanding at the end of the year. Alternatively, they may deduct 60 percent of net income (before the bad-debt reserve deduction but after distributions to depositors), provided the deduction does not bring the reserve account above 6 percent of total mortgage loans outstanding at the end of the year. There is no requirement that either of the alternatives be followed consistently.

As can be seen from table 3, both the 3-percent and 6-percent rule have no relationship to actual loss experience. Not only are they more generous than the 2.4-percent ratio allowed commercial banks, but since they apply to a larger portion of the assets of the savings institutions than the 2.4-percent ratio for commercial banks, the value of the excess bad-debt reserve deduction is further enhanced for mutual savings banks and savings and loan associations. This effect is indicated below for 1965 data:

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[11] See Rev. Rul. 68–630, C.B. 1968–50, 6, for definition of items includable in the loan base. A bank may establish a higher reserve if use of the 6-year moving average formula available to ordinary firms gives it a higher ratio than 2.4 percent.

[12] The only other industry allowed to use an industrywide loss ratio was SBIC's (small business investment companies). Their temporary industrywide loss ratio was prescribed by Rev. Rul. 64–48 (C.B. 1964–1, 104). This provided that these firms may establish a bad debt reserve equal to 10 percent of outstanding loans for the period through 1968. After 1968, individual SBIC's will be required to use their own loss experience to establish a ceiling on their loss reserve. The use of a temporary industrywide figure was based on the lack of adequate loss experience, SBIC's being a new institution.

[13] Individual associations can use their individual loss experience for building up a reserve if they so wish, but they then will have to operate under the general rule described at the first part of this section.

[14] To obtain the full benefit of the formulas, savings and loan associations must keep a certain proportion of their assets in cash, Government securities, or loans on residential 1- to 4-family units.

MAXIMUM BAD DEBT RESERVE PERMITTED COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, BY LAW OR REGULATIONS, AS PERCENT OF TOTAL ASSETS, 1965

[Dollar amounts in millions]

| | Commercial banks [1] | Mutual savings banks [1] | Savings and loan associations [2] |
|---|---|---|---|
| Assets | $375,394 | $50,500 | $127,474 |
| Uninsured loans | [3] 194,362 | | |
| Mortgage loans | | 39,436 | 108,463 |
| Maximum bad debt reserve permitted: | | | |
| 2.4 percent of uninsured loans | [3] 4,665 | | |
| 3 percent of mortgages | | 1,180 | 3,254 |
| 6 percent of mortgages | | 2,361 | 6,508 |
| Reserve permitted as percent of assets: | | | |
| 2.4 percent of uninsured loans | [3] 1.24 | | |
| 3 percent of mortgages | | 2.34 | 2.55 |
| 6 percent of mortgages | | 4.68 | 5.11 |

[1] Insured by the FDIC.
[2] Members of the Federal Home Loan Bank System.
[3] Slightly overstated as definition of "uninsured loan" used herein includes some items not so included by Rev. Rul. 68–630.

Sources: "Annual Report of the FDIC, 1967;" FHLBB, "Combined Financial Statements of Members of the Federal Home Loan Bank System, 1965."

As to the history of the present treatment of commercial banks, in mimeograph 6209 (C.B. 1947–2, 26), the Department allowed each bank to compute its bad debt ratio by using a 20-year moving average (including the current year as the 20th year) of its losses and to build up reserves to three times the annual average loss ratio. In Rev. Rul. 54–148 (C.B. 1954–1, 60) the Department permitted a commercial bank to use its loss experience for *any* 20 consecutive years after 1927 as the basis for determining the loss ratio to be applied to currently outstanding loans. Then Rev. Rul. 65–92 set forth the industrywide reserve ratio of 2.4 percent. Rev. Rul. 68–630 (C.B. 1968–50, 6) clarified the rules regarding the loan base to which the 2.4 percent is to be applied.

The action of the Treasury Department in 1947 set a precedent in income tax policy. The commercial bank bad debt reserve position of the Department departed from a true measure of income by permitting: (1) the use of quite remote experience as part of the loss ratio norm so as to achieve a larger deduction than warranted by current experience;[15] and (2) the use of a catastrophe reserve (the three times rule).

In substance the present bad debt reserve provisions for commercial banks, mutual savings banks, and savings and loan associations are minomers, and to a large degree are merely techniques for lowering the tax burden of these institutions. This tax reduction intent is quite obvious in the case of the two latter types of institutions where the lower effective tax rate is the result of the law itself. While the reasons were not fully spelled out, it appears that the Congress desired to continue to provide some preferential tax treatment to these institutions and that the way to achieve it was through the bad debt reserve deduction. The Congress presumably was influenced by the two factors that originally had led to outright tax exemption for many years: (1) the

[15] This situation was further heightened by the 1954 action.

use of the two institutions by small savers, and (2) the emphasis on home mortgage loans in the institutions' lending policies. Also probably a factor was the influence of the view earlier advanced that a catastrophe type reserve was needed because of widespread mortgage defaults in the 1930's.

While the Treasury Department also probably granted commercial banks a very generous bad debt reserve provision in 1947 because of a feeling that the place of banks in the economy warranted their being prepared for catastrophic losses of the type incurred in the 1930's, the subsequent two decades of fiscal and financial developments have made this type of reasoning less tenable. As of today, the commercial bank bad debt reserve formula has become more of a tax lowering device than a necessary precaution against catastrophe losses.

The 3-year carryback of net operating losses permitted by law (together with the quick refund procedure) is the procedure available to ordinary firms to recoup taxes paid in good times to meet unexpected or extraordinary losses.[16] If this is not considered sufficient in all cases, the action taken by Congress in 1968 with respect to mortgage guaranty insurance companies points up a way of allowing special reserve treatment to companies or items with exposure to the possibilty of losses on long-term financial contracts while at the same time removing the major tax advantage of excess reserve deductions.

The 1968 legislation (Public Law 90–240) setting forth rules for measuring the taxable income of mortgage insurance companies permits the deduction of all amounts (but not in excess of the lesser of 50 percent of premiums earned or taxable income for the year computed before any mortgage guaranty loss reserve deduction or any carryback of net operating loss) required by State law or regulation to be set aside for a reserve for mortgage guaranty losses. Any part of the guarantee fund not used within 10 years is to be returned to gross income. The legislation, however, recognized that State law and regulations contemplated a reserve to meet catastrophic losses and that inappropriate tax benefits would arise from deductions which were excessive in relation to normal loss possibilities. Therefore, the law provides that the deduction for the guaranty loss account should be permitted only if a company in turn purchased noninterest bearing, nontransferable Federal bonds to the extent of the tax benefit attributable to the deduction of amounts set aside in the reserve for mortgage guaranty losses. This provision thus removes the tax benefit from that part of the reserve required to meet the possibility of catastrophic losses.

### B. CAPITAL GAINS AND LOSSES

Commercial banks, savings and loan associations, and mutual savings banks benefit from nonparallel treatment of long-term capital gains and capital losses on bonds. They are permitted long-term capital gains treatment on gains but are allowed to deduct losses without limit from ordinary income (sec. 582 IRC). This nonparallel treat-

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[16] The bad debt reserve formula accorded all other businesses is sufficient only to meet expected and ordinary losses.

ment of gains and losses on bonds is available only to these banking institutions.[17]

The present tax situation generates security trading by banking institutions to obtain gains from this tax provision. Changes in market conditions and the Federal Reserve System's actions to provide monetary and credit conditions conducive to economic growth, full employment, and stable prices cause price fluctuations in fixed income securities. These fluctuations create the opportunity for banking institutions to achieve tax savings without any economic purpose being served by their portfolio switches. As the net of capital gains and capital losses determines the gain or loss for tax purposes for a particular year, these institutions seek to maximize their tax advantage by realizing only gains in one year and only losses in another. As the market prices for fixed-interest securities rise during periods of easy money, the banking institutions seek to sell securities at peak prices to realize maximum paper gains taxable at 25 percent, but immediately buy similar bonds, notes, or certificates to have a new high basis. When the market prices fall during the next period of tight money, the institutions seek to sell these securities at the bottom of the market, to realize the maximum losses which are deductible against ordinary income taxable at up to 48 percent. The banking institutions immediately reinvest in approximately equivalent issues to maintain their portfolios. When monetary policy has gone full-cycle from easy to tight and back, the banking institution will have realized a substantial tax gain while holding continuously essentially the same security portfolios.

The major rationale offered for the present treatment when adopted in 1942 was to encourage these institutions to support the large new issues of war bonds which were then being offered to finance the wartime Federal borrowing. It is highly questionable whether this special tax provision strengthens the market for Government securities. Whatever value the provision had in World War II has long disappeared with changed economic circumstances.

### C. TAX-EXEMPT INTEREST

Commercial banks are the largest owners of tax-exempt securities, holding $52.6 billion out of $118 billion outstanding at the end of June 1968. The commercial bank holdings of these securities have risen rapidly in recent years from $20.3 billion at the end of 1961, to $33.5 billion in 1964, $41 billion in 1966, $50 billion in 1967, and $52.6 billion on June 29, 1968. Mutual savings banks held about $206 million, and savings and loan associations held only small amounts of State and local securities at midyear 1968. The importance of tax-exempt income for these different institutions is presented in table 5. Especially obvious is the large and increasing significance of tax-exempt interest for commercial banks. The trend has been sharply upward since 1960 and by 1966 tax-exempt interest amounted to 33

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[17] A similar nonparallel treatment exists to some extent in the case of depreciable property used in any trade or business.

percent of economic income. At the same time, the effective rate of tax for commercial banks has declined greatly.

In computing taxable income, these financial institutions currently may deduct all their expenses against income which is subject to tax, with none of their operating expenses, including the cost of borrowed funds in the form of deposits, charged against the tax-exempt interest.[18] In effect, these institutions, and especially commercial banks, borrow funds by paying interest on time and savings deposits and use these funds to acquire tax-exempt securities. Their interest revenue on these securities is exempt from tax, but their interest payments on time and savings deposits is deductible against ordinary income.

### D. DIVIDENDS RECEIVED DEDUCTION

Commercial banks and mutual thrift institutions, as well as other corporations, in general, may deduct 85 percent of the dividends they receive from domestic corporations in calculating income subject to income tax. The purpose of this deduction is to limit triple taxation of corporate income, under our nonintegrated corporate tax.[19]

While triple taxation can occur to some extent for stock institutions, it cannot arise for mutual thrift institutions. So long as these institutions get a full deduction for interest paid, any dividends they receive are taxed to the depositor (shareholder) as interest if distributed, or to the institution if retained. Since these institutions do not pay nondeductible dividends, there is only one layer of taxation beyond the taxes paid by the payor corporation. The same is true for commercial banks and stock savings and loan associations to the extent dividends received constitute part of the income paid out to depositors as deductible interest rather than becoming part of the bank's net income for immediate or eventual distribution to shareholders. Thus, paralleling the situation with tax exempt securities, these financial institutions may now use borrowed funds (deposits) on which interest payments are deductible to buy corporate stock on which 85 percent of the dividends received are in effect tax exempt. As shown by table 5 mutual savings banks have utilized the dividends received deduction as a method of achieving a significant reduction in the effective rate of the corporate income tax. While all corporations could avail themselves of this opportunity to the extent permitted by their charters,[20] nonfinancial corporations would not generally raise capital out of "borrowed" funds to the extent that financial institutions would.

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[18] The Internal Revenue Code at sec. 265(2) provides that interest on indebtedness incurred to purchase or hold tax-exempt securities is not deductible. The legislative history indicates that the Congress did not intend that this provision apply to interest on deposits of banks. The statutory rules for life insurance companies require them to allocate tax-exempt interest (and dividends) between expenses and net income.

[19] Without the intercorporate dividends received deduction, the Federal income tax might apply three times (or more) when one corporation owned shares in another. For example, if corporation A pays dividends to corporation B which in turn pays dividends to its stockholders, the income tax would apply on the net income of A, again to B on the dividend from A, and also to stockholders in B on their dividends. Companies with subsidiaries qualifying for consolidated returns may avoid any tax on intercorporate dividends within the consolidated group. Regulated investment companies and real estate investment trusts which distribute 90 percent of their income (exclusive of net long-term capital gains) within a specified period are not taxed on income distributed to shareholders.

[20] Savings and loan associations, for instance, are severely limited in their right to buy corporate stock.

TABLE 1.—INCOME TAX REPORTED IN "STATISTICS OF INCOME" AS A PERCENT OF INCOME SUBJECT TO TAX AND AS A PERCENT OF ECONOMIC INCOME OF COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1955–66

[Dollar amounts in millions]

| | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Income subject to tax (SOI): | | | | | | | | | | | | |
| A. Commercial banks | (1) | (1) | (1) | (1) | $1,696 | $2,914 | $2,855 | $2,531 | $2,366 | $2,292 | $2,204 | $2,092 |
| B. Mutual savings banks | (1) | (1) | (1) | (1) | $3 | $3 | $5 | $7 | $10 | $15 | $24 | $22 |
| C. Savings and loan associations | (1) | (1) | (1) | (1) | $16 | $15 | $15 | $20 | $264 | $298 | $317 | $251 |
| II. Federal income tax (SOI):[2] | | | | | | | | | | | | |
| A. Commercial banks | $721.6 | $763.3 | $988.4 | $1,215.5 | $807.8 | $1,362.6 | $1,291.7 | $1,168.7 | $1,078.8 | $999.8 | $879.9 | $845.2 |
| B. Mutual savings banks | $1.9 | $1.2 | $.8 | $1.5 | $.9 | $.8 | $1.5 | $1.5 | $3.4 | $5.2 | $8.2 | $7.2 |
| C. Savings and loan associations | $5.6 | $6.7 | $5.9 | $7.3 | $6.2 | $5.6 | $5.8 | $7.2 | $115.6 | $122.2 | $126.0 | $98.1 |
| III. Tax as a percent of income subject to tax: | | | | | | | | | | | | |
| A. Commercial banks | (1) | (1) | (1) | (1) | 47.6 | 46.8 | 45.2 | 46.2 | 45.6 | 43.6 | 39.9 | 40.4 |
| B. Mutual savings banks | (1) | (1) | (1) | (1) | 33.2 | 31.3 | 29.9 | 21.9 | 32.9 | 34.8 | 33.9 | 33.0 |
| C. Savings and loan associations | (1) | (1) | (1) | (1) | 38.5 | 37.7 | 38.6 | 35.5 | 43.8 | 41.1 | 39.8 | 39.1 |
| IV. Economic income:[3] | | | | | | | | | | | | |
| A. Commercial banks | $2,109 | $2,257 | $2,578 | $3,379 | $2,360 | $3,601 | $3,626 | $3,513 | $3,523 | $3,546 | $3,783 | $3,643 |
| B. Mutual savings banks | $132 | $139 | $133 | $182 | $159 | $115 | $237 | $139 | $158 | $190 | $249 | $118 |
| C. Savings and loan associations | $346 | $391 | $398 | $454 | $539 | $539 | $704 | $811 | $723 | $824 | $830 | $579 |
| V. Tax as a percent of economic income: | | | | | | | | | | | | |
| A. Commercial banks | 34.2 | 33.8 | 38.3 | 36.0 | 34.2 | 37.8 | 35.6 | 33.3 | 30.6 | 28.2 | 23.3 | 23.2 |
| B. Mutual savings banks | 1.4 | .9 | .6 | .8 | .6 | .7 | .6 | 1.1 | 2.2 | 2.7 | 3.3 | 6.1 |
| C. Savings and loan associations | 1.6 | 1.7 | 1.5 | 1.6 | 1.2 | 1.0 | .8 | .9 | 16.0 | 14.8 | 15.2 | 16.9 |

[1] Not available.

[2] Figures for 1962–66 are after tax credits; for prior years, tax is gross tax before tax credits.

[3] Economic income includes receipts from all sources less deductions as shown in SOI adjusted by adding the bad debt deduction in SOI and subtracting actual losses as shown in table 3.

Sources: Internal Revenue Service. Statistics of Income, Source Book; Federal Deposit Insurance Corporation, annual report; and table 3.

TABLE 1a.—EFFECTIVE RATE OF FEDERAL INCOME TAX ON ECONOMIC INCOME[1] OF COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1965–67

[In percent]

| | 1965 | 1966 | 1967 |
|---|---|---|---|
| Commercial banks: | | | |
| All banks (SOI) | 23.3 | 23.2 | (2) |
| Insured banks (FDIC)[3] | 24.1 | 23.8 | 22.4 |
| Mutual savings banks: | | | |
| All banks (SOI) | 3.3 | 6.1 | (2) |
| Insured banks (FDIC)[4] | 3.4 | 5.6 | 4.7 |
| Savings and loan associations: | | | |
| All associations (SOI) | 15.2 | 16.9 | (2) |
| Members of FHLBS[5] | 14.3 | 13.2 | 13.2 |

[1] Economic income is receipts from all sources less all expenses. Payments to depositors or shareholders of mutual savings banks and savings and loan associations are considered expenses. The deductions for additions to reserves for bad debts are disregarded and to the extent possible from published data, only actual net losses on loans are deducted.

[2] Not available.

[3] Represent some 99 percent of the assets of all commercial banks.

[4] Represent over 85 percent of the assets of all mutual savings banks.

[5] Represent over 98 percent of the assets of all savings and loan associations.

Sources: SOI Source Book; FDIC annual report; Federal Home Loan Bank Board, Members Combined Financial Statements.

TABLE 2.—INCOME TAX THAT WOULD HAVE BEEN PAID BY COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS IF THEY HAD BEEN TAXED ON THEIR ECONOMIC INCOME, 1955–66

[In millions of dollars]

| | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Economic income: [1] | | | | | | | | | | | | |
| A. Commercial banks | 2,109 | 2,257 | 2,578 | 3,379 | 2,360 | 3,601 | 3,626 | 3,513 | 3,523 | 3,546 | 3,783 | 3,643 |
| B. Mutual savings banks | 132 | 139 | 133 | 182 | 159 | 115 | 237 | 139 | 158 | 190 | 249 | 118 |
| C. Savings and loan associations | 346 | 391 | 398 | 454 | 539 | 539 | 704 | 811 | 723 | 824 | 830 | 579 |
| II. Income tax: [2] | | | | | | | | | | | | |
| A. Commercial banks | 1,054 | 1,128 | 1,289 | 1,690 | 1,180 | 1,800 | 1,813 | 1,756 | 1,762 | 1,702 | 1,740 | 1,676 |
| B. Mutual savings banks | 66 | 70 | 66 | 91 | 80 | 58 | 118 | 70 | 79 | 91 | 114 | 54 |
| C. Savings and loan associations | 173 | 196 | 199 | 227 | 270 | 270 | 352 | 406 | 362 | 396 | 382 | 266 |

[1] Economic income includes receipts from all sources less deductions as shown in SOI adjusted by adding the bad debt deduction in SOI and subtracting actual losses as shown in table 3. No adjustment is made for the investment credit.

[2] A 50-percent rate is used for the years 1955–63, 48 percent for 1964, and 46 percent for 1965–66.

Source: Table 1.

TABLE 3.—DEDUCTION FOR BAD DEBTS, ACTUAL LOSSES ON LOANS, AND RELATIONSHIP TO UNINSURED LOANS AT END OF YEAR; COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1951, 1955–66

[Dollar amounts in millions]

| | 1951 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Deduction for bad debts for tax purposes (SOI): | | | | | | | | | | | | | |
| (a) Commercial banks | $173 | $322 | $441 | $271 | $246 | $283 | $391 | $403 | $492 | $580 | $641 | $831 | $810 |
| (b) Mutual savings banks | (1) | 91 | 94 | 88 | 131 | 115 | 85 | 152 | 130 | 88 | 123 | 119 | 101 |
| (c) Savings and loan association | (1) | 335 | 374 | 383 | 442 | 521 | 531 | 696 | 804 | 490 | 539 | 541 | 421 |
| II. Actual losses on loans: | | | | | | | | | | | | | |
| (a) Commercial banks [2] | 35.3 | 49.8 | 92.7 | 72.1 | 61.5 | 53.7 | 207.4 | 191.0 | 168.0 | 239.4 | 253.4 | 326.2 | 420.6 |
| (b) Mutual savings banks [3] | (.4) | .6 | .2 | 1.0 | .9 | .3 | 1.5 | 1.6 | 1.0 | 5.1 | 2.2 | 3.4 | 9.1 |
| (c) Savings and loan associations [4] | (.8) | 1.9 | .6 | 3.6 | 3.4 | 1.3 | 6.5 | 7.4 | 4.7 | 25.5 | 10.8 | 16.5 | 41.9 |
| III. Deduction for bad debts for tax purposes as a percent of uninsured loans outstanding at end of year: | | | | | | | | | | | | | |
| (a) Commercial banks | 0.331 | 0.430 | 0.533 | 0.310 | 0.269 | 0.273 | 0.352 | 0.340 | 0.369 | 0.389 | 0.378 | 0.424 | 0.378 |
| (b) Mutual savings banks | (1) | 1.178 | 1.115 | .983 | 1.349 | 1.093 | .749 | 1.232 | .930 | .556 | .689 | .586 | .447 |
| (c) Savings and loans associations | (1) | 1.333 | 1.355 | 1.223 | 1.217 | 1.211 | 1.076 | 1.211 | 1.195 | .618 | .601 | .548 | .409 |
| IV. Actual losses on loans as a percent of uninsured loans outstanding at end of year: | | | | | | | | | | | | | |
| (a) Commercial banks | .068 | .066 | .112 | .082 | .067 | .052 | .187 | .161 | .126 | .161 | .149 | .167 | .196 |
| (b) Mutual savings banks | (.007) | .008 | .002 | .011 | .009 | .003 | .013 | .013 | .007 | .032 | .012 | .017 | .041 |
| (c) Savings and loan associations | (.007) | .008 | .002 | .011 | .009 | .003 | .013 | .013 | .007 | .032 | .012 | .017 | .041 |

[1] Not taxed.

[2] Includes net losses on direct chargeoffs and net losses charged to valuation reserves. Loss data for insured banks inflated to U.S. total by applying loss ratio on uninsured loans of insured banks to uninsured loans of all banks.

[3] Includes net losses on direct chargeoffs on mortgage loans and net losses on mortgage loans charged to valuation reserves plus, for 1963–66, net losses on "other real estate." Loss data for insured banks inflated to U.S. total by same method as for commercial banks.

[4] Estimated by applying the ratio of losses on loans to uninsured loans of mutual savings banks to uninsured loans of all savings and loan associations.

Note: Figures in parentheses equal gain.

Sources: (1) Deduction for bad debts for tax purposes from Internal Revenue Service, Statistics of Income, Source Book; (2) actual losses on loans from Federal Deposit Insurance Corporation, Annual Report; (3) uninsured loans from table 4.

TABLE 4.—LOANS OUTSTANDING (INSURED AND UNINSURED), AND BAD DEBT RESERVES OF COMMERCIAL BANKS, MUTUAL SAVINGS BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, 1951, 1955–66

[Dollar amounts in millions]

| | 1951 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Loans outstanding at end of year: | | | | | | | | | | | | | |
| A. Commercial banks: | | | | | | | | | | | | | |
| 1. Insured [1] | $6,631 | $9,439 | $9,587 | $8,875 | $9,625 | $9,484 | $8,396 | $9,536 | $10,290 | $10,774 | $10,573 | $10,927 | $10,143 |
| 2. Uninsured | 52,324 | 74,949 | 82,833 | 87,488 | 91,266 | 103,975 | 111,097 | 118,525 | 133,171 | 149,812 | 169,564 | 195,911 | 214,422 |
| 3. Total | 58,955 | 84,388 | 92,420 | 96,363 | 100,891 | 113,459 | 120,493 | 128,061 | 143,461 | 160,586 | 180,137 | 206,838 | 224,566 |
| B. Mutual savings banks: | | | | | | | | | | | | | |
| 1. Insured [2] | 4,292 | 9,922 | 11,548 | 12,459 | 13,862 | 14,864 | 16,060 | 17,312 | 19,012 | 21,125 | 23,408 | 25,199 | 25,970 |
| 2. Uninsured | 5,751 | 7,758 | 8,448 | 8,978 | 9,724 | 10,489 | 11,292 | 12,315 | 13,934 | 15,791 | 17,901 | 20,313 | 22,480 |
| 3. Total | 10,043 | 17,670 | 19,996 | 21,437 | 23,586 | 25,353 | 27,352 | 29,627 | 32,946 | 36,916 | 41,309 | 45,512 | 48,451 |
| C. Savings and loan associations: | | | | | | | | | | | | | |
| 1. Insured [2] | 3,999 | 7,287 | 8,129 | 8,654 | 9,283 | 10,189 | 10,746 | 11,319 | 11,486 | 11,656 | 11,577 | 11,543 | 11,428 |
| 2. Uninsured | 11,565 | 24,121 | 27,600 | 31,353 | 36,344 | 43,005 | 49,324 | 57,515 | 67,284 | 79,288 | 89,756 | 98,763 | 103,019 |
| 3. Total | 15,564 | 31,408 | 35,729 | 40,007 | 45,627 | 53,194 | 60,070 | 68,834 | 78,770 | 90,944 | 101,333 | 110,306 | 114,447 |
| II. Uninsured as a percent of total loans: | | | | | | | | | | | | | |
| A. Commercial banks | 88.8 | 88.8 | 89.6 | 90.8 | 90.5 | 91.6 | 92.2 | 92.6 | 92.8 | 93.3 | 94.1 | 94.7 | 95.5 |
| B. Mutual savings banks | 57.3 | 43.8 | 42.2 | 41.9 | 41.2 | 41.4 | 41.3 | 41.6 | 42.3 | 42.8 | 43.3 | 44.6 | 46.4 |
| C. Savings and loan | 74.3 | 77.8 | 77.2 | 78.4 | 79.7 | 80.8 | 82.1 | 83.6 | 85.4 | 87.2 | 88.6 | 89.5 | 90.0 |
| III. Bad debt reserves at end of year: | | | | | | | | | | | | | |
| A. Commercial banks | $816 | $1,270 | $1,565 | $1,780 | $1,960 | $2,175 | $2,361 | $2,612 | $2,701 | $3,003 | $3,564 | $4,023 | $4,347 |
| B. Mutual savings bonds [3] | 2,407 | 2,812 | 2,947 | 3,059 | 3,219 | 3,359 | 3,553 | 3,768 | 3,951 | 4,204 | 4,400 | 4,661 | 4,869 |
| C. Savings and loan associations [3] | 1,453 | 2,557 | 2,950 | 3,363 | 3,845 | 4,393 | 4,983 | 5,708 | 6,520 | 7,209 | 7,899 | 8,704 | 9,102 |
| IV. Bad debt reserves as a percent of uninsured loans: | | | | | | | | | | | | | |
| A. Commercial banks | 1.6 | 1.7 | 1.9 | 2.0 | 2.1 | 2.1 | 2.1 | 2.2 | 2.0 | 2.0 | 2.1 | 2.1 | 2.0 |
| B. Mutual savings banks [3] | 41.9 | 36.3 | 34.9 | 34.1 | 33.1 | 32.0 | 31.5 | 30.6 | 28 4 | 26.6 | 24.6 | 22.9 | 21.7 |
| C. Savings and loan associations [3] | 12.6 | 10.6 | 10.7 | 10.7 | 10.6 | 10.2 | 10.1 | 9.9 | 9.7 | 9.1 | 8.8 | 8.8 | 8.8 |
| V. Bad debt reserves as a percent of total loans: | | | | | | | | | | | | | |
| A. Commercial banks | 1.4 | 1.5 | 1.7 | 1.8 | 1.9 | 1.9 | 2.0 | 2.0 | 1.9 | 1.9 | 2.0 | 1.9 | 1.9 |
| B. Mutual savings banks [3] | 24.0 | 15.9 | 14.7 | 14.3 | 13.6 | 13.2 | 13.0 | 12.7 | 12.0 | 11.4 | 10.7 | 10.2 | 10.0 |
| C. Savings and loan associations [3] | 9.3 | 8.1 | 8.3 | 8.4 | 8.4 | 8.3 | 8.3 | 8.3 | 8.3 | 7.9 | 7.8 | 7.9 | 8.0 |

[1] Insured FHA loans, VA guaranteed loans, and (except for 1966) loans to farmers directly guaranteed by the Commodity Credit Corporation.

[2] Insured FHA loans and VA guaranteed loans.

[3] Bad debt reserve is taken to be the sum of "surplus" and "undivided profits and reserves" as reported in balance sheet statements.

Sources: (1) Commercial bank and mutual savings banks data from Federal Deposit Insurance Corporation, Annual Report; (2) Savings and loan data from Federal Home Loan Bank Board, Savings and Home Financing Source Book and Federal Reserve Bulletin.

TABLE 5.—TAX EXEMPT INCOME OF COMMERCIAL BANKS, MUTUAL SAVINGS, BANKS AND SAVINGS AND LOAN ASSOCIATIONS AS A PERCENT OF ECONOMIC INCOME, 1955-66

[In percent]

| | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I. Commercial banks: | | | | | | | | | | | | |
| A. Tax exempt interest | 12.3 | 12.5 | 12.0 | 11.0 | 18.5 | 13.5 | 15.2 | 18.4 | 23.3 | 25.4 | 29.0 | 33.2 |
| B. 85 percent of dividends received | .9 | .8 | .7 | .6 | 1.1 | .6 | .6 | .7 | .7 | .6 | .6 | .7 |
| C. Excess of bad debt deduction over actual losses | 12.9 | 15.4 | 7.7 | 5.4 | 9.7 | 5.1 | 5.9 | 9.2 | 9.7 | 10.9 | 13.3 | 10.7 |
| D. 50 percent of long-term capital gains | 1.2 | .5 | 1.2 | 9.9 | .8 | 4.5 | 6.5 | 3.5 | 2.8 | .9 | 1.6 | .6 |
| E. Total | 27.3 | 29.2 | 21.6 | 26.9 | 30.1 | 23.7 | 28.2 | 31.8 | 36.5 | 37.8 | 44.5 | 45.2 |
| II. Mutual savings banks: | | | | | | | | | | | | |
| A. Tax exempt interest | 12.8 | 16.3 | 14.8 | 13.0 | 16.1 | 20.4 | 10.1 | 13.2 | 9.3 | 6.5 | 4.8 | 8.0 |
| B. 85 percent of dividends received | 20.8 | 22.7 | 26.1 | 19.7 | 24.3 | 33.4 | 17.1 | 31.3 | 30.7 | 27.5 | 23.1 | 52.5 |
| C. Excess of bad debts deductions over actual losses | 68.8 | 67.5 | 65.4 | 71.8 | 72.1 | 72.3 | 63.3 | 92.4 | 52.5 | 63.7 | 46.5 | 77.6 |
| D. 50 percent of long-term capital gains | 6.5 | 7.0 | 4.4 | 6.1 | 16.9 | 13.2 | 11.6 | 22.7 | 7.9 | 9.1 | 5.5 | 22.2 |
| E. Total | 108.9 | 113.5 | 110.7 | 110.6 | 129.4 | 139.3 | 102.1 | 159.5 | 100.4 | 106.8 | 79.9 | 160.3 |
| III. Savings and loan associations: | | | | | | | | | | | | |
| A. Tax exempt interest | .2 | .3 | .3 | .5 | .7 | .8 | .6 | .8 | 1.5 | .8 | 1.0 | 1.2 |
| B. 85 percent of dividends received | .2 | .1 | .3 | .4 | .1 | .2 | .2 | .2 | .6 | .1 | .1 | .1 |
| C. Excess of bad debt deduction over actual losses | 96.3 | 95.6 | 95.6 | 96.7 | 96.4 | 97.3 | 97.9 | 98.6 | 64.2 | 64.2 | 63.2 | 65.5 |
| D. 50 percent of long-term capital gains | .3 | .2 | .3 | .8 | .3 | .6 | .6 | 2.1 | .8 | .6 | .8 | .8 |
| E. Total | 97.0 | 96.2 | 97.1 | 98.4 | 97.5 | 98.9 | 99.3 | 101.7 | 67.1 | 65.7 | 65.1 | 67.6 |

Sources: Internal Revenue Service, Statistics of Income, Source Book and tables 1 and 3.

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