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95th Congress
2d Session

COMMITTEE PRINT

WMCP:95-65

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

THE PRESIDENT'S 1978 TAX PROGRAM

PREPARED STATEMENTS OF ADMINISTRATION WITNESSES

(Appearing January 30, 31 and February 1, 1978)

FEBRUARY 1, 1978

Printed for the use of the Committee on Ways and Means

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CONTENTS

JANUARY 30 AND 31, 1978

	Page
Statement of the Honorable W. Michael Blumenthal, Secretary of the Treasury	1
Detailed Descriptions and Supporting Analyses of the Proposals	51

JANUARY 31, 1978

Statement of the Honorable Charles L. Schultze, Chairman, Council of Economic Advisers	375
Statement of the Honorable James T. McIntyre, Jr., Acting, Director Office of Management and Budget	413

FEBRUARY 1, 1978

Statement of the Honorable Peter Henle, Deputy Under Secretary for Economic Policy Review, U.S. Department of Labor	421
Statement of the Honorable Frank Horton, M.C. formerly Chairman, Commission on Federal Paperwork	427

Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE UPON DELIVERY
Expected At 9:30 a.m.
January 30, 1978

STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
ON
THE PRESIDENT'S TAX PROGRAM
BEFORE THE COMMITTEE ON WAYS AND MEANS
WASHINGTON, D.C.

Mr. Chairman and members of this distinguished Committee:

I am pleased to appear before you today to discuss one of the President's highest legislative priorities for 1978--a significant revision of our Nation's tax laws. Last year, the Administration thoroughly studied the present tax system. The President himself had extensive personal involvement. This study reaffirmed our view that the tax system should be made more equitable and simpler for the average taxpayer.

In recent months, it has become apparent that tax reform should be combined with substantial tax reductions. The continued growth of the economy requires tax cuts to sustain the purchasing power of individuals. And businesses must have adequate incentives and resources to modernize facilities and to create permanent jobs for American workers.

Therefore, the President submitted to Congress on January 21 a tax package that will attain three overall goals: tax reduction for individuals, improvement of the tax structure, and increased incentives for business investment. The specific proposals to secure these objectives are closely interrelated: the gross tax cuts of $34 billion are partially financed by $9 billion in revenue-raising structural changes. Enactment of the tax reductions and incentives without the structural changes would result in an excessive drain on tax revenues and a serious distortion in the allocation of the tax burden. For this reason, the President offers his proposals in the form of a balanced tax program, and we urge Congress to consider these recommendations as an integrated package.

The President's tax package consists of the following elements:

-- Net income tax reductions for individuals of $16.8 billion, comprising gross tax cuts of $23.5 billion and revenue-raising structural changes of $6.8 billion.

-- Net income tax reductions for businesses of $5.7 billion, reflecting gross business cuts of $8.3 billion combined with $2.6 billion of structural reform.

-- Excise and payroll tax reductions of $2.0 billion.

This program will achieve major structural reform, but we have not attempted to correct all the inequities nor to simplify all the complications in the Code. What we seek through the President's proposals is enactment of structural changes that are urgently needed, but will not disproportionately consume the time of the Committee. It is critical that a program of tax reform and reduction be passed in 1978, and we have devised a tax package that reflects the importance of expeditious action. Most of the reforms involve provisions with which this Committee is familiar; and, in fact, many of the Administration's recommendations have been approved by the Committee in recent Congressional sessions. We believe our tax package can be fully considered and adopted this year.

The remainder of my statement will outline the principal features of the package. A detailed technical explanation is being submitted for the convenience of the Committee and other witnesses. In addition, I have attached to this statement exhibits that contain revenue estimates and other statistical data.

THE IMPORTANCE TO THE ECONOMY OF A BALANCED PROGRAM OF TAX REDUCTIONS AND STRUCTURAL CHANGES

The economic importance of the tax program is emphasized after a review of our economy's recovery to date. When the President assumed office one year ago, our Nation's economy was making only a halting recovery from recession. The unemployment rate for December 1976 was 7.8 percent, with 7.5 million Americans out of work. In 1976, the economy operated at approximately $120 billion below its high employment potential.

After surveying the economic situation in January 1977, the President offered a two-year economic recovery package as one of his first official acts. Enactment of that stimulus program has had a favorable impact on economic conditions. The unemployment rate dropped almost 1-1/2 points during 1977 to a level of 6.4 percent as of the end of the year. Over four million more people are employed now than were employed one year ago, and a record 58 percent of the working age population now holds jobs. The real gross national product--the Nation's combined output of goods and services, adjusted for inflation--has grown at a rate of 5-3/4 percent from the fourth quarter of 1976 to the fourth quarter of 1977.

For the most part, the economic performance for 1977 has been encouraging. Nevertheless, an unemployment rate of 6.4 percent is still too high. This Administration will not be satisfied as long as millions of Americans are jobless and billions of dollars of productive capacity of the business sector remain idle. It is imperative that steady economic recovery be sustained.

However, there are impending forces that threaten the recovery. In 1979, social security tax liabilities will be increased over 1977 levels by $4 billion due to previously scheduled rate increases and by an additional $7 billion due to changes enacted in 1977. Many individuals also face the prospect of bearing an "automatic" income tax increase, as inflation pushes taxpayers into higher rate brackets even though real purchasing power of incomes may remain constant. A combination of these and other tax increases would cause Federal receipts to assume an unacceptably large share of our Nation's gross national product. The result would be a significant slowdown in economic growth toward the end of this year, with the rate of real growth falling to about 3-1/2 percent in 1979. Unemployment would remain above 6 percent and, by the end of 1979, would be moving upward.

These developments must be averted by sound fiscal policy. The President has submitted a budget for fiscal year 1979 that will reduce the ratio of Federal spending to the gross national product from 22.6 percent to 22 percent. This Administration is determined to release sufficient resources through income tax reductions to enable the private sector to take the lead in sustaining a strong economic recovery.

Therefore, a carefully fashioned, net tax reduction of $25 billion is the centerpiece of the Administration's economic program. These tax cuts will maintain consumer purchasing power by offsetting both the scheduled social security tax increases and the impact of inflation on effective tax rates. The ratio of personal taxes and employee and self-employed social security taxes to personal income in 1979 will be brought down to the 1977 level, 14 percent. Without the proposed tax cut, the ratio would rise at least 1 full percentage point. At the same time, business tax reductions will provide incentives for investment to meet expanding demand and to furnish the tools of production for a growing labor force.

Together with the programs outlined in the President's Budget Message, this tax package should assure that our economy will grow at a 4-1/2 to 5 percent pace through 1979, with unemployment declining to about 5-3/4 percent by the end of 1979. Five million new jobs will be created--about one million more than would be created in the absence of a tax cut.

Yet, in fashioning a tax program that ensures steady and sustainable economic growth, we have been wary of providing excessive "stimulus." Enlarging the net reduction substantially beyond the $25 billion level would put at serious risk the balanced, steady character of our economic recovery. The average recovery in the postwar period has lasted four years and has typically been destroyed by the appearance of rapid inflation or radical imbalances between the various sectors or elements in the economy. We are now in the third year of this recovery; and, as I have indicated, it is proceeding in a remarkably smooth and balanced fashion. We have experienced solid economic growth. There has been a steady reduction in the rate of unemployment. The inflation rate, while far too high, is not accelerating.

If the recommended net tax cut were significantly increased, an appropriate economic balance might well be upset. Private sector confidence in our ability to manage the Federal budget would be eroded, for we could make no progress in reducing the deficit. Financial markets would tighten, thereby blunting the effects of our proposed tax incentives for job-creating investments and injuring the housing sector. Finally, we would damage our chances of getting better control over inflation. A $25 billion tax cut is required to maintain the momentum of economic recovery, but the risks associated with a larger net tax reduction are simply not worth taking.

PROPOSALS TO PROVIDE A TAX SYSTEM THAT IS MORE EQUITABLE, SIMPLER, AND LESS BURDENSOME FOR INDIVIDUALS

Although the tax program is a central element of this Administration's economic policy for the years ahead, it should not be assessed solely in macroeconomic terms. In devising the program--both reductions and structural changes--we have kept in sharp focus the tax system's impact on individual taxpayers. That system directly involves 130 million Americans annually in a process that has an important bearing not only upon their financial well being, but also upon their perception of the quality of the Federal government.

Unlike some systems in which a government determines the amount of tax due and sends the taxpayer a bill, the first formal determination of income tax liability occurs when an individual files his tax return. The withholding system and IRS auditing procedures assist the tax collection process. But in the end, the tax structure relies upon the honesty, trust, and diligence of individual citizens who are asked to calculate their share of the burden of public support.

In many ways, the tax system reflects our highest national ideals. It represents the active participation of Americans in the affairs of their government. And it reflects a mutual trust between that government and its citizens.

However, if our system of self-assessment is to remain successful, it is essential that the tax structure be considered fair by taxpayers and that average Americans understand how their tax liability is computed. Accordingly, our tax program has been structured to address the important needs of individual taxpayers:

-- The tax system should not claim too large a share of personal incomes; incentives to work and invest must not be impeded by an onerous tax burden.

-- The income tax burden should be allocated fairly among taxpayers. Individuals with similar levels of income should have similar tax liabilities, and the proportionate tax burden should vary among income classes in accordance with ability to pay.

-- Tax calculations and return preparation should be comprehensible for average taxpayers.

I. REDUCING THE TAX BURDEN FOR INDIVIDUALS

The President recommends a gross tax reduction for individuals of $23.5 billion, with offsetting structural reforms of $6.8 billion. When both the reductions and reforms are considered, the typical family of four at the $20,000 income level will save $270, a 12.4 percent reduction in income tax liability. Commencing October 1, 1978, that family's withholding rates will be reduced so that it will then experience an increase in take-home pay and purchasing power.

The recommended tax reduction is needed to maintain the standard of living of American taxpayers. Without an income tax cut, scheduled increases in the social security tax will reduce the take-home pay of workers. In 1979, the family of four with one earner at the $20,000 income level will bear an additional payroll tax liability of $261 due to the combination of social security tax increases enacted prior to this Congress and the financing package that was enacted last year. I commend the members of this Committee for facing up to the challenge of restoring the financial integrity of the social security system; large infusions of revenue were urgently needed to ensure social security benefits for future generations. Congress determined to accomplish that objective entirely through the payroll tax. Consequently, unless income taxes are reduced, payroll tax increases will drain purchasing power of American workers, stall the economic recovery, and impose a very onerous burden on low and middle-income families.

The President's tax program will provide the necessary tax relief. For most taxpayers, there will be a net reduction in combined income and payroll tax liability through 1979 even after the scheduled social security tax increases are considered. Tables 1 and 2 compare the combined income and FICA taxes under 1977 law and the proposed law for 1978 and 1979. Included in the calculations are the FICA tax increases resulting from legislation enacted prior to 1977 as well as the increases contained in the Social Security Amendments of 1977. The tables assume a four person, one-earner family with wage income at various levels. Our recommended income tax cuts will completely offset the increase in social security taxes for families with wage income up to $25,000 in 1978 and $20,000 in 1979. A substantial offset will result even above those levels. Only 16 percent of families have wage income of more than $25,000 a year and 23 percent have wage income of more than $20,000 a

year. Tables 3 and 4 present similar information for a four person, two-earner family, assuming that each spouse earns one-half of total family income; under these assumptions, the proposed income tax reductions for 1978 and 1979 will offset the social security tax increase up to $30,000 of total family income.

In proposing this substantial income tax relief, the Administration recommends a more equitable allocation of the tax burden. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most--low and middle-income Americans. Through a combination of substantial tax cuts and needed reforms, the Administration's program: provides sizable tax reductions for low and middle-income individuals who now shoulder a disproportionately large portion of the burden of public support; lowers taxes for most high-income taxpayers as well; and raises the tax liability of some persons who now use unjustified tax preferences to escape paying their fair share of taxes.

Over 94 percent of the income tax relief is provided to families making less than $30,000, but typical families in every income class through $100,000 will experience a tax cut. The net tax reductions are proportionately largest at the low end of the income scale. For example, families earning between $5,000 and $10,000 will have their taxes reduced by 22.6 percent. The percentage reduction is 9.7 percent for the $20,000 to $30,000 income class. In the income classes over $100,000, some persons will have a tax reduction while those now using tax preferences may have an increase; overall for this group, the tax program will result in a modest tax increase of 3.7 percent. Stated in dollar terms, the typical family earning $20,000 a year will save $270 in taxes; on the average, a family at the $100,000 income level will pay $590 more.

In short, the Administration's tax package will reduce the share of the total income tax burden for each income class through $30,000, thereby resulting in a decrease from 60.8 percent to 57.6 percent in the aggregate individual income tax liability that falls on those low and middle-income taxpayers. Under current law, the effective rates of tax range from 0.2 percent for individuals with incomes under $5,000 to 30.0 percent for persons making over $200,000 annually. The tax program will have the effect of reducing effective tax rates for all income classes through $100,000, with a new range of effective tax rates from -0.4 percent (reflecting the refundable earned income credit) to 31.7 percent.

Rate Cuts

The gross tax reduction for individuals will be accomplished primarily through a sizable cut in tax rates that will benefit every taxpayer. The proposed rate schedule for joint returns will range from a tax bracket of 12 percent for the first $1,000 of taxable income to a rate of 68 percent on taxable income exceeding $200,000. (These taxable income figures and all others I will discuss do not include the "zero bracket amount.") For single taxpayers, the 12 percent rate will apply to the first $500 of taxable income and the 68 percent rate to taxable income over $100,000. The present rate schedule covers a 14 percent to 70 percent span. A comparison of the old and new schedules is contained in Tables 5 and 6.

This new rate schedule will provide the largest rate cuts in the middle-income brackets. For example, the marginal rate for each taxable income bracket from $12,000 through $24,000 on a joint return will be reduced by 5 percentage points whereas the marginal rates in income brackets above $44,000 are generally reduced only 1 or 2 percentage points. Nevertheless, high-income taxpayers will also derive substantial benefits from these rate cuts--benefits that must be borne in mind when assessing the impact of the per capita credit proposal and the recommendations that will broaden the income base subject to taxation.

Per Capita Tax Credit

As a part of the substantial tax relief provided to low and middle-income families, we propose a new tax credit of $240 for each dependent. This credit will replace the current $750 exemption for each family member and the general tax credit, which is now equal to the greater of $35 per dependent or 2 percent of the first $9,000 of taxable income. The existing tax benefits for family members vary directly in proportion to income level. A family of four in the 50 percent tax bracket now enjoys a tax savings of $1,680 for dependents while a family earning $10,000 saves about one-third of that amount. By contrast, the $240 credit will provide a tax savings of $960 to a four-member family regardless of income level. Due in large part to the new credit, the tax-free level of income for a family of four will rise to $9,256 under the tax program as compared to $7,200 under current law.

Although the per capita credit is being proposed in combination with a restructuring of tax rates, it may be helpful for the Committee to know the credit's "break-even level" if presented as an isolated change. For a four-person family with less than $20,200 of income, the new $240 credit will provide greater tax savings than the existing personal exemption and general tax credit, assuming no changes were made in the tax rate schedule. At that level of income, the family is neither better off nor worse off. The tax would be $2,580 under either the $240 credit or under existing law.

	Current Law	Proposed Law (assuming current law rate schedule)
Adjusted gross income	$20,200	$20,200
Less personal exemptions	3,000	--
Taxable income*/	17,200	20,200
Tax before credits	2,760	3,540
General tax credit	180	--
Per capita credit	--	960
Tax after credits	$2,580	$2,580

I want to emphasize, however, that families above $20,200 of income are not going to be worse off under the Administration's proposal. The proposed rate schedules have been designed to offset the tax increases that would occur at high income levels if a $240 credit simply replaced the existing personal exemption and general tax credit. What we achieve with the $240 credit and the new rate schedule are:

*/ The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount. If the taxpayer had average itemized deductions equal to 23 percent of income, the break-even point would be $22,078 of income.

Equity--the credit for family members is worth the same regardless of the family's level of income; and

Simplification--one credit will replace the existing combination of a deduction and alternative credits.

And these improvements in the tax system are accomplished without providing tax increases for families above the so-called break-even level.

Adoption of the per capita credit will also facilitate additional tax reductions the President may recommend to adjust for Congressional action on the National Energy Plan. In April, the President proposed that Congress pass the crude oil equalization tax and rebate the proceeds to the American people on a per capita basis. This action is essential if we are to protect the real incomes of consumers. If the final energy bill includes the full rebate of the net proceeds of the crude oil tax, no further Presidential action will be required. However, if the final bill contains a rebate provision only for 1978--as provided in the House version--the President intends to recommend that the individual tax reductions proposed in his message to Congress be increased by the net proceeds of the crude oil tax.

II. TAX EQUITY AND SIMPLIFICATION FOR INDIVIDUALS

The rate cuts and the per capita credit I have described will help achieve a more equitable and simpler tax structure. But those tax changes cannot stand alone. The $23.5 billion of tax relief provided by these measures would have to be scaled down considerably in the absence of revenue-raising structural changes. Steady, noninflationary economic growth can be sustained only if we keep the net revenue loss of the entire package--including individual and business reductions--at approximately $25 billion.

The structural changes are focused in part on serious inequities in the tax laws. Without such changes, tax relief simply cannot be focused effectively on those persons who are now bearing a disproportionately heavy tax burden--especially middle-income taxpayers. A tax program that provides large-scale relief to taxpayers would be inequitable if the benefits were fully shared by those already avoiding payment of their fair share of tax liability.

The proposed tax cuts are also closely interrelated with the Administration's efforts to promote tax simplification. For many middle-income persons, the major source of complexity in the tax laws relates to itemized deductions. Average Americans are forced to assemble detailed records for tax purposes and to grapple with complicated tax forms and instructions in order to prepare a schedule for itemized deductions.

Changes in itemized deductions are essential if the tax system is to be simplified for middle-income taxpayers. We are recommending such changes. But we are also recommending substantial rate reductions in the middle-income classes--cuts ranging from 3 to 5 percentage points in each taxable income bracket from $8,000 through $44,000--that will more than offset the tax increases that would otherwise result from the proposed itemized deduction changes.

Changes in Itemized Deductions

The Administration's proposals continue the simplification efforts that began last year. In the Tax Reduction and Simplification Act of 1977, Congress worked with the Administration to enact changes in the standard deduction that have increased the percentage of nonitemizers from 69 percent to 77 percent. We now recommend additional steps that will increase the percentage of nonitemizers still further, to 84 percent of all individual taxpayers. The changes we propose will enable over 6 million Americans to switch to the simple, flat standard deduction that was recently enacted and thereby avoid vexing recordkeeping requirements.

These proposals can accomplish drastic tax simplification without creating significant controversy. The recommended changes curtail deductions that add complexity and inequity to the tax system without advancing major objectives of public policy.

(1) State and Local Taxes. The special deduction will be eliminated for general sales taxes, personal property taxes, gasoline taxes, and miscellaneous taxes but retained for State and local income and real property taxes. Most itemizers determine the amount of deductions for their State sales and gasoline taxes by reference to published tables that provide nearly uniform deductions and result in a relatively small tax benefit. Due to the fact that the tax benefit is so

slight for itemizers and the fact that there is no benefit at all for the 77 percent of individuals claiming the standard deduction, deductibility is not a major factor for State and local governments in determining the rate of tax to impose.

This Committee has already voted in connection with the energy bill to eliminate the deduction for gasoline taxes--a decision supported by the recognition that the deduction runs counter to our national goal to conserve energy. We propose that the Committee renew that decision and also terminate the deduction for general sales taxes, personal property taxes, and miscellaneous taxes.

(2) Political Contributions. We also recommend simplification of the present confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim an itemized deduction for the first $200 of contributions. In lieu of the deduction, he may claim a credit for one-half of his political contributions, with a maximum credit of $50. We propose that the political contribution deduction be repealed while the credit is retained. As a result, whatever incentive a tax subsidy provides for political contributions will be equally available to itemizers and nonitemizers and will not rise with the income level of the taxpayer.

(3) Medical and Casualty Expenses. Twelve lines on Schedule A for Form 1040 are devoted to computation of the deduction for medical and dental expenses. The form reflects a tax provision that is unnecessarily complicated and that results in recordkeeping and record-searching burdens for millions of taxpayers. Currently, one-half of the first $300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses are deductible to the extent they exceed 3 percent of adjusted gross income, with this latter category of deductibility including the remaining portion of health insurance premiums and medicines and drugs in excess of 1 percent of adjusted gross income.

Another six lines on Schedule A relate to a deduction for damage to property from a casualty, such as a theft or fire. A casualty loss may be deducted only if it exceeds $100 and is not reimbursed by insurance.

We propose that the deductions for medical and casualty expenses be combined in a new "hardship expense" deduction. This new deduction will apply only to medical and casualty expenses in excess of 10 percent of adjusted gross income. In the case of casualty losses, the excess over $100 per casualty will be included in the computation. Medical insurance premiums, drugs and medicines will be treated the same as other medical expenses. In this manner, tax return preparation will be simplified greatly, and the deduction will be available only to taxpayers whose ability to pay has been significantly affected by medical and casualty expenditures that can truly be considered "abnormal" in the light of the current relationship between medical and casualty costs and income.

Tax Shelters

The members of this Committee are familiar with the basic concept of a tax shelter. Although shelter devices can assume a wide variety of forms and include a great diversity of activities, they share a common characteristic: "paper" losses generated by shelters are used by high-income individuals to reduce taxable income from other sources. Typically, shelter investments are made not because of anticipated economic productivity, but in anticipation of the various tax preferences that are packaged together by shelter promoters to provide optimum tax writeoffs. This drain of investment dollars into shelter activities creates economic distortions and harms legitimate profit-seeking businesses.

Due in large part to tax shelter devices, there is now a wide disparity in effective tax rates among individuals with similar economic incomes. This phenomenon is especially prevalent in the upper income brackets. For example, some taxpayers with incomes exceeding $200,000 effectively pay only one or two cents in taxes for every dollar of income received; other individuals are taxed at effective rates of about 60 percent.

Data recently compiled by the IRS graphically illuminate the disturbing impact of tax shelters. Through the use of tax preferences, thousands of affluent Americans are reporting poverty-level income for tax purposes. In 1976, tax preference items were enjoyed by 16,000 taxpayers statistically classified as having "adjusted gross income" below $10,000. But these individuals are not members

of the low-income class; on the average, each of them claimed $35,000 of preference income. Our tax system needs significant improvement if it is to approach the objective of providing equal tax treatment for equals.

Congress is to be commended for its recognition of tax shelter abuses in 1976 and its innovative and forceful reform efforts in this area. The Tax Reform Act of 1976 contains important provisions designed to curtail shelter activities. The principal methods used in that legislation were revisions of the minimum tax on certain tax preference items and the adoption of an "at risk" rule that denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability.

Unfortunately, the 1976 amendments--significant as they are--have not ended shelter abuses. In fact, tax shelter activity may have increased during 1977. The National Association of Securities Dealers reports that over $1 billion of shelters were publicly offered by its members during the first 9 months of 1977--a 30 percent increase over offerings for a similar period in 1976. And there is some evidence that unreported shelter deals may have increased even more dramatically.

The explanation for this high level of post-1976 shelter activity is simple. Promoters have adapted their operations to provide shelters in forms that were not substantially affected by the 1976 Act. The Internal Revenue Service is waging a vigorous campaign against tax shelter gimmicks, but it must be given stronger weapons.

The Administration is not proposing any radically new approaches to this problem. Rather, in the light of experience, we are recommending that Congress build upon the efforts that led to reforms in 1969 and 1976. Flagrant tax shelter abuses must be curtailed.

In the Administration's program, we are proposing several different methods of continuing the attack on tax shelters.

(1) Elimination of Certain Tax Preferences. Some of our recommendations eliminate or limit directly a tax preference that makes shelter investments attractive. An example of this approach is our recommended reform of real estate depreciation. Shelter investments in such real estate projects as shopping centers and office buildings are attractive, in large part, due to the fact that depreciation may be claimed for tax purposes that far exceeds a realistic measurement of actual economic decline. Real estate shelters, in contrast to other major shelter investments, were left virtually untouched by the 1976 Act. As a result, they have become even more popular.

We propose elimination of accelerated depreciation for most real estate. The reform program will generally require taxpayers to base their depreciation for buildings on the straight-line method and to use the present average tax lives claimed by taxpayers for different classes of property.

Exceptions from the general rule will be granted until 1983 for new multi-family and used low-income housing, which will be permitted to use a 150 percent and 125 percent declining balance method, respectively. New low-income housing will remain eligible for a 200 percent declining balance method until 1983, and for 150 percent thereafter. In the interim period, the Administration intends to analyze tax and nontax subsidies for housing. Our objective is to determine the need for subsidizing particular segments of the housing market and the most efficient means of providing needed subsidies.

In addition to reform of real estate depreciation, the elimination of two other shelter preferences is proposed. The Administration recommends that the earnings of most deferred annuities, purchased for shelter purposes, be taxed currently to the purchaser. Also, we propose an extension of the 1976 Act's accrual accounting rule relating to large corporate farms; under our proposal, accrual accounting will be required for most farming syndicates and the current exemption for large "family owned" farm corporations (with gross receipts exceeding $1 million) will be eliminated.

(2) Extension of "at risk" Rule. Another Administration proposal is designed to deal with a common shelter financing technique--the use of nonrecourse loans to enable a shelter investor to obtain tax writeoffs greatly exceeding his own investment. "At risk" rules were enacted in 1976 to limit this abuse, but coverage was extended only to partnerships and certain specified activities of individuals. Action should be taken now to curtail the extensive shelter activities that have arisen in situations not expressly covered by the 1976 Act; recent shelter promotions project tax writeoffs as high as $170,000 for $25,000 cash investments in such items as books, television programs, and lithographic plates. We recommend that the "at risk" rule be extended to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons.

(3) Restricting Use of Limited Partnership as Shelter Vehicle. The attractiveness of the limited partnership as a shelter vehicle will be limited by the reform program. New limited partnerships with more than 15 limited partners will be treated as corporations for tax purposes so that shelter losses may not ordinarily be passed through the partnership to reduce the taxable income of the limited partners. An exception will be made for partnerships formed before 1983 to engage in the construction and operation of residential real estate, with the exception continuing after 1982 for new low-income housing as long as it remains eligible for accelerated depreciation. By 1983, the Administration will have made recommendations to Congress as to what form of subsidy is appropriate to our housing needs.

(4) Auditing Partnerships. We also propose that the Internal Revenue Service be authorized to implement tax audits of partnerships and to determine tax issues at the partnership level rather than being forced to proceed against each partner individually.

(5) Strengthening the Minimum Tax. Finally, the benefits available through excessive use of tax preferences will be restricted through a tightening of the minimum tax provision. In its current form, the minimum tax is imposed at a rate of 15 percent on the amount of certain tax preference items enjoyed by a taxpayer.

However, the total amount of tax preferences can now be reduced by the greater of $10,000 or one-half of an individual's regular tax liability before the minimum tax is applied.

We propose to eliminate the offset of one-half of regular tax liability so that the minimum tax will attack tax shelters more directly and effectively. High-income individuals will no longer be able to use their taxes on non-preferred income to avoid the minimum tax on excessive preference income. On the other hand, those individuals with modest preference income will still be totally exempted from the minimum tax by the $10,000 preference offset, and the minimum tax will not be applied to capital gain realized on the sale of a personal residence.

Termination of Alternative Tax for Capital Gains

The current deduction for the long-term capital gains of individuals generally has the effect of taxing such gains at a rate that is one-half of the rate for ordinary income. During our intensive study of the tax laws, this capital gains preference was carefully studied. The study also included such matters as the partial integration of corporate and shareholder taxes and drastic rate reductions for investment income.

These aspects of the tax system are both controversial and relatively unexplored. Full consideration of the issues raised would require extensive Congressional debate. Therefore, in order to expedite consideration of tax legislation this year, the program does not involve these matters.

We do propose in this tax package to eliminate what is left of the 25 percent alternative tax for capital gains. The effect of the current provision is to grant taxpayers in the highest income brackets an additional tax preference over and above the special capital gains deduction. Through the alternative tax, individuals above the 50 percent tax bracket can take advantage of a 25 percent tax ceiling on the first $50,000 of capital gains.

The alternative tax cannot be said to benefit the middle-class investor. Its benefits accrue exclusively to persons with taxable income exceeding $52,000 (if filing a joint return) or $38,000 (if filing a single return)--less than one percent of all taxpayers. And for those families

with taxable income in excess of $200,000, the benefit is greatest of all. Those wealthy investors can use the alternative tax to exclude nearly 65 percent of $50,000 of capital gains each year from taxation; by contrast, a family with income of $50,000 a year can exclude only one-half of capital gains, and most workers are taxed on every cent of their wages and salaries.

This Committee has voted on prior occasions to terminate this inequitable and complicating provision. I urge the Committee to repeat such action this session.

Unemployment Compensation

We recommend that the current tax exemption for unemployment compensation benefits be phased out as an individual's income rises above $20,000 for single persons or $25,000 for married couples. Under the Administration's proposal, 50 cents of unemployment compensation will be taxed for every dollar of total income (including unemployment compensation) received in excess of these income ceilings.

Dollars received as unemployment benefits are just as valuable as dollars received in any other form. Therefore, a continued exemption at middle and high-income levels violates the tax policy principle that persons should be taxed in accordance with ability to pay. In the 1976 Act, Congress repealed the sick pay exclusion for workers at higher income levels on the grounds that sick pay is a substitute for wages and should generally be taxed in the same manner. This rationale should now be extended to unemployment compensation.

Reforming the tax treatment of unemployment benefits is especially important in view of the serious abuses that can be caused by the preference. In many cases, the unemployment compensation system serves not to relieve hardship but to discourage work for taxable income. For example, an individual can receive a substantial income every year through stock dividends and the salary from his 9-month job, take a winter vacation and collect untaxed unemployment benefits. There is no reason we should continue to permit such persons to "beat the system" at the expense of their neighbors who work throughout the year for taxable wages.

Fringe Benefits Unavailable to Rank-and-File Workers

The major tenet of tax equity--that tax liability be based on ability to pay--should also be considered by this Committee as it examines certain employee fringe benefits. Application of the principle in its pure sense requires that compensation be taxed to an employee regardless of the form that compensation assumes. A worker who receives cash wages that he uses to provide benefits for his family should not ordinarily be taxed more heavily than the employee who receives those benefits directly from his employer.

Yet, the tax laws now contain numerous exceptions for various employee benefits. For example, if an employer establishes a medical insurance plan for his employees, the premium payments by the employer are deductible while neither the premiums nor the benefits are taxable to the employee. Favored tax treatment is also conferred upon certain pension plans, group life insurance plans, and employee death benefits.

Again, the Administration is not proposing a radical departure from the current treatment of fringe benefits. Instead, we recommend Congressional action to ensure that these tax preferences benefit rank-and-file workers as well as corporate management. Preferential tax treatment for these fringe benefits can be justified only as a means of ensuring that a wide range of employees are protected against such contingencies as sickness, disability, retirement, or death. We should move closer to fulfilling that objective.

Accordingly, the President recommends the following proposals:

(1) Medical, Disability, and Group Life Insurance Plans. The full tax exemption for employer-established medical, disability, and group life insurance plans will be denied if those plans discriminate in favor of officers, shareholders, and higher-paid employees. Preferential treatment is now available to pension plans and group legal plans only if nondiscrimination standards are met. The tax laws should require similar nondiscriminatory treatment for workers in the case of these other types of employee benefit plans.

(2) Integration of Social Security and Private Pension Benefits. Although there is now a nondiscrimination requirement for qualified retirement plans, such plans are permitted to cover only employees who earn amounts exceeding the social security wage base. When Congress established new nondiscrimination standards in the Employee Retirement Income Security Act of 1974 (ERISA), this issue of proper "integration" of social security and private pension plans was expressly left unresolved.

In view of the fact that the social security wage base will rise to $29,700 by 1981 under the recently enacted social security financing legislation, it is especially important that Congress act now to address this question left open by the 1974 ERISA legislation. It is unfair to grant tax preferences for private pension plans that exclude all low and middle-income employees. We recommend that a new integration formula be enacted so that no qualified pension plan can provide benefits beyond social security for highly compensated employees unless all workers receive substantial coverage under the plan.

(3) Employee Death Benefits. We propose the repeal of the current exclusion for the first $5,000 of payments made by an employer on account of the death of an employee. These death benefits typically represent deferred wages that would have been paid to a high-income employee, and they should not be given preferential tax treatment.

Entertainment and Other Expenditures for Personal Consumption

For many average taxpayers, the inequity of current tax law is demonstrated most vividly by the treatment of entertainment expenses that are claimed as business deductions. The deductibility of entertainment expenses is a significant revenue item; approximately $2.2 billion a year are lost to the Federal Treasury through the deductibility of expenditures for items such as theater and sports tickets, country club dues, yachts, hunting lodges, first class air fare, and business meals. However, the recapture of a large revenue loss is not the only consequence of reforms the President recommends in this area. Of greater significance will be the effect on the morale of average taxpayers, who are now forced to subsidize the untaxed personal consumption of some of the most affluent Americans.

Some persons have become accustomed to living luxuriously on tax-deductible dollars. One individual deducted 338 business lunches in one year, skipping Thanksgiving day but not the Friday, Saturday, or Sunday of Thanksgiving weekend. A surgeon deducted $14,000 a year for maintaining a yacht where he allegedly "talked shop" with other doctors. And, another wealthy professional claimed a deduction of $17,000 for the cost of entertaining associates at his home, at a country club, at sporting events, at restaurants, and at a rental cottage.

Yet, in spite of the disturbing impact on average Americans of such tax-deductible extravagance, some persons would have us believe there is really no tax preference involved--that reform in this area represents an anti-business attitude without a sound basis in tax policy. These persons argue that business bears part of the cost of deductible entertainment expenditures and that business can, and should, determine which expenditures are nonproductive. Under this line of reasoning, entertainment expenses are viewed as being analogous to business expenditures for advertising or research, and any attempt to limit deductibility is seen as an interference with business decision-making.

This argument is dead wrong. Entertainment expenditures, unlike expenditures for advertising and research, confer untaxed personal benefits to the participants. Preparing or reading an advertisement is not comparable to dining at an elegant restaurant, sailing on a yacht, or attending a Sunday football game. Entertainment is more closely analogous to wages; they both provide personal benefits to employees. However, the tax collector withholds a portion of wages before they can be spent for personal consumption while entertainment benefits are now received tax-free by employees.

Ideally, the preference for business meals and other entertainment expenditures would be eliminated by taxing the participants, but such an approach would obviously be very complex and disruptive. What we propose instead is to deny a deduction for entertainment expenditures to the extent they provide the participants with untaxed personal benefits. This is the approach Congress used in 1962 when business deductions for gifts were limited.

The President's recommendations are based on sound theories of tax law and public finance. Economists tell us that an employer's entertainment expenditures are wage substitutes. Tax lawyers tell us that the law should deny the employer a deduction where compensation, in whatever form, is untaxed to the employee. Internal Revenue Service agents describe problems in trying to enforce a law that often becomes a test for a taxpayer's imagination and ingenuity. And, as the Secretary of the Treasury, I am concerned about the loss of billions of dollars in Federal revenue.

However, this issue will not be decided on such academic grounds. Nor should it. The general public realizes there is something wrong here. For example, Mr. Fisher has sent me the results of a poll which canvassed 22,000 of his constituents. This question was posed: "Would you favor or oppose elimination of business expense deductions for items such as lunches, club and other membership fees, and the first class portion of air fares?" Over 72 percent said they would favor elimination of the deduction.

Public irritation will become increasingly evident as the "expense account" issue is debated in Congress. I doubt that Congress would appropriate direct Federal expenditures to subsidize elegant restaurants and the affluent individuals who dine there. There is no reason to permit these governmental subsidies to be provided indirectly through the tax system.

The President's proposals address this public concern. Let me describe them briefly.

(1) Tickets and Certain Other Entertainment Expenses. No deduction will be permitted for purchases of tickets to such events as theater performances and athletic contests. A deduction will also be denied for the expenses of maintaining facilities such as yachts, hunting lodges, and swimming pools, and for fees paid to social, athletic, or sporting clubs.

(2) Meals. Fifty percent of currently deductible business entertainment expenses for food and beverages will remain deductible, and 50 percent will be disallowed. A substantial portion of business meal expenses represents the cost of personal consumption that must be incurred regardless of the business connection. The 50 percent disallowance represents an approach that approximates the actual personal benefit involved and provides a reasonable, simple answer to the problem.

(3) Foreign Conventions. There will be a modification of the rules in the 1976 Act relating to the deductibility of foreign convention expenses. Current law now effectively permits taxpayers to deduct the expenses for two foreign vacations a year--as long as those vacations are packaged with the label of a "convention." We recommend that the two-convention rule be stricken. In its place will be a rule that denies deductibility for foreign convention expenses unless factors such as the purpose and membership of the sponsor make it reasonable to hold the convention outside the United States and possessions. This proposal will eliminate abuses while easing restrictions on conventions held in foreign countries for legitimate business reasons.

(4) First Class Air Fare. The 1976 Act denied a deduction for first class flights to foreign conventions. The President recommends that this rule be extended to tickets for domestic business travel. Although business travel constitutes a legitimate cost of producing income, the business purpose is served by purchasing a ticket at coach fare. Private extravagence should not be publicly supported through the deductibility of first class air fare.

MUNICIPAL FINANCING

Interest on debt obligations issued by State and local governments is exempt from Federal income tax. There is also a current tax exemption for certain "industrial development bonds" that are issued by State and local governments for the benefit of private borrowers. In order to qualify for tax-exempt status, industrial development bonds must be issued to provide financing for certain facilities such as pollution control equipment, sports arenas and convention halls, airports, industrial parks, and the facilities (such as hospitals) of private, nonprofit organizations. There is also a "small issue" exemption for certain industrial development bonds where the amount of the bonds sold does not exceed $1 million or the total capital expenses of the facility being financed do not exceed $5 million.

This current structure for State and local bonds creates two problems. First, the present system is a very inefficient means of providing a Federal subsidy to State and local governments; less than three-fourths of the revenue loss to the Federal Treasury actually accrues to

State and local governments through lower borrowing costs. Second, the exemption is a major source of tax avoidance by wealthy individuals and by commercial banks, which retain for themselves the portion of the Federal revenue loss not accruing to State and local governments.

In the Administration's tax program, we are recommending measures that will address both of these weaknesses in the current structure. A more efficient subsidy will be made available to State and local governments to reduce their borrowing costs below what a tax exemption alone can provide; and at the same time, the equity of the tax system will be improved. Yet, our program retains the autonomy of State and local governments over the financing of their projects and preserves the freedom of State and local governments to issue tax-exempt bonds in whatever amounts they choose. It does not restrict State and local discretion to determine the governmental purposes for which subsidized financing is used.

Taxable Bond Option

State and local governments will be given the option of continuing to issue tax-exempt bonds or of issuing taxable bonds which will receive a subsidy from the Treasury for a fixed percentage of the interest costs. The choice will be entirely a matter for State and local governments to decide. For bonds issued in 1979 and 1980, the subsidy will be equal to 35 percent of the interest costs, with the subsidy level rising to 40 percent for bonds issued after 1980.

This proposal is not intended to be a step toward elimination of the tax exemption, nor a movement to exert more Federal control over State and local decision-making. The taxable bond option is not an interim proposal, but a reasonable long-term solution to the problems of tax policy and public finance that have plagued the municipal bond area. A sizable tax-exempt market will remain; in fact, we project that 75 percent of State and local bonds will continue to be issued in tax-exempt form after an initial adjustment period, of perhaps 5 years, during which 40 to 50 percent of new issues might be taxable. It is our firm conviction that the addition of a taxable bond option to a tax-exempt market, which currently applies to a limited class of investors, will prove to be an enormous benefit for State and local governments. Borrowing costs on municipal debt will be reduced by about 15 percent whether bonds are issued in tax-exempt or taxable form.

Termination of Exemption for Pollution Control Bonds, Bonds for the Development of Industrial Parks, and Private Hospital Bonds

There will no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. The exemption will also be removed for bonds issued to finance construction of hospital facilities for private, nonprofit institutions unless there is a certification by the State that a new hospital is needed.

These activities are essentially for the benefit of private users. The tax exemption in such cases serves little or no governmental purpose, but increases the supply of bonds in the tax-exempt market. The cost of municipal financing is raised as a result.

Municipal financing is injured particularly by the abundance of pollution control bonds in the marketplace. I will describe later our proposal to liberalize the investment tax credit for pollution control facilities so that Federal assistance in bringing existing plants into compliance with environmental standards can be provided in a manner that is much more efficient and less disruptive of the tax-exempt market.

Small Issue Exemption for Economically Distressed Areas

The existing "small issue" exemptions will be retained only for economically distressed areas; and, with respect to those areas, the $5 million exemption will be raised to $10 million.

Option for Certain Industrial Development Bonds

Industrial development bonds that continue to enjoy tax-exempt status will be eligible for the taxable bond option with the same interest subsidy applicable to general obligation bonds of State and local governments.

REDUCTION AND REFORM OF BUSINESS TAXATION TO ENCOURAGE EFFICIENCY AND PRODUCTIVITY

The business portion of the tax program is designed to encourage the productive investments needed to satisfy consumer demand, to create permanent jobs and to move toward greater price stability. The President has recommended gross business tax reductions of $8.3 billion in 1979 in a

form that will provide efficient incentives for investment in productive facilities and will apply equitably to a wide spectrum of businesses, affecting every industry and benefitting both small and large firms. Tied integrally with these gross cuts are business tax reforms that will eliminate tax preferences that have proved to be wasteful and inequitable. As in the case of individual tax reductions, the business cuts have been combined with reforms in order to ensure that Federal tax revenues are focused where relief is needed--both to make the tax system more equitable and to provide the maximum benefit to our economy.

I. BUSINESS TAX REDUCTIONS

Increased incentives for business investment are essential if we are to maintain a strong economic recovery. In recent years, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak reached in the first quarter of 1974.

The portion of our gross national product devoted to investment must be increased in the years ahead. As we look to the long-term needs of the economy, we must depend upon private businesses to provide permanent jobs for a growing labor force while meeting the goals of our national energy plan and providing a cleaner environment and safer workplaces. Vigorous business investment will also prevent capacity bottlenecks and price pressures that might otherwise occur as consumer demand increases.

The real income of workers can grow steadily over the years only if businesses increase productivity with investments in new machinery and more efficient plants. By providing substantial, permanent tax incentives for business expansion, the Administration's tax program will help to create an atmosphere that is conducive to a continued economic recovery led by the private sector.

Corporate Rate Cut

The President recommends a sizable rate cut for both small and large corporations. Effective October 1, 1978, the corporate tax rate will be reduced from 20 percent to 18 percent on the first $25,000 of income, from 22 percent to 20 percent on the next $25,000, and from 48 percent to 45 percent on income exceeding $50,000. The highest rate will be reduced an additional point, to 44 percent, on January 1, 1980. These rate reductions will reduce corporate taxes by $6 billion in 1979 and by $8.5 billion in 1980.

The corporate rate cut will provide an impetus to capital formation in a simple and straightforward manner. The cash flow of businesses will be increased significantly; for a business with $100,000 of taxable income, $2,500 more in after-tax earnings will be available in 1979 and an additional $3,000 in 1980 to provide internal financing for needed capital expenditures. The reduced tax rate will also increase the anticipated after-tax profits on investment projects and will thereby encourage businesses to increase capital spending. This increased after-tax return on corporate investments will stimulate external financing by making corporate stock more attractive to public investors.

Liberalization of the Investment Tax Credit

Needed business investments will also be encouraged by improvements in the investment tax credit. The President recommends that the credit be made available to a wider range of taxpayers and for a broader scope of investments. In addition, the present 10 percent rate will be made permanent--rather than reverting to the 7 percent level that is now scheduled to apply after 1980--so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

In addition to proposing that the 10 percent credit be made permanent, the President recommends the following extensions of the investment credit:

(1) Application to Industrial Structures. The investment credit should be extended to utility and industrial structures as well as machinery and equipment. The current ineligibility of structures is based in large part upon the investment patterns that existed when the credit was first introduced in 1962; at that time, investment in equipment was lagging behind the investment in nonresidential structures. Also, structures were then eligible for depreciation allowances that were even more favorable than those available today.

We are now confronted with a different set of circumstances. In contrast to the investment patterns in the early 1960's, a particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures; investment in structures reached its peak almost 4 years ago and is now 11 percent below that level. The tax preference for depreciation of structures has been reduced through the operation of the "recapture" rules and the minimum tax. In view of these developments, it is important that the investment credit be changed to remedy the existing tax bias against structures and to encourage balanced industrial expansion.

We recommend that the investment credit be available both for the construction of new utility and industrial structures and the rehabilitation of existing structures so that the proposal will have no anti-urban bias. Eligibility for the credit will provide five times more tax savings for investments in structures than does the current provision for accelerated depreciation. By combining our investment credit proposal with the repeal of accelerated depreciation for structures, we will provide a tax incentive that is stronger, more efficient, and much simpler.

The President recommends that this provision apply to construction costs incurred after December 31, 1977. In the case of new structures, there will be an additional requirement that the facility be placed in service after that date.

(2) Application to Pollution Control Facilities. Currently, only one-half of the full investment credit can be claimed by a taxpayer who elects special 5-year amortization for pollution control equipment installed in pre-1976 plants. This restriction should be removed.

We propose that pollution control equipment placed in service after December 31, 1977 be allowed to qualify for the full 10 percent credit even if rapid amortization is claimed under the provisions of existing law. As in the case of industrial structures, our recommendation will provide tax relief in a form that is more efficient and straight-forward than current government tax subsidies; this proposal will permit the tax exemption to be removed for pollution control bonds without increasing the costs of compliance with environmental standards.

(3) Increase in Tax Liability Ceiling. The investment credit will be made more fully available to businesses with relatively high investment needs and low taxable incomes. Currently, the investment credit claimed during any taxable year cannot generally exceed $25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7-year carryforward). The President recommends that the tax liability ceiling be raised to 90 percent of all tax liability, with no firm being able to use investment credits to eliminate its entire tax liability.

Revision and Simplification of Regulations Under the Asset Depreciation Range (ADR) System

The asset depreciation range (ADR) system provides substantial tax benefits to businesses through generous depreciation allowances. However, certain complexities in the ADR regulations discourage most businesses from electing ADR and impose administrative burdens on those businesses that do use ADR.

The President proposes that legislation be enacted expressly to permit the Treasury Department to issue regulations that will simplify the ADR system. Included among the simplifications will be the termination of the annual reporting requirement.

Proposals Focused on Small Business

The President's tax cut proposals will provide significant relief for small businesses. Reductions in individual and corporate tax rates will increase the net earnings of small businesses whether conducted in the form of a sole proprietorship, a partnership, or a corporation. For example, a small corporation with profits of $50,000 will experience a tax reduction of about 10 percent in 1979 because 2 points of the 4-point corporate rate cut have been targeted to small businesses and made fully effective as of October 1, 1978. The resulting increase in cash flow will enable small firms to expand their facilities and compete more effectively.

In addition to these general tax reduction recommendations, the Administration's program contains three proposals designed specifically to aid small companies. First, the Subchapter S rules that treat certain small corporations as partnerships will be simplified and liberalized. Second, a

22-302 O - 78 - 3

new, simple table for equipment depreciation, tantamount to a streamlined ADR system, will be authorized for small businesses. And third, risk-taking will be encouraged by doubling the amount of a small corporation's stock (from $500,000 to $1 million) that can qualify for special ordinary loss treatment and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

II. CURTAILMENT OF BUSINESS TAX PREFERENCES THAT ARE WASTEFUL AND UNFAIR

The business incentives I have discussed total $8.3 billion. Revenue-raising reforms (including those relating to entertainment expenditures) will offset that gross reduction by $2.6 billion. To understand the importance of the reforms, the President's tax proposals should be viewed in the context of a tight Federal budget for fiscal year 1979. This Presidential budget is the first that reflects the results of a zero-based review of all Federal expenditures; projected government spending for fiscal year 1979 has been held to $500 billion through a process that demands that Federal dollars be spent most productively and efficiently.

On the other side of the Federal ledger, the President's tax program reflects the same concern for an efficient allocation of resources. The $8.3 billion of increased incentives is desirable only in combination with reforms that eliminate inequitable and inefficient business tax preferences that contribute little to our efforts to sustain economic growth and create jobs for American workers. We must not leave the careful budgeting process half completed; the same scrutiny that is used in allocating Federal outlays must be used in examining tax expenditures.

Tax Treatment of Financial Institutions

Viewed in this light, it is imperative that the tax treatment of financial institutions be modified. Financial institutions do not pay income taxes on the same basis as other taxpayers. Commercial banks, savings and loan associations, and mutual savings banks can reduce taxable income by special bad debt deductions that do not reflect actual loss experience. Credit unions are provided an even greater preference; they are completely exempted from taxation.

The preferred tax status of financial institutions is based largely on outmoded concepts regarding the nature of these businesses. Commercial banks, mutual savings banks

and savings and loan associations were permitted to deduct artificially inflated reserves for bad debts supposedly to protect the banking system from catastrophic losses that were prevalent decades ago. However, since the 1930's, the Federal government has acted to protect commercial banks and thrift institutions and their depositors from financial crises. These protections include deposit insurance, regulatory restrictions on bank practices, and the availability of the Federal Reserve discount window. Also, financial institutions are eligible for special 10-year carryback and 5-year carryforward provisions so that large losses in any one year can be used to reduce taxable income over a broad span of years. The excess bad debt deductions seriously distort the measurement of a financial institution's income, and that distortion cannot be rationalized on the grounds that the preference is needed to protect the banking system.

Likewise, the exemption for credit unions is an anachronism. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. Today, many have expanded to a point where they are functionally identical to and compete directly with savings and loan associations and commercial banks.

The Administration recommends changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations and credit unions more in line with the taxation of other businesses.

(1) Commercial Banks. Commercial banks may now claim bad debt deductions that greatly exceed their actual losses. Under legislation enacted in 1969, this special bad debt deduction is scheduled for elimination after 1987. The Administration proposes that the effective date for repeal be accelerated so that beginning in 1979 banks, like other businesses, will base their bad debt reserves on their own experience in the current and 5 preceding years.

(2) Mutual Savings Banks and Savings and Loan Associations. Mutual savings banks and savings and loan associations are generally entitled to deduct 40 percent of their net income (this percentage is scheduled to apply in 1979) as a bad debt reserve. The tax program will reduce the percentage to 30 percent over a 5-year period.

(3) Credit Unions. We recommend that credit unions be made taxable on the same basis as mutual savings banks and savings and loan associations, with this change imposed gradually over a 5-year phase-in period.

Domestic International Sales Corporation (DISC)

The so-called "DISC" provision is another example of a wasteful tax expenditure that should be eliminated. In 1971, the Code was amended to add a special tax program to shield export income from taxation. This program grants tax benefits for exports channeled through a company's specially created subsidiary, usually a paper organization, known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of eligible DISC income is deferred as long as these profits are invested in export-related assets.

When DISC was enacted, Congress wisely included a provision for an annual study by the Treasury Department to evaluate DISC's impact. Those studies have demonstrated that DISC is a very inefficient and wasteful export subsidy. The most recent Treasury study indicates that DISC may have contributed only $1 to $3 billion to U.S. exports in 1974--an increase of less than 3 percent in total exports--at a tax revenue cost of $1.2 billion. In the long run, even these increased exports are probably offset by rising imports that result from the operation of the flexible exchange rate system. DISC helps exporters with large profit margins and does nothing for, and may even disadvantage, our import sensitive industries. Independent experts believe that DISC may have had no lasting effect on our balance of payments.

If government support is to be provided for exports, tax dollars should be expended more efficiently. In this regard, it is significant to note that the President's budget for fiscal year 1979 provides for a $2.2 billion increase between 1977 and 1978 in authorizations for direct loans by the Export-Import Bank and for another $800 million increase in 1979. Likewise, the Export-Import Bank's guarantee and insurance authorizations are increased by $1.8 billion in 1978 and by $1.7 billion in 1979. The Bank will use these funds to provide financial support for exports, targeted on areas of greatest need for this assistance. By contrast, DISC tax benefits are claimed without regard to whether there is any need for them or whether any real export improvement occurs through them.

Congress recognized the wasteful nature of DISC in 1976 when the Tax Reform Act limited its applicability. However, DISC continues to cost U.S. taxpayers over $1 billion per year, with well over one-half of DISC benefits realized by only 2 percent of the DISC's. While the 1976 changes reduced the cost of this wasteful program, we seriously doubt that those changes made the program more cost-effective.

We recommend the elimination of one-third of DISC benefits in 1979, two-thirds in 1980, and all DISC benefits in 1981 and later years. However, our proposal will not affect past earnings; accumulated DISC income will remain tax deferred as long as it continues to be invested in export-related assets.

Foreign Tax Deferral

Domestic corporations now pay a U.S. tax on the earnings from operations that they conduct directly overseas, such as through a foreign branch. However, domestic corporations can avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. The U.S. tax is usually deferred until dividends are paid by a subsidiary to its domestic parent, and then U.S. tax liability is offset by a tax credit for foreign income taxes paid on those remitted earnings. The President recommends that this deferral privilege be phased out over a 3-year period. At least one-third of a foreign subsidiary's earnings will be taxed to the U.S. parent in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980.

The fundamental problem with current law is that it makes the tax consequences of foreign investment depend upon the form of an investment, rather than its substance. Deferral is an artificial concept that causes the taxation of U.S. taxpayers to depend upon whether a foreign corporate charter has been placed as a screen between the foreign income and the U.S. taxpayer. In 1969, Congress revised the corporate surtax exemption provisions so that a commonly owned business enterprise would be taxed at the same rate, whether it operated under a single corporate charter or under multiple charters and regardless of the business reason for the use of multiple charters. We propose that Congress act in a similar manner to prevent the interposition of foreign corporate charters from affecting the level of U.S. taxation.

You will undoubtedly hear some persons argue that the termination of deferral will cause U.S. multinationals to lose their competitive position in world markets. The vast majority of investment is made in response to real market forces rather than the lure of the deferral preference. And consequently, when deferral is terminated, these overseas investments will continue to be made--and to be competitive--because they are governed not by tax consequences but by basic investment factors such as large and growing markets overseas, high consumer incomes, and a substantial demand for U.S. products.

In some countries, our tax deferral, in combination with their low tax rates, may provide an artificial tax incentive for U.S. investment. Elimination of deferral may restrict that insignificant portion of U.S. investment overseas that is now tax induced. But in such instances, there is no reason to favor a distortion of normal market forces that may work to the detriment of overall U.S. investment.

In short, the primary impact of deferral is to grant a tax preference to firms doing what prudent business judgment would dictate in the absence of deferral--investing in profitable foreign markets. There is no sound reason to continue this preference. The substantial business incentives recommended by the President will help ensure that U.S. multinationals have ample after-tax funds available to make the productive investments necessary to remain competitive in world markets. Terminating deferral represents only a small offset to the gains that businesses will realize through other provisions in the tax package. The Administration has proposed a program of business taxation that is generous and fair and does not depend upon the formalistic structure of international business operations.

SPECIAL TAX REDUCTIONS PROPOSED TO REDUCE COSTS FOR CONSUMERS AND BUSINESSES

Finally, we propose two tax reduction measures--outside the income tax system--that will assist our efforts to attain price stability.

Repeal of Excise Tax on Telephone Services

The present 4 percent excise tax on amounts paid for telephone services is now being phased out at the rate of 1 percentage point a year, with full repeal scheduled as of

January 1, 1982. The Administration's program will completely repeal this tax as of October 1, 1978. This action will reduce the cost of living directly. It will also lower consumer prices indirectly through a reduction of the business cost associated with telephone services.

Federal Unemployment Insurance Tax

We also recommend a reduction in the Federal unemployment insurance tax to reduce the payroll costs of employers. On January 1, 1977, the unemployment insurance tax rate rose from 0.5 percent to 0.7 percent of an employer's taxable wage base. This tax increase was instituted in order to replenish general revenue funds that have been loaned to the unemployment insurance trust fund during recent periods of high unemployment. We remain committed to sound financing of unemployment compensation; a National Committee on Unemployment Compensation will soon be appointed to study the long-term financing issue. Pending that study, we believe that the proposed tax cut can make a significant contribution to our efforts to fight the immediate problem of inflation. The President's tax program will reduce the tax rate to the 0.5 percent level as of January 1, 1979.

CONCLUSION

The President's recommendations would effect important changes in our Nation's tax laws. These proposals are presented in the form of a balanced package of tax reductions and reforms that should be manageable in one Congressional session. Action this year is vital. The sustained growth of our economy requires tax reductions for individuals to maintain their purchasing power, and for businesses to encourage investment in new facilities.

Tax reforms, designed to promote equity and simplification, are carefully integrated with the proposed tax cuts. Reforms finance a major part of the gross tax reductions. In the absence of offsetting reforms, we must either reduce the cuts substantially or face a budget deficit for fiscal year 1979 that expands well beyond the fiscal year 1978 figure; neither of these alternatives is acceptable.

Moreover, the tax reforms enable us to target the net tax relief where it is needed most. Substantial reductions can be provided to individuals heavily burdened by current tax liability without passing along an unwarranted tax cut

to those persons already avoiding the payment of their fair share. Likewise, the merging of tax reform with the proposed business cuts produces investment incentives that are potent, efficient and equitable.

Our efforts in developing this package have been assisted greatly by the consultations we have had with members of this Committee. That relationship will become even more important in the weeks ahead as this Committee and the Administration work together to fashion tax legislation. The American people deserve prompt enactment of a tax reform and reduction program, and we must meet that challenge.

Table 1

1978

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1978 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 1/	FICA tax 3/	Total tax	Income tax	FICA tax	Total tax
	(dollars)								
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	965	3,145	2,042	1,071	3,113	-138	106	-32
25,000	3,150	965	4,115	3,025	1,071	4,096	-125	106	-19
30,000	4,232	965	5,197	4,150	1,071	5,221	-82	106	24
40,000	6,848	965	7,813	6,748	1,071	7,819	-100	106	6
50,000	9,950	965	10,915	9,855	1,071	10,926	-95	106	11
100,000	28,880	965	29,845	28,640	1,071	29,711	-240	106	-134

Office of the Secretary of the Treasury
Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table 2

1979

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1979 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 3/	FICA tax 4/	Total tax	Income tax	FICA tax	Total tax
(dollars)									
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	965	3,145	1,910	1,226	3,136	-270	261	-9
25,000	3,150	965	4,115	2,830	1,404	4,234	-320	439	119
30,000	4,232	965	5,197	3,910	1,404	5,314	-322	439	117
40,000	6,848	965	7,813	6,630	1,404	8,034	-218	439	221
50,000	9,950	965	10,915	9,870	1,404	11,274	-80	439	359
100,000	28,880	965	29,845	29,470	1,404	30,874	590	439	1,029

January 20, 1978

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Assumes deductible expenses equal to 20 percent of income under proposal.

4/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 3

1978

Combined Income Tax and FICA Tax Burdens

Four Person, Two-earner Families 1/

Wage Income	Present Law Tax: Income tax 2/	Present Law Tax: FICA tax 3/	Present Law Tax: Total tax	1978 Proposed Tax: Income tax 2/	1978 Proposed Tax: FICA tax 4/	1978 Proposed Tax: Total tax	Change in Tax: Income tax	Change in Tax: FICA tax	Change in Tax: Total tax
(dollars)									
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	1,170	3,350	2,042	1,210	3,252	-138	40	-98
25,000	3,150	1,463	4,613	3,025	1,513	4,538	-125	50	-75
30,000	4,232	1,755	5,987	4,150	1,815	5,965	-82	60	-22
40,000	6,848	1,931	8,779	6,748	2,142	8,890	-100	211	111
50,000	9,950	1,931	11,881	9,855	2,142	11,997	-95	211	116
100,000	28,880	1,931	30,811	28,640	2,142	30,782	-240	211	-29

Office of the Secretary of the Treasury
Office of Tax Analysis

January 23, 1978

1/ Assumes that each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income.

3/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

4/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table 4

1979

Combined Income Tax and FICA Tax Burdens

Four Person, Two-earner Families 1/

Wage Income	Present Law Tax			1979 Proposed Tax			Change in Tax		
	Income tax 2/	FICA tax 3/	Total tax	Income tax 4/	FICA tax 5/	Total tax	Income tax	FICA tax	Total tax
(dollars)									
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	1,170	3,350	1,910	1,226	3,136	-270	56	-214
25,000	3,150	1,463	4,613	2,830	1,533	4,363	-320	70	-250
30,000	4,232	1,755	5,987	3,910	1,839	5,749	-322	84	-238
40,000	6,848	1,931	8,779	6,630	2,452	9,082	-218	521	303
50,000	9,950	1,931	11,881	9,870	2,808	12,678	-80	877	797
100,000	28,880	1,931	30,811	29,470	2,808	32,278	590	877	1,467

Office of the Secretary of the Treasury
Office of Tax Analysis

January 23, 1978

1/ Assumes that each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income under present law.

3/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

4/ Assumes deductible expenses equal to 20 percent of income under proposal.

5/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 5

Individual Tax Rate Schedules For
Joint Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14%	0	12%
500 - 1,000	70	14	60	12
1,000 - 2,000	140	15	120	14
2,000 - 3,000	290	16	260	16
3,000 - 4,000	450	17	420	17
4,000 - 8,000	620	19	590	18
8,000 - 12,000	1,380	22	1,310	19
12,000 - 16,000	2,260	25	2,070	20
16,000 - 20,000	3,260	28	2,870	23
20,000 - 24,000	4,380	32	3,790	27
24,000 - 28,000	5,660	36	4,870	32
28,000 - 32,000	7,100	39	6,150	36
32,000 - 36,000	8,660	42	7,590	39
36,000 - 40,000	10,340	45	9,150	42
40,000 - 44,000	12,140	48	10,830	44
44,000 - 48,000	14,060	50	12,590	48
48,000 - 52,000	16,060	50	14,510	48
52,000 - 54,000	18,060	53	16,430	51
54,000 - 62,000	19,120	53	17,450	51
62,000 - 64,000	23,360	53	21,530	51
64,000 - 76,000	24,420	55	22,550	54
76,000 - 88,000	31,020	58	29,030	57
88,000 - 90,000	37,980	60	35,870	57
90,000 -100,000	39,180	60	37,010	60
100,000 -110,000	45,180	62	43,010	60
110,000 -120,000	51,380	62	49,010	62
120,000 -130,000	57,580	64	55,210	62
130,000 -140,000	63,980	64	61,410	64
140,000 -150,000	70,380	66	67,810	64
150,000 -160,000	76,980	66	74,210	65
160,000 -175,000	83,580	68	80,710	65
175,000 -180,000	93,780	68	90,460	66
180,000 -200,000	97,180	69	93,760	66
200,000 and over	110,980	70	106,960	68

Office of the Secretary of the Treasury
Office of Tax Analysis

January 24, 1978

1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $3,200.

Table 6

Individual Tax Rate Schedules For
Single Returns

Taxable Income Bracket 1/	Present Law		Tax Proposal	
	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 500	0	14	0	12
500 - 1,000	70	15	60	13
1,000 - 1,500	145	16	125	15
1,500 - 2,000	225	17	200	15
2,000 - 3,000	310	19	275	18
3,000 - 4,000	500	19	455	19
4,000 - 6,000	690	21	645	20
6,000 - 8,000	1,110	24	1,045	20
8,000 -10,000	1,590	25	1,445	22
10,000 -12,000	2,090	27	1,885	23
12,000 -14,000	2,630	29	2,345	25
14,000 -16,000	3,210	31	2,845	25
16,000 -18,000	3,830	34	3,345	29
18,000 -20,000	4,510	36	3,925	29
20,000 -22,000	5,230	38	4,505	33
22,000 -24,000	5,990	40	5,165	33
24,000 -26,000	6,790	40	5,825	38
26,000 -28,000	7,590	45	6,585	38
28,000 -32,000	8,490	45	7,345	41
32,000 -36,000	10,290	50	8,985	46
36,000 -38,000	12,290	50	10,825	50
38,000 -40,000	13,290	55	11,825	50
40,000 -44,000	14,390	55	12,825	51
44,000 -48,000	16,590	60	14,865	57
48,000 -50,000	18,990	60	17,145	58
50,000 -52,000	20,190	62	18,305	58
52,000 -54,000	21,430	62	19,465	60
54,000 -60,000	22,670	62	20,665	60
60,000 -62,000	26,390	64	24,265	60
62,000 -64,000	27,670	64	25,465	63
64,000 -70,000	28,950	64	26,725	63
70,000 -76,000	32,790	66	30,505	63
76,000 -80,000	36,750	66	34,285	66
80,000 -88,000	39,390	68	36,925	66
88,000 -90,000	44,830	68	42,205	66
90,000 -100,000	46,190	69	43,525	67
100,000 and over	53,090	70	50,225	68

Office of the Secretary of the Treasury January 21, 1978
Office of Tax Analysis

1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $2,200.

Table 7

Summary of Revenue Effects of Income Tax Reductions, Tax Reforms and Telephone Excise and Unemployment Insurance Tax Reductions

($billions)

	Fiscal Years				
	1979	1980	1981	1982	1983
Individual Income Tax:					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax:					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemployment insurance tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1
Total	**-25.0**	**-26.6**	**-28.6**	**-30.8**	**-34.9**

Table 8

The Effect of Tax Proposals on Calendar Year Tax Liability

($ millions)

	Full year 1976	Calendar Years 1978	1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-6,067	-23,538	-26,583	-30,272	-34,732	-40,110
Itemized deduction changes:							
Repeal gasoline tax deductions	582		862	983	1,121	1,277	1,456
Repeal sales tax deductions	1,672		2,477	2,824	3,219	3,670	4,184
Repeal miscellaneous tax deductions	384		569	649	739	843	961
Deduction for medical and casualty expenses	1,396		1,909	2,119	2,352	2,611	2,898
Repeal political contributions deduction	2		2	4	2	3	3
Repeal capital gains alternate tax	113		140	151	162	174	187
Individual real estate tax shelters	320		61	181	296	407	514
Taxation of unemployment benefits	275		212	207	204	204	214
Tax interest element of annuity contracts	320		12	26	40	57	80
Minimum tax change	229		284	306	329	353	380
Taxable bond option (individual)	255		197	592	1,080	1,666	2,218
Extend 10 percent investment tax credit to structures (indiv.)	-36	-47	-54	-65	-73	-79	-86
Limit individual tax credits to 90 percent of tax before credits	38		52	58	64	71	79
Tax qualified retirement plans and employee death benefits	30		32	32	33	33	34
Corporate real estate shelters	180		40	118	194	265	335
Corporate family farm accounting	30		40	25	10	5	7
Bad debt reserves:							
Commercial banks	196		227	232	232	23	--
Mutual savings banks and savings and loans	82		37	85	145	221	316
Credit unions	82		22	50	83	123	171
Entertainment expenses	1,125		1,476	1,633	1,771	1,932	2,107
Taxable bond option (corporations)	-24		-15	-47	-79	-113	-150
Phase-out DISC over 3 years	852	193	664	1,228	1,513	1,613	1,751
Phase-out deferral of tax on foreign source income	523		88	280	768	830	897
Corporate tax rate reduction	-5,718	-1,349	-5,965	-8,516	-9,228	-10,010	-10,764
At risk limitation (corporations)	10		14	10	8	5	6
Increase investment tax credit limit to 90 percent	-71		-882	-576	-114	-194	-205
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,100	-1,389	-1,649	-1,869	-2,074	-2,268
Nondiscrimination rule for health and group term life plans	29		32	33	34	35	36
Full investment tax credit for pollution abatement facilities	-90	-142	-93	-107	-127	-115	-144
Total individual	-11,725	-6,114	-16,783	-18,516	-20,704	-23,442	-26,988
Total corporate	-3,849	-2,398	-5,704	-7,201	-6,659	-7,454	-7,905
Subtotal tax reform	-15,574	-8,512	-22,487	-25,717	-27,363	-30,896	-34,893
Repeal telephone excise tax	--	-355	-1,200	-900	-500	--	--
Reduce unemployment payroll tax rate	--	--	-850	-900	-950	-1,000	-1,050
Total	-15,574	-8,867	-24,537	-27,517	-28,813	-31,896	-35,943

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Table 9

The Effect of Tax Reform Proposals on Fiscal Years Receipts

($ millions)

Provisions	Full year 1976	Fiscal Year 1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-22,544	-25,669	-29,166	-33,394	-38,497
Itemized deduction changes:						
Repeal gasoline tax deductions	582	603	947	1,080	1,230	1,402
Repeal sales tax deductions	1,672	1,734	2,720	3,100	3,535	4,030
Repeal miscellaneous tax deductions	384	398	625	712	812	926
Deduction for medical and casualty expenses	1,396	1,336	2,056	2,282	2,533	2,812
Repeal political contributions deduction	2	1	3	3	3	3
Repeal capital gains alternate tax	113		140	151	162	174
Individual real estate tax shelters	320	9	93	228	361	448
Taxation of unemployment benefits	275	151	208	205	204	211
Tax interest element of annuity contracts	320		12	26	40	57
Extend 10 percent investment tax credit to structures (individual)	-36	-55	-61	-72	-81	-82
Minimum tax changes	229		284	306	329	353
Taxable bond option (individual) 1/	255	30	301	783	1,381	1,873
Limit individual tax credits to 90 percent of tax before credits	38	7	58	64	71	74
Tax qualified retirement plans and employee death benefits	30	5	34	35	35	33
Corporate real estate shelters	180	18	75	152	226	296
Corporate family farm accounting	30	18	33	18	8	6
Bad debt reserves:						
Commercial banks	196	102	229	232	138	13
Mutual savings banks and savings and loans	82	17	59	112	179	264
Credit unions	82	10	35	65	101	145
Entertainment expenses	1,125	664	1,547	1,695	1,843	2,011
Taxable bond option (corporations) 1/	-24	-7	-29	-61	-94	-130
Phase out DISC over 3 years	852	249	807	1,551	1,771	1,675
Elimination of deferral of tax on foreign source income	523	40	174	500	796	860
Corporate tax rate reduction	-5,718	-3,953	-7,078	-8,827	-9,570	-10,339
At risk limitation	10	2	14	10	8	5
Increase investment tax credit limit to 90 percent	-71	-397	-744	-368	-150	-199
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,725	-1,506	-1,748	-1,961	-2,161
Nondiscrimination rule for health and group term life plans	29	14	32	33	34	35
Full investment tax credit for pollution abatement facilities	-90	-184	-99	-116	-122	-128
Total individual	-11,725	-18,325	-18,249	-20,263	-22,779	-26,183
Total corporate	-3,849	-5,132	-6,451	-6,752	-6,793	-7,647
Subtotal, tax reform	-15,574	-23,457	-24,700	-27,015	-29,572	-33,830
Repeal telephone excise tax	--	-955	-1,050	-700	-250	--
Reduce unemployment payroll tax rate	--	-600	-900	-900	-1,000	-1,100
Total	-15,574	-25,012	-26,650	-28,615	-30,822	-34,930

Office of the Secretary of the Treasury, Office of Tax Analysis January 27, 1978

1/ Outlays associated with the proposal are $99 million in 1979, $495 million in 1980 increasing to $222 million in 1983.

22-302 O - 78 - 4

Table 10

Expanded Income and Tax Liability Under Present Law
And Tax Proposals (Personal Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class ($000)	Number of Returns (thousands)	Expanded Income	Present Law: Tax Liability	Present Law: Effective Tax Rate	Administration Proposal: Tax Liability	Administration Proposal: Effective Tax Rate
Less than 5	25,474	57,557	141	0.2%	-251	-0.4%
5 - 10	20,109	149,590	8,227	5.5%	6,368	4.3%
10 - 15	16,106	201,036	18,071	9.0%	15,361	7.6%
15 - 20	11,824	205,086	23,009	11.2%	20,148	9.8%
20 - 30	9,907	237,041	32,778	13.8%	29,593	12.5%
30 - 50	3,347	124,836	22,017	17.6%	20,971	16.8%
50 - 100	985	67,484	16,492	24.4%	16,344	24.2%
100 - 200	198	27,371	8,084	29.5%	8,261	30.2%
200 and over	49	21,573	6,476	30.0%	6,838	31.7%
Total	87,998	1,091,573	135,293	12.4%	123,633	11.3%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Note: Details may not add to totals due to rounding.

Tax Reform Program: Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.

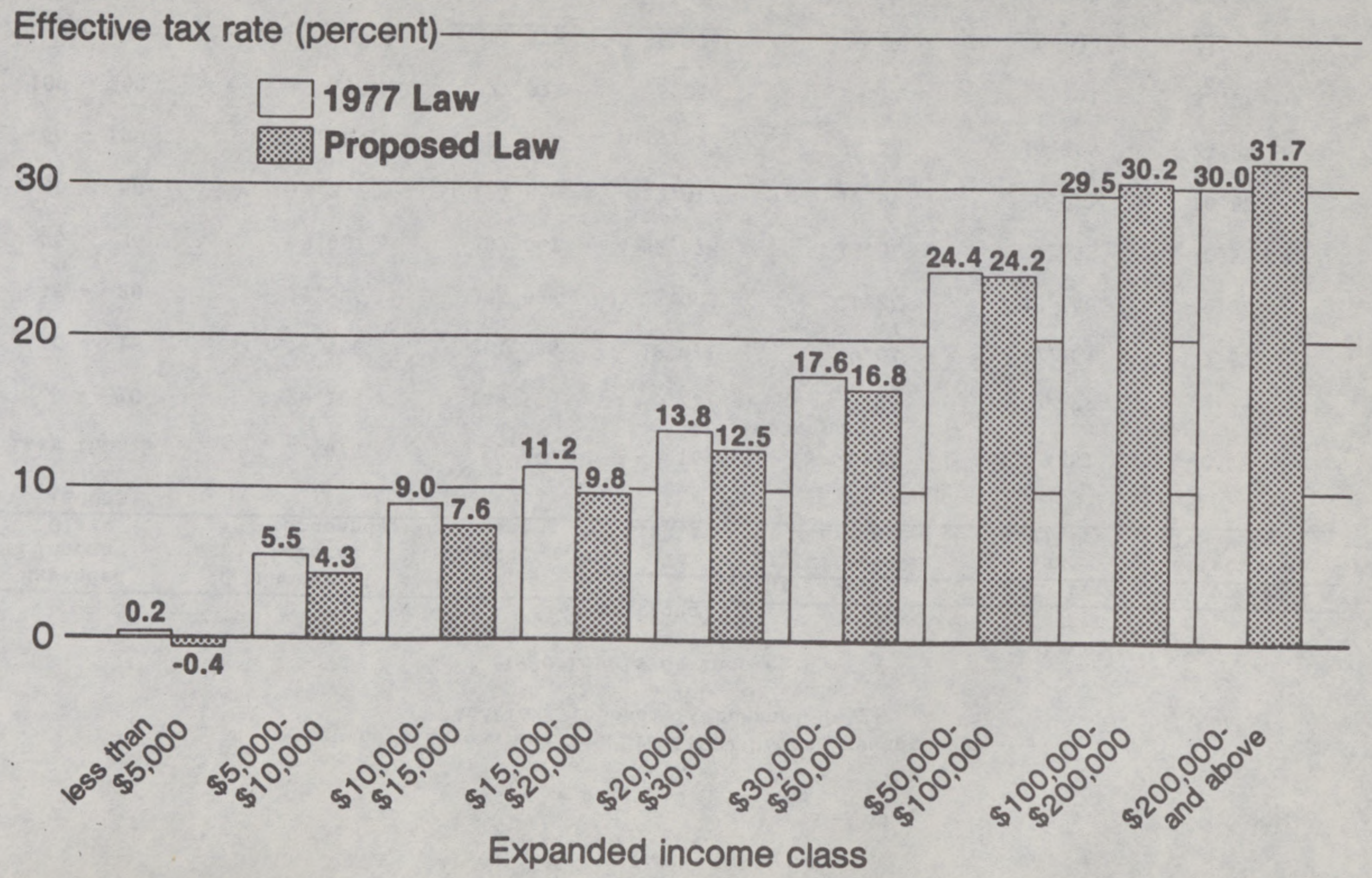


Table 12

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Note: Details may not add to totals due to rounding.

Table 13

Burden Table

Single Returns

(1976 Levels of Income)

Expanded income class ($000)	Average tax present law	Average tax under proposal	Average tax change	Percentage change
	(..... dollars .....)			(.. percent ..)
Less than 10	217	181	-36	-16.4%
10 - 15	1,595	1,519	-76	-4.8
15 - 20	2,768	2,591	-177	-6.4
20 - 30	4,236	3,917	-319	-7.5
30 - 50	8,254	7,660	-594	-7.2
50 - 100	18,465	17,889	-576	-3.1
100 - 200	42,015	41,714	-301	-0.7
200 and over	161,723	167,760	6,037	3.7

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Table 14

Burden Table
Joint Returns
No Dependents

(1976 Levels of Income)

Expanded income class ($000)	Average tax present law	Average tax under proposal	Average tax change	Percentage change
	(..... dollars .....)			(.. percent ..)
Less than 10	168	95	-73	-43.6%
10 - 15	1,104	983	-121	-11.0
15 - 20	2,084	1,906	-178	-8.5
20 - 30	3,615	3,308	-307	-8.5
30 - 50	6,921	6,535	-386	-5.6
50 - 100	17,020	16,647	-373	-2.2
100 - 200	40,403	40,956	553	1.4
200 and over	132,121	137,140	5,020	3.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Table 15

Burden Table
Joint Returns
One Dependent

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..... dollars .....)			(.. percent ..)
Less than 10	65	-38	-103	-157.8%
10 - 15	1,024	824	-200	-19.5
15 - 20	1,922	1,696	-226	-11.7
20 - 30	3.392	3,063	-329	-9.7
30 - 50	6,709	6,327	-382	-5.7
50 - 100	16,938	16,625	-313	-1.8
100 - 200	41,993	42,264	271	0.6
200 and over	121,583	125,202	3,620	3.0

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January 21, 1978

Table 16

Burden Table
Joint Returns
Two Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..... dollars .....)			(.. percent ..)
Less than 10	9	-79	-88	-975.6%
10 - 15	867	589	-278	-32.1
15 - 20	1,739	1,461	-278	-16.0
20 - 30	3,117	2,780	-337	-10.8
30 - 50	6,287	5,979	-308	-4.9
50 - 100	16,336	16,088	-248	-1.5
100 - 200	40,885	41,087	202	0.5
200 and over	127,666	130,473	2,807	2.2

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January 21, 1978

Table 17

Burden Table
Joint Returns
Three Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..... dollars .....)			(.. percent ..)
Less than 10	-41	-81	-40	-97.7%
10 - 15	693	367	-326	-47.0
15 - 20	1,562	1,218	-344	-22.0
20 - 30	2,867	2,514	-353	-12.0
30 - 50	5,872	5,609	-263	-4.5
50 - 100	15,924	15,785	-139	-0.9
100 - 200	40,417	40,827	410	1.0
200 and over	126,915	130,397	3,483	2.7

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January 21, 1978

Table 18

Burden Table
Joint Returns
Four Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..... dollars .....)			(.. percent ..)
Less than 10	-64	-70	-6	-9.9%
10 - 15	526	177	-349	-66.3
15 - 20	1,375	985	-390	-28.3
20 - 30	2,590	2,248	-342	-13.2
30 - 50	5,720	5,521	-199	-3.5
50 - 100	16,529	16,593	64	0.4
100 - 200	42,090	42,707	617	1.5
200 and over	127,755	131,298	3,543	2.8

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January 10, 1978

The President's 1978 Tax Program

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Detailed Descriptions and Supporting Analyses of the Proposals

January 30, 1978

DEPARTMENT OF THE TREASURY Washington, D.C.

TABLE OF CONTENTS

page

I. OVERVIEW OF THE TAX REDUCTION AND REFORM ACT OF 1978

A. Fiscal Stimulus and Economic Growth Achieved by the Tax Program 3

B. Increased Equity Achieved by the Tax Program 11

C. Simplification Achieved by the Tax Program 18

II. TAX TREATMENT OF INDIVIDUALS

A. Rates and Credits
1. Individual Tax Rates and the Personal Credit 25
2. Ordering Tax Credits. 39

B. Itemized Deductions
1. Introduction 42
2. Medical and Casualty Deductions 45
3. Deductions for State and Local Taxes. 51
4. Deductions for Political Contributions. . . . 55

C. Capital Gains--Repeal of Alternative Tax 59

D. Tax Shelters
1. Introduction 64
2. Examples of Tax Shelter Abuse 71
3. Real Estate Depreciation 81
4. Minimum Tax for Individuals 103
5. At Risk 109
6. Classification of Limited Partnerships. . . . 117
7. Audit of Partnerships 121
8. Tax Shelter Annuities 132

		page
E.	Employee Benefits	
	1. Introduction	
	2. Qualified Retirement Plans and Social Security	145
	3. Medical, Disability, and Life Insurance Provided by Employer	147
	4. Employee Death Benefits	164
	5. Unemployment Compensation Benefits	174
		177
F.	Entertainment and Travel	
	1. Introduction	
	2. Examples of Problems Under Present Law	182
	3. Entertainment Expenses	183
	4. First Class Air Fare	195
	5. Foreign Conventions	205
		208
III.	TAX EXEMPT FINANCING	
A.	State and Local Taxable Bond Option	215
B.	Tax Treatment of Industrial Development Bonds	236
IV.	TAX TREATMENT OF BUSINESS	
A.	Corporate Tax Rate Reduction	251
B.	Investment Credit	254
C.	Small Business	
	1. Introduction	
	2. Liberalization of Subchapter S	263
	3. Depreciation for Small Business	264
	4. Small Business Stock	268
		271
D.	Corporate Preferences	
	1. Repeal of DISC	
	2. Terminating Deferral	274
	3. Financial Institutions	282
	4. Accrual Accounting for Agricultural Corporations	298
		314
E.	Simplification of ADR Depreciation	321
V.	EXCISE TAXES	
A.	Communications Tax Repeal	327
B.	Unemployment Tax Rate Reduction	329

I

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Overview of the Tax Reduction and Reform Act of 1978

IA

FISCAL STIMULUS AND ECONOMIC GROWTH

ACHIEVED BY THE TAX PROGRAM

The Need for a Tax Cut

To achieve the economic goals outlined in the President's Budget and Economic Messages, prompt, permanent tax reductions for both individuals and corporations are required. Such reductions are needed not because the U.S. economy is weak today, but rather to strengthen and maintain the current economic expansion, and to assure the future productivity of the economy. The unemployment rate has declined by more than two and a half points from its peak in 1975, but unemployment remains unacceptably high. To assure that it will continue to decline through 1979, the economy must continue to grow at a rate of 4-1/2 to 5 percent.

To maintain this growth rate will require a fiscal offset to the drain on consumer purchasing power from higher taxes and inflation. The outlook for future increases in consumption is dimmed by the recently legislated increases in social security taxes, which will reduce consumer take-home pay in 1978 and especially in 1979 and subsequent years. Furthermore, without personal tax reductions, inflation would operate to move individual taxpayers into higher marginal tax brackets, increasing their effective tax burden just as though higher rates had been enacted.

The tax cut is also designed to stimulate business investment. In recent years, the growth in the stock of productive capital in the United States has been inadequate. During the current recovery, the level of business investment has been particularly sluggish. Real business investment during the fourth quarter of 1977 was three percent below its previous peak (during the first quarter of 1974). This weakness was particularly noticeable in investment in non-residential structures which, during the fourth quarter of 1977 (corrected for inflation), remained 14 percent below its peak during the third quarter of 1973.

The sluggishness of business investment could become a major long-run problem. For the longer term, an increasing portion of GNP must be devoted to investment in order to

facilitate the introduction of new technology and to expand and modernize the nation's stock of capital, thereby raising the overall productivity of the economy and reducing inflationary pressures. Additional capital is needed to equip a growing labor force, to meet the goals of the National Energy Plan, and to provide a cleaner environment and safer workplaces. In addition, the real income of workers can grow over the long run only if labor productivity is enhanced. Increased capital formation, which provides new and more efficient productive facilities, can help accelerate the growth of labor productivity, offsetting inflationary pressures and improving U.S. competitiveness in world markets.

Moreover, growth in the stock of capital must be accompanied by increased efficiency in its use. Much of the current capital stock is outmoded. It is energy intensive, predicated on the existence of cheap energy--something that will not occur again. Similarly, much of the existing capital was constructed when environmental standards were less stringent than they are today. The achievement of a more efficient capital stock will require high levels of new investment, which in turn requires a tax program that will assure adequate after-tax returns to capital.

Finally, the composition of the existing capital stock has been distorted by features of current tax law. For example, opportunities for tax-sheltered investments and more lightly-taxed investment abroad, as well as restrictions on the investment in industrial facilities eligible for the investment credit, all tend to discourage the most efficient allocation of capital resources. These tax impediments to an efficient overall stock of capital must be removed.

In a suitable fiscal environment, the private sector is capable of strong economic growth, but a tax cut is necessary at this time to ensure that the present expansion is not choked off by Federal taxes claiming a rising share of income. A balanced tax program is needed to strengthen and extend the current economic expansion in a non-inflationary way, to improve the capacity of the economy to supply goods and services, to increase real wages over time, and to insure that future growth is not aborted by capacity shortages. If the vigor of the current economic expansion is to be maintained and the unemployment rate is to be reduced below six percent, legislation must be enacted promptly.

The Proposals in General

The specific tax proposals will be discussed in detail below, but their general magnitude is presented in Table IA-1. Individual tax changes, reflecting primarily the $240 credit and the new individual rate schedules, will provide a gross tax cut for individuals of $23.5 billion in 1979 and,

Table IA-1

Summary of Tax Proposals
($ billions)

Proposal	Revenue Effect 1979
* Reduce Individual Tax Rates and Adopt $240 Personal Credit	-23.5
* Limit Itemized Deductions	+5.8
* Restrict Tax Shelters and Other Opportunities to Receive Tax-Preferred Income	+1.0
* Restrict Deductions for Entertainment and Travel Expenses . . .	+1.5
* Reduce Corporate Tax Rates	-6.0
* Liberalize Investment Tax Credit	-2.4
* Curtail Business Tax Preferences	+1.1
* Reduce Telephone Excise and Unemployment Taxes	-2.0
TOTAL	-24.5

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after allowing for revenue raising reforms, a net reduction in individual income tax liabilities of $16.8 billion. Corporate changes consist of rate reductions and liberalization of the investment credit. These cuts, together with business tax reforms, yield a net reduction of almost $6 billion in 1979. In addition, both businesses and individuals will derive benefits from the $2 billion reduction in telephone excise taxes and a reduction in the payroll tax for unemployment insurance.

While these measures will tend to increase the budget deficit during 1979, the stimulus to the economy, which will lead to higher levels of economic activity during 1979, should offset about 35 percent of the initial revenue loss by 1980. With the proposed tax cuts, the unemployment rate will continue to decline throughout the period.

The Personal Tax Proposals

The largest single aspect of the package, introduction of the $240 credit and reduction of the individual tax rates, will become effective October 1, 1978, while most of the reforms, which generally lead to revenue gains, become effective January 1, 1979. Thus, the net tax reduction for individuals during calendar 1978 will be slightly over $6 billion, increasing to almost to $17 billion by 1979. The phase-in of this stimulus is such that its impact will be felt primarily during late 1978 and 1979, when it will be most needed.

The Business Tax Proposals

The benefits to the economy from the individual tax cuts will be augmented by the business tax program. This program not only will provide the stimulus to regain full employment, but it will also correct the current imbalance between the growth of productive capacity and the growth of the labor force. In the long run, this program will operate to increase the share of national output devoted to expansion and modernization of the nation's capital stock. Thus, the business tax proposals are designed to achieve multiple objectives, while assuring the continued vigor of the national economy.

First, and of overriding importance, is the stimulation to capital formation both in the near future and over the longer term. A significant cause of the recent sluggishness in business investment has been the low after-tax rate of return on investment. There has been a downward trend in the rate of return on reproducible assets since the mid-1960's, a trend that must be reversed. To this end, corporate tax rates will be reduced as of October 1, 1978, and further reduced on January 1, 1980. The 10 percent investment tax

credit will be made permanent, and will be extended to the construction or rehabilitation of industrial and utility structures. The full investment credit also will be extended to all pollution abatement facilities currently amortized over five years with a five percent credit. In addition, investors will be permitted to use these credits to offset 90 percent of tax liability in any year. Effective as of the first of January 1978, these liberalizations of the credit together with the corporate rate cuts will have a substantial impact on business investment beginning in 1978, an impact that will grow in 1979 and thereafter.

These tax reductions will stimulate capital formation in two ways. First, the lower taxes will have an immediate, favorable effect on corporate cash flow, facilitating the financing of capital expenditures. Second, the lower tax rates will increase after-tax profits on investment, creating incentives for corporations to increase capital spending. While there are substantial delays in the response of capital expenditures to stimulative measures, prompt enactment of this tax program should induce increased investment spending even during the current calendar year.

The degree of permanent investment stimulus in the program may be measured by the overall reduction in tax on returns from all investment, including the reductions in individual tax rates as they apply to dividends, interest, rents, royalties, capital gains, and profit of noncorporate enterprises. Even after allowances for revenue raising reforms, there will be a significant reduction in overall taxation of income from ownership of capital. 1/ As measured at 1979 levels of income, the entire tax program, when fully phased in, will reduce taxes on capital income by an estimated $7.3 billion. The elements of the program included in this estimate are set forth in Table IA-2. The table discloses that the combined amounts of individual and corporate rate reductions and liberalization of the investment credit will substantially outweigh selective tax increases from business reforms. This permanent, net reduction in taxes on investment income will provide a lasting incentive to capital formation.

It is equally important that the increase in aggregate capital spending be allocated in an efficient way. Efforts must therefore be made to reduce incentives in the tax system that give rise to inefficiencies in the allocation of capital. The restructuring of the investment credit and a number of the reforms in the business tax proposals are directed toward this goal.

Table IA-2

Change in Tax on Capital Income

($ millions)

Proposal	:Full Year : 1979
Individual rate reductions, $240 credit, and itemized deductions (capital income only) 1/	-1,832
Repeal alternate tax for individuals	140
Minimum tax change	284
Real estate shelters	666
Financial Institutions	224
Taxable bond option	257
Tax credits limited to 90 percent of individual liability	52
At risk limitation	13
Elimination of deferral of tax on foreign source income	660
Phase out of DISC	1,032
Corporate family farm accounting	35
Investment tax credit:	
Extend to structures	-1,443
Increase liability limit to 90 percent	- 84
Pollution abatement facilities	- 120
Corporate tax rate reductions	-7,203
Total for capital income	-7,319

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1/ Capital income items are: dividends, interest, rents, royalties, capital gains, proprietorship, and partnership income.

For example, the investment credit currently applies to industrial equipment, but not to the buildings needed to house that equipment. Thus, the tax system encourages businesses to build a capital stock that is "over-equipped" and "under-housed" relative to what it would be under a more neutral tax system. Extending the credit to industrial structures will eliminate this bias.

Other efficiency losses stem from variations in the tax rates paid by different industries. Such variations occur because of the very different way in which different forms of business income are taxed. The present tax proposals seek to encourage a more efficient allocation of capital resources by reducing the tax incentives that distort investment decisions. This would be accomplished by making effective business tax rates more equal through repeal of some special provisions for taxing business income. These include the phase-out of DISC, the elimination of tax deferral on foreign source income, changes in provisions for bad debt reserves by financial institutions, and increasing the taxation of tax shelters and other tax preference items.

Overall Impact of the Tax Program

In the absence of this tax program, the share of the nation's output going to the Federal government will continue to rise. The Social Security tax increases, the unemployment insurance tax increases, and the "inflation tax" increases would mean that in fiscal year 1979, Federal receipts would be equal to 20.4 percent of GNP. The Administration's tax program would reduce this share to 19.3 percent.

A similar pattern is reflected in individual income taxes as a percent of personal income. Under current law, this ratio would rise to 10.7 percent in calendar year 1978 and 11.4 percent in 1979--close to its historic high (11.6 percent in 1969). The Administration's tax program will reduce these ratios to 10.3 percent and 10.5 percent, respectively, thus working to offset the fiscal drag on the economy.

While the impact of the entire tax package on the performance of the economy will be modest in 1978, it will become significant in 1979. In the absence of the tax package, we would expect the unemployment rate to remain steady at 6.3 percent or move slightly upwards. The tax stimulus will increase output by $40 billion by the end of 1979, creating one million more jobs and reducing the rate of unemployment below six percent. Forecasting the performance of the economy beyond 1979 is hazardous, but it seems clear that, in the absence of the tax package, there would be further softening of the economy, while with the tax package the economy will continue to expand.

Such economic stimulus is not entirely without cost: while the rate of inflation will continue to decline each year, it would decline more rapidly in the absence of the stimulus. In proposing this package, the Administration has made the judgment that the production of an additional $40 billion of goods and services (in 1977 prices) and the creation of almost a million new jobs is worth the risk of an extra one-tenth of one percent in the inflation rate at the end of 1979.

The tax program is thus a key element in the Administration's overall economic plan, which relies principally upon growth in the private sector to create the jobs needed to achieve high employment. The tax program is designed to offset such fiscal changes as the "inflation tax" and increased social security taxes that would otherwise tend to limit economic growth. It will reform our present system in order to achieve greater equity and simplification. The tax program will also raise the rate of return on investment, to stimulate expansion and modernization of our capital stock, increasing employment in the short run and raising productivity and removing capacity bottlenecks in the future. At the same time, the tax program avoids excessive stimulation, for potential inflationary pressures are still present in the economy. The reductions in the telephone excise tax and the unemployment insurance tax work directly against such pressures by reducing the cost of output. Other aspects of the Administration's economic program will also help in restraining inflation, most notably the expenditure restraint contained in the fiscal year 1979 Budget and the program for voluntary wage and price restraint. Taken together, all these programs will enable the U.S. economy to enjoy steady, sustainable, non-inflationary economic growth.

Footnote

1/ Regardless of whether the tax on capital income is paid by corporations or individuals.

IB

INCREASED EQUITY ACHIEVED BY THE TAX PROGRAM

One important goal of the Administration's tax proposals is to restructure the law to increase the extent to which it reflects the two basic principles of tax fairness. The first principle, generally referred to as horizontal equity, is that people with comparable incomes should pay a comparable amount of tax. The second principle, vertical equity, is that tax liabilities should increase with increasing ability to pay; that is, the tax system should be progressive. Although other objectives of the income tax system may at times come into conflict with the principles of equity, our income tax structure -- if it is to be maintained -- must rest on this foundation.

Effective administration of our income tax depends upon the perception by taxpayers that the system is basically equitable. If honest citizens begin to doubt the equity or fairness of the system, the level of voluntary compliance will be diminished. Therefore, when taxpayers with an equal ability to pay are taxed at vastly different rates, or when higher income taxpayers are taxed at lower rates than lower income taxpayers, the viability of our income tax system becomes threatened.

Vertical Equity

Progressivity. The income tax has always been designed to be progressive, so that higher income individuals are to pay a larger share of their incomes in tax than lower income individuals. The Administration's tax proposals would reinforce the current progressivity of the income tax. The proposals are structured to give the lowest income classes the greatest percentage reductions in tax liability, the next greatest reductions to the middle income classes, and the smallest reductions to the upper income classes. In fact, the average taxpayer with an expanded income 1/ of $100,000 or more will have a slight tax increase. As a result, as shown in Table IB - 1, taxpayers with expanded income of up to $30,000 will bear a smaller proportion of the total tax burden, while those with expanded income of $30,000 or more will bear a greater proportion.

This increase in progressivity will be accomplished through replacement of the personal exemption with a personal credit and a restructuring of the tax rates. In addition, the proposals to provide further limits on tax shelters, to treat interest income from annuities the same as other

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Table IB-1

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

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Office of Tax Analysis

January 15, 1978

Note: Details may not add to totals due to rounding.

interest income, to repeal the alternative tax on capital gains and to tighten the minimum tax will enhance the equity of the tax system by restricting the extent to which individuals can lower their tax merely by the choice of their investments. The taxable bond option will reduce the extent to which high-bracket taxpayers can increase their after-tax income by holding tax-exempt bonds.

Chart IB-1 and Table IB-2 below, provide a comparison of effective tax rates under present law and the Administration's proposal.

Tax Reform and Poverty Levels. A major equity objective of reform of the individual income tax is the elimination of any income tax upon people whose incomes are at or near poverty levels. Since poverty level income is sufficient to purchase only minimum amounts of food, shelter, and other necessities, imposition of income tax on income below these levels is inappropriate.

The tax-free level of income is defined to be the maximum level of adjusted gross income at which no income tax is paid by a taxpayer who does not itemize deductions. The tax-free level is determined by the combination of personal exemptions, personal credits, and the zero bracket amount (or standard deduction) 2/.

In recent years, the tax-free level of income has been increased primarily through increases in the size of a minimum standard deduction. Under the tax proposals, the tax-free level will rise primarily from the change of the personal exemption to the personal credit.

Raising the tax-free levels of income also serves to limit the overlap of the income tax system with the welfare system. Under most welfare programs, there is a phase-out of benefits as income rises. If welfare benefits are reduced at the same level that income is taxed, a wage earner can face a situation where he can keep little if anything from an additional dollar of earned income. Therefore, to avoid strong disincentives to work at low income levels, it is desirable that tax-free levels of income be set high enough to prevent a dollar of increased earned income from causing both a reduction in welfare assistance and an increase in income tax liability.

A comparison of the tax-free levels of income and poverty levels is presented in Table IB - 3. Under the Administration's tax proposals the tax-free level of income would rise substantially above the poverty level for 1979.

It should be noted that the poverty level is defined in terms of total income, while the tax-free level of income is defined in terms of adjusted gross income for a taxpayer who

CHART I-B-1

Tax Reform Program: Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.

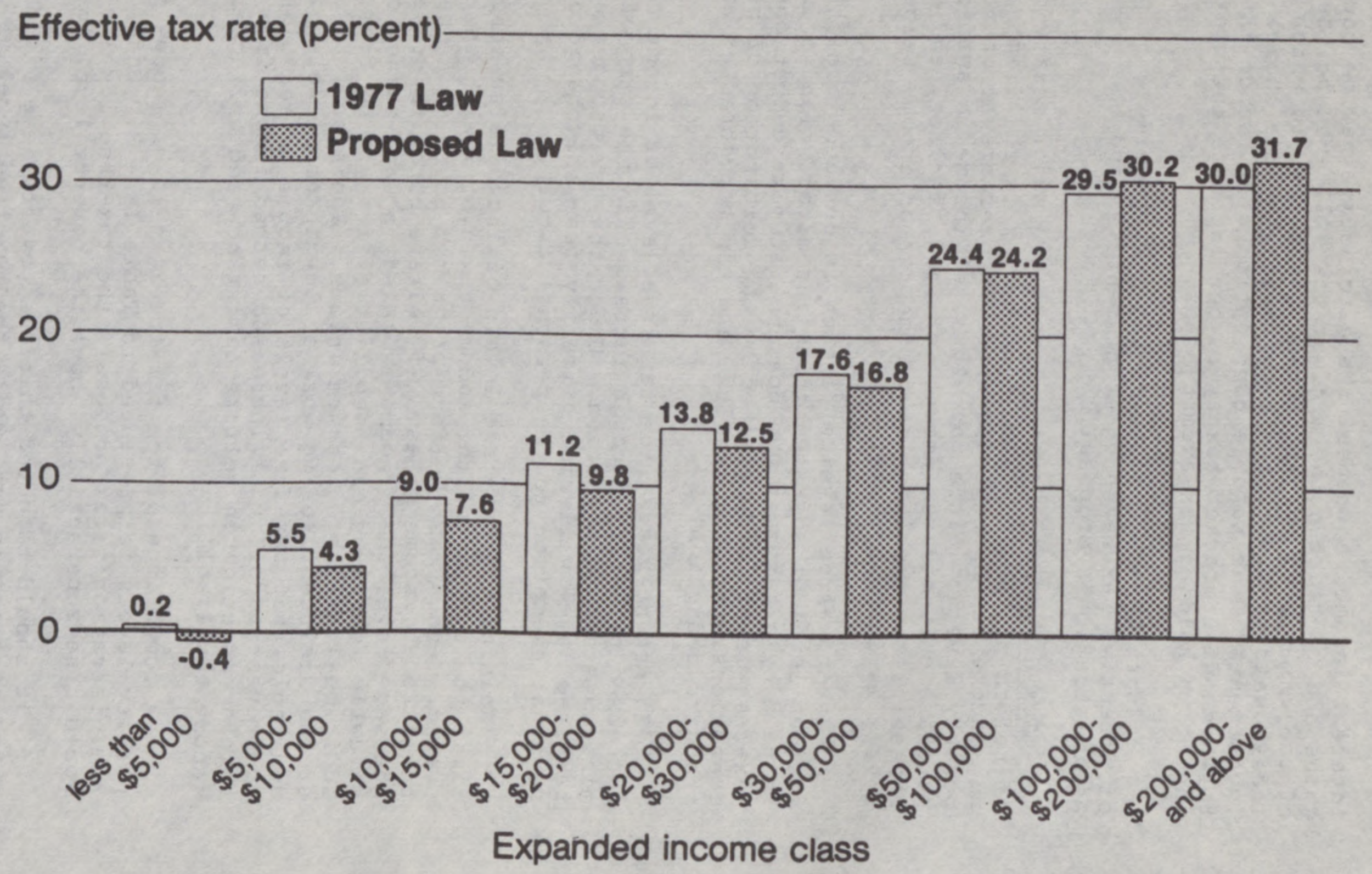


Table IB-2

Expanded Income and Tax Liability Under Present Law
And Tax Reform Proposals (Individual Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class ($000)	Expanded Income	Present Law		Tax Reform Proposal	
		Tax Liability	Effective Tax Rate	Tax Liability	Effective Tax Rate
Less than 5	57,557	141	0.2%	-251	-0.4%
5 - 10	149,590	8,227	5.5	6,368	4.3%
10 - 15	201,036	18,071	9.0%	15,361	7.6%
15 - 20	205,086	23,009	11.2%	20,148	9.8%
20 - 30	237,041	32,778	13.8.	29,593	12.5%
30 - 50	124,836	22,017	17.6	20,971	16.8%
50 - 100	67,484	16,492	24.4	16,344	24.2%
100 - 200	27,371	8,084	29.5	8,261	30.2%
200 and over	21,573	6,476	30.0	6,838	31.7%
Total	1,091,573	135,293	12.4%	123,633	11.3%

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Office of Tax Analysis

January 12, 1978

Note: Details may not add to totals due to rounding.

TABLE IB-3

Tax-Exempt and Poverty Levels

Of Income

Family Size 1/	Tax-Exempt Levels of Income Under Current Law 2/	Tax-Exempt Levels of Income Under Proposal 2/	1979 Poverty Levels 3/
1	3,200	3,967	3,449
2	5,200	6,553	4,438
3	6,200	7,922	5,429
4	7,200	9,256	6,954
5	8,183	10,589	8,223
6	9,167	11,884	9,280

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Office of Tax Analysis

Jan. 26, 1978

1/ Family size assumed to equal number of exemptions. For family sizes greater than two, families are assumed to file joint returns and be two parent families.
2/ Excludes Earned Income Credit.
3/ Non-farm families.

does not itemize and does not receive additional credits because of age or blindness. Thus, for some taxpayers, the tax-free level of income may be higher than the numbers reported in the table. This higher level may be the result of nontaxable income such as social security payments, extra credits, additional exemptions for age and blindness, or itemized deducions in excess of the zero bracket amount.

Employee Benefits -- Employer programs designed to provide retirement income to employees or to provide protection in the event of illness, death or disability receive favorable tax treatment. The President's proposals relating to qualified retirement plans and Social Security and medical, disability and life insurance provided by the employer will assure that a greater portion of the benefits from these plans will inure to rank and file employees.

Horizontal Equity -- Equal Incomes, Equal Tax

The tax proposals are also designed to move in the direction of equalizing the tax treatment of taxpayers with an equal ability to pay. The tax reform proposals previously described will reduce the disparity in tax treatment arising from choice of investment. Also, the President's proposal relating to entertainment benefits will tend to equalize the tax burden between those who are able to arrange their business activities so as to enjoy entertainment which is deductible and those who must provide these amenities out of after-tax dollars.

Finally, for taxpayers with over $20,000 of income if single and over $25,000 of income if married, at least some portion of their unemployment benefits will be taxed. These taxpayers with unemployment benefits will, therefore, be taxed more like other taxpayers at a comparable income level whose income is from other sources.

Footnotes

1/ As used here, the term "expanded income" is generally a taxpayer's adjusted gross income plus items of tax preference (not otherwise included in adjusted gross income).

2/ Before the Tax Reduction and Simplification Act of 1977, there was no zero bracket amount but rather a minimum standard deduction (low income allowance).

IC

SIMPLIFICATION ACHIEVED BY THE TAX PROGRAM

In our tax system, equity and public policy goals often conflict with the desire to achieve simplicity. Many deductions and credits are allowed in order to further public policies; however, government spending via the tax system invariably adds complexity to the tax laws. In many cases, factual situations are distinguishable and arguably ought to be taxed differently in the interest of equity. However, the more distinctions which the tax system recognizes, the more complicated it becomes and the more difficult it is to determine tax liability in even the most ordinary situations.

Some complexity in our tax laws cannot be avoided since the law must reflect the enormous complexity and vitality of the American economy. It is essential to our system of self-assessment, however, that the law be understandable to the people to whom it applies. At the present time even routine applications of the tax laws frequently are not understood. Our tax laws must be made simpler, especially for the average taxpayer who does not have access to high priced professional counsel.

The President's proposals include important steps toward simplification, without sacrificing equity. For both individual and business taxpayers, the proposals will reduce the amount of time and energy spent on recordkeeping and tax computation. They will also reduce the frequency of disputes between taxpayers and the Internal Revenue Service. For individuals the most significant gain in simplification is that about 6 million individual taxpayers will be able to determine their tax liability without itemizing deductions. Even those who continue to itemize will be required to keep fewer records and to make fewer and easier calculations.

These proposals continue the Administration's efforts toward simplification which began with the Tax Reduction and Simplification Act of 1977. That Act provided a flat standard deduction (now called the "zero bracket amount"). The Act also provided new tax tables that 95 percent of all taxpayers are able to use. These taxpayers no longer are required to make separate calculations for the standard deduction, personal exemptions, or the very complicated general tax credit.

The proposals which will simplify the tax laws are as follows:

Itemized Deductions

Under the proposals, certain itemized deductions will be reduced or eliminated. This will make it easier for individuals to prepare their own tax returns, eliminate much recordkeeping, and reduce audit and administrative burdens on both taxpayers and the Internal Revenue Service.

The itemized deductions for state and local general sales taxes, personal property taxes and gasoline taxes will be repealed. Also the deductions for medical expenses and casualty losses will be combined into one "extraordinary expense" deduction which will be available only to the extent that these expenses exceed 10 percent of adjusted gross income. This proposal will eliminate the need for taxpayers to compile and retain detailed records unless their medical expenses and casualty losses are unusually large and seriously impair their ability to pay taxes. It will also eliminate many disputes between taxpayers and the IRS over the nature of medical expenses and the extent of casualty losses.

Reductions in tax rates applicable to individuals will substantially offset increases in tax liabilities which would otherwise result from these changes in the treatment of itemized deductions. Since these expenses are incurred in a relatively uniform manner, they can be reflected in the structure of tax rates.

Capital Gains

Generally, the Internal Revenue Code permits an individual taxpayer to deduct 50 percent of any net long-term capital gain from adjusted gross income. However, a special rule applies to the first $50,000 of net long-term capital gain realized in any one year. Instead of paying regular tax on one-half the gain, the individual taxpayer may elect to pay a 25 percent "alternative tax" on the entire gain up to $50,000. A taxpayer who does so may not utilize the averaging provisions of the Code. Therefore, two sets of calculations are required by taxpayers to minimize tax liability -- one based on the alternative tax and no averaging and one based on averaging but no alternative tax. Repeal of the alternative tax will simplify treatment of capital gains and computation of tax.

Political Contributions

The Internal Revenue Code now permits an itemized deduction for up to $200 of political contributions by a married couple filing jointly. As an alternative, a credit against tax of half of the first $100 of political contributions is permitted. To treat political contributions more equitably and to eliminate the complexity which results from an alternative deduction or credit, the deduction for political contributions will be repealed. Also, this will permit the tax return form to be shortened.

Personal Credit

The replacement of both the personal exemption and the general tax credit by a $240 personal credit represents an important conceptual simplification.

Small Business

Complexities in the tax law are especially burdensome for small businesses. Computation of the depreciation deduction is a particular source of complexity. In computing the deduction for depreciation, small businesses are now required to estimate the useful life of property. These estimates often provoke disputes with the IRS. To prevent these disputes from arising, the IRS will prepare for use by small businesses a simple table to determine the useful life of property.

Salvage value is another source of unnecessary complexity. The burdensome calculations have little practical effect on the depreciation deductions allowed. The proposal will permit small businesses to disregard salvage value if the table lives are used.

Losses on the sale of stock of certain small corporations can offset ordinary income. Under present law this beneficial treatment is available only if the taxpayer complies with complicated procedures when the stock is offered. Many taxpayers fail to receive this beneficial treatment because they are unaware that these procedures exist. Under the proposal this special treatment will be made automatic.

The ADR System

The Asset Depreciation Range (ADR) system, an optional method for computing depreciation, is designed to minimize disputes between taxpayers and the IRS. However, many taxpayers have not been able to use the ADR system because it is complicated and imposes burdensome reporting requirements. Several technical changes are proposed to simplify the ADR system, including replacing the current reporting requirements with a survey of sample taxpayers.

Real Estate

The ADR system generally does not apply to real estate. As a substitute for the ADR system, a simple table for use in computing depreciation of real estate will be provided. This will eliminate disputes between taxpayers and the IRS over the useful life of buildings.

Investment Credit

The proposed extension of the investment credit to industrial and utility structures will reduce disputes between taxpayers and the IRS caused by the need under current law to distinguish between two categories of equipment since equipment which is a structural component of a building is not eligible for the credit. Although it will be necessary to distinguish between industrial and other structures, this should be a simpler line to draw. Also, the expansion from 50 percent to 90 percent of the amount of tax liability that may be offset by an investment credit will reduce the need for taxpayers to use complicated carryover provisions or to engage in lease arrangements.

Deferral and DISC

The proposed phase-out of the deferral of income of controlled foreign subsidiaries and the DISC provision will eliminate some of the most complex provisions of the Code and reduce the circumstances where other little-understood rules must be applied.

Travel and Entertainment Expenses

The elimination of deductions for entertainment expenses such as theater tickets, yachts, and hunting lodges will reduce recordkeeping requirements and eliminate a source of taxpayer disputes. The proposed rules regarding expenses of attending foreign conventions will eliminate burdensome recordkeeping resulting from the 1976 Act's partial solution to the problem of vacations disguised as business-related conventions.

Ordering of Credits

The proposal will simplify the treatment of tax credits. Under present law, some credits can be taken against certain special taxes such as the minimum tax, but others cannot. The proposal will provide a uniform base for all credits.

II

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be designed to make the tax system more equitable and more progressive and to simplify the tax laws.

First, a personal credit is more equitable than an exemption in that it grants equal tax relief at all levels of income. A personal exemption reduces the amount of income subject to tax. The value of the exemption is dependent upon the marginal rate of tax which would otherwise apply to the income that is excluded and, therefore, rises with income. For instance, for a taxpayer in the 14 percent bracket, a $750 exemption is worth $105 in tax savings, while, for a taxpayer in a 50 percent bracket, a similar exemption is worth $375. A personal credit, on the other hand, reduces the amount of tax liability by the amount of the credit. Thus, the value of the credit does not depend upon the taxpayer's marginal tax rate or his income.

To the extent that the tax system relieves taxpayers of the burden of dependents, this relief should not be greater for high income taxpayers than it is for low and middle income taxpayers. Also, a credit is more appropriate than an exemption for providing assistance to taxpayers who are blind or aged. The expenses of blindness or age affect all blind and aged taxpayers without regard to their income, and accordingly, there is little justification for designing a tax assistance program which provides greater benefits as income rises.

Second, rates and credits can be changed to increase the level of income at which the taxpayer first begins to pay income tax. The income tax should avoid taxing those families with income near or below poverty levels.

Third, structural changes can be made to simplify the tax law. The combination of the personal exemption plus the general tax credit creates needless confusion for the average taxpayer trying to understand how his liability is determined. Also, the elimination of $5.8 billion in itemized deductions (see ITEMIZED DEDUCTIONS) will lead to substantial simplification of the tax law. However, to ensure that the average taxpayer enjoys the full benefits of simplification, the money saved by eliminating these itemized deductions will be used to further reduce tax rates.

Finally, the tax system should be designed in such a manner that changes in the law can be easily accomodated. Future changes may make use of the income tax system to rebate energy taxes or to meet the needs of those on welfare. In both cases -- energy rebates and welfare assistance -- it may be desirable to provide the same per capita tax benefits at every level of income. This can be most easily accomplished through modification of a personal credit.

General Explanation

Under the proposal beginning with 1978 a personal credit of $240 will replace the personal exemption and the general tax credit. For each exemption that a taxpayer is allowed under present law, he will be allowed a personal credit. Thus, for example, if a husband and wife file a joint return, they will both be allowed a personal credit.

Marginal tax rates will be reduced for all taxpayers. For 1979 and later years, the lowest rate will be decreased from 14 percent to 12 percent. The highest rate will be decreased from 70 percent to 68 percent. In many tax brackets, the reduction in rates will be even greater. For 1978, there will be a transitional rate schedule which will allow changes to begin in the last quarter of the year and which will result in a net tax reduction approximately one-fourth the size of the reduction for all of 1979. Tables IIA-1 and IIA-2 show the proposed reduction in rates for married couples filing joint returns and for single individuals.

Table IIA-1

Individual Tax Rate Schedules For
Joint Returns

Taxable Income Bracket	Present Law		Tax Proposal		1978 Tax Proposal	
	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 3,200	0	0%	0	0%	0	0%
3,200 - 3,700	0	14	0	12	0	14
3,700 - 4,200	70	14	60	12	70	14
4,200 - 5,200	140	15	120	14	140	15
5,200 - 6,200	290	16	260	16	290	16
6,200 - 7,200	450	17	420	17	450	17
7,200 - 11,200	620	19	590	18	6_0	19
11,200 - 15,200	1,380	22	1,310	19	1,380	21
15,200 - 19,200	2,260	25	2,070	20	2,220	23
19,200 - 23,200	3,260	28	2,870	23	3,140	26
23,200 - 27,200	4,380	32	3,790	27	4,180	30
27,200 - 31,200	5,660	36	4,870	32	4,380	33
31,200 - 35,200	7,100	39	6,150	36	6,700	36
35,200 - 39,200	8,660	42	7,590	39	8,140	40
39,200 - 43,200	10,340	45	9,150	42	9,740	43
43,200 - 47,200	12,140	48	10,830	44	11,460	45
47,200 - 51,200	14,060	50	12,590	48	13,260	48
51,200 - 55,200	16,060	50	14,510	48	15,180	48
55,200 - 57,200	18,060	53	16,430	51	17,100	52
57,200 - 65,200	19,120	53	17,450	51	18,140	52
65,200 - 67,200	23,360	53	21,530	51	22,300	52
67,200 - 79,200	24,420	55	22,550	54	23,340	55
79,200 - 91,200	31,020	58	29,030	57	29,940	56
91,200 - 93,200	37,980	60	35,870	57	36,660	60
93,200 - 103,200	39,180	60	37,010	60	37,860	60
103,200 - 113,200	45,180	62	43,010	60	43,860	61
113,200 - 123,200	51,380	62	49,010	62	49,960	62
123,200 - 133,200	57,580	64	55,210	62	56,160	63
133,200 - 143,200	63,980	64	61,410	64	62,460	64
143,200 - 153,200	70,380	66	67,810	64	68,860	66
153,200 - 163,200	76,980	66	74,210	65	75,460	66
163,200 - 178,200	83,580	68	80,710	65	82,060	67
178,200 - 183,200	93,780	68	90,460	66	92,110	67
183,200 - 203,200	97,180	69	93,760	66	95,460	69
203,200 and over	110,980	70	106,960	68	109,260	70

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Office of Tax Analysis

January 26, 1978

Table IIA-2

Individual Tax Rate Schedules For
Single Returns

Taxable Income Bracket	Present Law		Tax Proposal		1978 Tax Proposal	
	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 2,200	0	0%	0	0%	0	0%
2,200 - 2,700	0	14	0	12	0	14
2,700 - 3,200	70	15	60	13	70	15
3,200 - 3,700	145	16	125	15	145	16
3,700 - 4,200	225	17	200	15	225	17
4,200 - 5,200	310	19	275	18	310	18
5,200 - 6,200	500	19	455	19	490	19
6,200 - 8,200	690	21	645	20	680	20
8,200 - 10,200	1,110	24	1,045	20	1,080	20
10,200 - 12,200	1,590	25	1,445	22	1,480	24
12,200 - 14,200	2,090	27	1,885	23	1,960	25
14,200 - 16,200	2,630	29	2,345	25	2,460	28
16,200 - 18,200	3,210	31	2,845	25	3,020	31
18,200 - 20,200	3,830	34	3,345	29	3,640	33
20,200 - 22,200	4,510	36	3,925	29	4,300	35
22,200 - 24,200	5,230	38	4,505	33	5,000	37
24,200 - 26,200	5,990	40	5,165	33	5,740	39
26,200 - 28,200	6,790	40	5,825	38	6,520	40
28,200 - 30,200	7,590	45	6,585	38	7,320	44
30,200 - 34,200	8,490	45	7,345	41	8,200	45
34,200 - 38,200	10,290	50	8,985	46	10,000	50
38,200 - 40,200	12,290	50	10,825	50	12,000	55
40,200 - 42,200	13,290	55	11,825	50	13,100	55
42,200 - 46,200	14,390	55	12,825	51	14,200	55
46,200 - 50,200	16,590	60	14,865	57	16,400	60
50,200 - 52,200	18,990	60	17,145	58	18,800	60
52,200 - 54,200	20,190	62	18,305	58	20,000	60
54,200 - 56,200	21,430	62	19,465	60	21,200	62
56,200 - 62,200	22,670	62	20,665	60	22,440	62
62,200 - 64,200	26,390	64	24,265	60	26,160	64
64,200 - 66,200	27,670	64	25,465	63	27,440	64
66,200 - 72,200	28,950	64	26,725	63	28,720	64
72,200 - 78,200	32,790	66	30,505	63	32,560	65
78,200 - 82,200	36,750	66	34,285	66	36,460	65
82,200 - 90,200	39,390	68	36,925	66	39,060	68
90,200 - 92,200	44,830	68	42,205	66	44,500	68
92,200 - 102,200	46,190	69	43,525	67	45,860	69
102,200 and over	53,090	70	50,225	68	52,760	70

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Office of Tax Analysis

January 26, 1978

22-302 O - 78 - 6

Analysis of Impact

The proposals for the personal credit and the change in marginal tax rates will reduce individual income tax liabilities by $23.5 billion in 1979. As shown at 1976 levels of income in Table IIA-3, the proposed credit and rate structure will increase the progressivity of the Federal income tax. The largest percentage reduction in tax will occur at the lowest income levels, the next greatest at middle income levels, and the least at upper income levels. The new credit and rate schedule will provide tax reduction at every level of income, and, on average, will more than offset income tax increases proposed elsewhere in the program except for taxpayers at the highest levels of income.

Futhermore, for most taxpayers, the income tax reductions provided by the rate changes and the personal credit (despite the tax increases resulting from a loss of itemized deductions) will yield a net reduction in combined income and payroll tax liability through 1979 even after the scheduled social security tax increases are considered. Tables IIA-4 and IIA-5 compare the combined income and FICA taxes under 1977 law and proposed law for 1978 and 1979. Included in the calculations are the FICA tax increases resulting from legislation enacted prior to 1977 as well as the increases contained in the Social Security Financing Act Amendments of 1977. The tables assume a four person, one-earner family with wage income at various levels. With the exception of those who have virtually no income tax liability, the proposed income tax cuts will offset the increase in social security taxes for families with wage income up to $25,000 in 1978 and $20,000 in 1979.

Furthermore, as shown in Table IIA-6, the personal credit and, to a slight degree, the reductions in tax will raise tax-free levels of income substantially. For a married couple with two dependents, the tax-free levels will rise from $7,200 to $9,256. These changes will also result in 5.9 million returns becoming non-taxable.

The proposed rate cuts and the personal credit have been designed as a single package. Nonetheless, the separate effect of the credit by itself is of interest. Under the present tax rate schedule, a "break-even" level of income may be defined as that level at which the substitution of a $240 credit for the current $750 exemption and the general tax credit leaves a family with the same tax liability. As the example below demonstrates, for a family of four which does not itemize, the break-even level of income is $20,200. If tax rates were not changed, all families of four below this income level would have a tax decrease, and all other four person families would have a tax increase.

Example:

"Break-Even" Income Level for a Family of Four 2/

	Present Law	Proposed Law (assuming present law rate schedule)
Adjusted gross income	$ 20,200	$ 20,200
Less personal exemptions	3,000	--
Taxable income	17,200	20,200
Tax before credits	2,760	3,540
General tax credit	180	--
Per capita credit	--	960
Tax after credits	$ 2,580	$ 2,580

Table IIA-3

Change in Tax Liability

$240 Personal Credit and Rate Changes vs Current Law

(1976 Levels of Income)

Expanded Income Class	Tax Liability Under Present Law	Change in Tax Liability	
($000)	($ millions)	($ millions)	(Percentage)
Less than 5	141	-423	-300.0
5-10	8,227	-2,008	-24.4
10-15	18,071	-3,149	-17.4
15-20	23,009	-3,587	-15.6
20-30	32,778	-4,687	-14.3
30-50	22,017	-2,215	-10.1
50-100	16,492	-879	-5.3
100-200	8,084	-216	-2.7
200 or more	6,476	-143	-2.2
TOTAL	$135,293	-$17,305	-12.8

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Office of Tax Analysis

January 27, 1978

Table IIA-4

1978

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax: Income tax 1/	Present Law Tax: FICA tax 2/	Present Law Tax: Total tax	1978 Proposed Tax: Income tax 1/	1978 Proposed Tax: FICA tax 3/	1978 Proposed Tax: Total tax	Change in Tax: Income tax	Change in Tax: FICA tax	Change in Tax: Total tax
(dollars)									
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	965	3,145	2,042	1,071	3,113	-138	106	-32
25,000	3,150	965	4,115	3,025	1,071	4,096	-125	106	-19
30,000	4,232	965	5,197	4,150	1,071	5,221	-82	106	24
40,000	6,848	965	7,813	6,748	1,071	7,819	-100	106	6
50,000	9,950	965	10,915	9,855	1,071	10,926	-95	106	11
100,000	28,880	965	29,845	28,640	1,071	29,711	-240	106	-134

January 20, 1978

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Office of Tax Analysis

1/ Assumes deductible expenses equal to 23 percent of income.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table IIA-5

1979

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1979 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 3/	FICA tax 4/	Total tax	Income tax	FICA tax	Total tax
	(dollars)								
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	965	3,145	1,910	1,226	3,136	-270	261	-9
25,000	3,150	965	4,115	2,830	1,404	4,234	-320	439	119
30,000	4,232	965	5,197	3,910	1,404	5,314	-322	439	117
40,000	6,848	965	7,813	6,630	1,404	8,034	-218	439	221
50,000	9,950	965	10,915	9,870	1,404	11,274	-80	439	359
100,000	28,880	965	29,845	29,470	1,404	30,874	590	439	1,029

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Assumes deductible expenses equal to 20 percent of income under proposal.

4/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table IIA-6

Tax-Exempt and Poverty Levels

Of Income

Family Size 1/	Tax-Exempt Levels of Income Under Current Law 2/	Tax-Exempt Levels of Income Under Proposal 2/	1979 Poverty Levels 3/
1	3,200	3,967	3,449
2	5,200	6,553	4,438
3	6,200	7,922	5,429
4	7,200	9,256	6,954
5	8,183	10,589	8,223
6	9,167	11,884	9,280

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Jan. 26, 1978

1/ Family size assumed to equal number of exemptions. For family sizes greater than two, families are assumed to file joint returns and be two parent families.
2/ Excludes Earned Income Credit.
3/ Non-farm families.

Table IIA-7 shows this "break-even" income level for various family sizes again assuming the present tax rate schedules apply.

In the absence of changes in the rate structure, a personal credit would be a highly progressive tax change, and by itself would increase taxes in the upper range of the income distribution. However, these tax increases have been avoided or limited under the Administration's proposal by changing the whole structure of marginal tax rates.

The net effects of substituting the $240 personal credit for the exemption and general tax credit under present law, and of restructuring the schedule of marginal tax rates may be summarized as follows:

(1) The tax system will be made more progressive but not to the degree that would be accomplished by instituting the $240 credit by itself.

(2) A substantial increase will occur in tax-free levels of income so that those at or near poverty levels will have no income tax liability.

(3) The tax structure will be made more equitable. An additional dependent will result in the same tax savings regardless of an individual's income level.

(4) The tax structure will be simplified by combining several provisions of the law into one.

(5) The tax system will also be made more adaptable to future changes in policy. Rebates of energy taxes, for example, could easily be made through modifications of the personal credit.

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Table IIA-7

"Break-Even" Levels of Income

$240 Credit in Lieu of Exemptions, Credits
and Rate Schedule of 1977 Law

Number of Exemptions	"Break-Even" Level
	(millions of dollars)
1	7,075
2	12,500
3	16,700
4	20,200
5	21,950
6	22,700

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Office of Tax Analysis

January 27, 1978

Note: The case of one exemption is for a single return; cases of more than one exemption are for joint returns. Assumes taxpayers have no itemized deductions in excess of the zero bracket amount.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-6,067	-23,538	-26,583	-30,272	-34,732	-40,110

Footnotes

1/ There is also a separate schedule for estate and trusts.

2/ The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount.

ORDERING TAX CREDITS

Present Law

There are eight nonrefundable tax credits: the general tax credit, the credit for the elderly, the foreign tax credit, the investment credit, the political contributions credit, the WIN credit, the child care credit, and the jobs credit. In addition, certain tax credits are refundable, including the earned income credit and other credits which involve a repayment of taxes previously paid.

Several sections of the Code must be examined to determine the order in which these credits may be claimed. Moreover, some credits which may be carried over and applied against tax liabilities in other tax years must be taken in the current tax year prior to credits which expire that year if unused. Finally, the tax base against which the credits may be claimed varies. Some credits can be taken against certain special taxes (such as the minimum tax) while others cannot.

Reasons for Change

As a structural matter, the provisions which govern the order in which credits are allowed and the taxes against which they can be applied are unduly complex. Moreover, no consistent theory underlies the present variations in the tax base against which certain credits may be claimed. Significant simplification and consistency can be achieved by providing in a single section a uniform tax base against which credits are applied in a prescribed order.

The order in which credits must presently be taken may result in the unjustified loss of credits that expire if unused. This occurs because some of the credits that may be carried to different tax years are applied before other credits that expire if unused. For example, a taxpayer must take the foreign tax credit, which can be carried over to later taxable years, before the child care credit, which cannot be carried over. Thus, instead of using the child care credit in the current year and the foreign tax credit next year, a taxpayer is required to use the foreign tax credit currently, even though the child care credit expires unused. A taxpayer should not be required to use a credit that may be carried over before a credit that cannot.

General Explanation

The order in which tax credits must be taken as well as the tax base against which all nonrefundable credits must be applied will be prescribed in a single section of the Internal Revenue Code. All credits that expire if unused in the year they arise will be taken prior to credits that may be carried over. Refundable credits will be taken last.

The base against which nonrefundable credits may be applied will be limited to the amount of tax imposed by the section pursuant to which the primary income tax liability of the particular taxpayer is determined. Thus, the tax base will not include special taxes such as the minimum tax and the tax on accumulation distributions from trusts.

Effective Date

The proposal will apply to taxable years beginning after December 31, 1978.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

Technical Explanation

Under the proposal, a taxpayer will be required to take credits in the following order:

(1) All credits which are nonrefundable and for which no carryover is allowed, including (a) the personal credit (which under the Administration's proposal replaces the present personal exemption and general tax credit), (b) the credit for the elderly, (c) the political contributions credit, and (d) the child care credit. Since all these credits are limited to tax liability and cannot be carried over, no order need be prescribed.

(2) The foreign tax credit.

(3) The investment credit and the WIN credit. 1/ Since under the Administration's proposal the base and carryback and carryover periods of these credits will be identical (see INVESTMENT CREDIT), no order need be prescribed.

(4) The refundable credits (the withholding credits; the credit for certain uses of gasoline, special fuels, and lubricating oil; and the earned income credit). 2/

Individuals will be allowed to take nonrefundable tax credits only against the tax imposed by section 1 of the Internal Revenue Code or taxes imposed in lieu thereof. Corporations will be allowed to take nonrefundable credits only against the applicable normal tax and surtax (imposed by sections 11, 511, 802, 821, 831, 852, or 857 of the Internal Revenue Code) or taxes imposed in lieu thereof. Both individuals and corporations will be allowed to take refundable credits against all taxes imposed by the Internal Revenue Code.

Footnotes

1/ The jobs credit will not be affected by this proposal because it is not allowable for taxable yers beginning after December 31, 1978.

2/ The Energy bill, which is now in conference, provides for residential and business energy credits. Upon enactment, an adjustment in the ordering of credits will be required.

ITEMIZED DEDUCTIONS

INTRODUCTION

One of the major principles underlying our system of taxation is that individuals with equal income should pay the same amount of tax regardless of how they spend their income. This is implemented by not allowing deductions for personal, living, or family expenses. Over the years, many exceptions to this principle have been introduced into the tax laws. The exceptions generally are justified on one of two grounds. First, some deductions are allowed in order to further a public policy. For example, by allowing a deduction for charitable contributions, charitable organizations are able to attract more contributions than would otherwise be possible. Second, certain deductions are allowed on equity grounds in recognition of the fact that substantial expenditures which are unanticipated and unavoidable reduce an individual's ability to pay tax. Deductions for medical expenses are justified on this basis.

All deductions for personal, living, or family expenses are in conflict with the goal of simplicity. For the average taxpayer, these deductions are one of the greatest sources of complexity in the tax laws. A taxpayer has to maintain burdensome records to substantiate the deductions, and has to cope with extremely complicated statutory rules to calculate the deductions. Furthermore, a taxpayer faces the task of having to support the correctness of the deduction if the tax return is audited.

Several of the provisions which allow deductions for personal, living, or family expenses can be greatly simplified without sacrificing either policy goals or equity. In general, the deductions for which changes are proposed are claimed in approximately the same amounts by taxpayers within the same income group. The President's tax proposals limit the availability of the deductions and at the same time lower individual tax rates so that the tax burden on most taxpayers who itemize will not increase. This is illustrated by Table IIB-1.

Table IIB-1

Distribution and Average Amount of Tax Change under the President's Proposals
for Tax Returns under Present Law Using Itemized Deductions,
by Income Class

Expanded Income Class	Number of Returns		Returns with Tax Decrease		Returns with Tax Increase	
	All Returns (millions)	Returns with Tax Change 1/ (millions)	Percentage	Average Decrease	Percentage	Average Increase
Under $5,000	0.53	0.14	94.9%	$ -62	5.1%	$ 27
$ 5,000 - 10,000	1.76	1.34	79.2	-94	20.8	60
$ 10,000 - 15,000	3.48	3.36	78.9	-155	21.1	74
$ 15,000 - 20,000	4.59	4.56	89.4	-207	10.6	106
$ 20,000 - 30,000	6.29	6.26	93.6	-306	6.4	119
$ 30,000 - 50,000	2.74	2.73	88.4	-391	11.6	266
$ 50,000 - 100,000	0.89	0.88	80.1	-519	19.9	725
$100,000 - 200,000	0.19	0.19	58.8	-614	41.2	1,641
$200,000 and over	0.05	0.05	31.0	-2,196	69.0	6,979
TOTAL	20.52	19.52	87.3%	$-268	12.7%	$295

January 28, 1978

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Most tax returns with no tax change are nontaxable under present law.

As described below, changes are proposed with respect to deductions for the following items: medical care expenses, casualty and theft losses, taxes, and political contributions. The proposed changes will result in approximately six million taxpayers switching to the standard deduction. In addition, the administrative burden on taxpayers who continue to itemize will be significantly reduced.

DEDUCTIONS FOR MEDICAL CARE EXPENSES AND CASUALTY AND THEFT LOSSES

Present Law

An individual is allowed a deduction for medical care expenses and casualty and theft losses only if he elects to itemize deductions on his tax return.

Calculating the deduction for medical care expenses is a formidable task. The deduction consists of two components: (a) the lesser of $150 or one-half of the amounts paid for medical insurance, plus (b) the amount by which medical care expenses exceed 3 percent of the taxpayer's adjusted gross income. For purposes of the 3 percent computation, amounts paid for medical insurance are included as medical care expenses to the extent they are not deductible under (a), and amounts paid for medicine and drugs are so included to the extent they exceed 1 percent of adjusted gross income. Of course, in order to make the calculation a taxpayer must first determine whether and to what extent expenditures qualify as medical care expenses. Furthermore, to support the deduction the taxpayer must keep records dividing medical expenses into three categories: medical care insurance, medicine and drugs, and all other medical care. An Internal Revenue Service study of 1973 tax returns 1/ indicates that of those taxpayers deducting medical expenses, more than 75 percent claimed the wrong amount.

Deductions for casualty and theft losses are calculated independently of the deduction for medical care expenses. Regardless of the amount of an individual's income, each such loss is deductible to the extent it exceeds $100. The same Internal Revenue Service study indicates that of those taxpayers deducting casualty and theft losses, more than 64 percent claimed the wrong amount.

Reasons for Change

A common rationale underlies the deduction for medical care expenses and the deduction for casualty and theft losses. Substantial expenditures which are unanticipated and unavoidable reduce an individual's ability to pay tax. To prevent an unwarranted hardship, a deduction should be allowed for these expenditures.

To determine whether unanticipated and unavoidable expenditures are substantial and so have impaired an individual's ability to pay tax, it obviously is necessary to aggregate all such expenditures. Current law, however,

22-302 O - 78 - 7

fails to do this. The deduction for medical care expenses and the deduction for casualty and theft losses are computed independently of one another.

Furthermore, the separate floors provided in the respective provisions allow deductions even though expenditures could have been anticipated or are not substantial. In 1978 the average taxpayer will spend approximately 8 percent of income on medical care. This means that today for the average taxpayer medical care expenditures can be characterized as unanticipated only if they exceed 8 percent of income. Nevertheless, an individual with medical care expenses in excess of 3 percent of income is allowed a deduction. In the case of casualty and theft losses, the statute allows a deduction even though the expenditures are not substantial. The $100 floor is merely a de minimis rule. The homeowner who loses a $200 tree in a windstorm has not had his ability to pay tax reduced.

The allowance of deductions even where expenditures and losses could have been anticipated or are not substantial results in millions of taxpayers itemizing deductions even though they have not experienced extraordinary expenses or losses. Also, the tax laws, in effect, provide insurance against loss for individuals in high-tax brackets. For example, through reduction of tax liability, a taxpayer in the 68 percent marginal bracket can recover from the Federal Government 68 cents for each dollar of casualty loss in excess of $100. There is no reason for the Federal Government to provide this benefit.

The deductions for medical care expenses and casualty and theft losses should be combined and the floor on these deductions should be set at 10 percent of income. Consistent with the rationale for their allowance, medical care expenses and casualty and theft losses would be deductible only under extraordinary circumstances. Furthermore, wealthy individuals could no longer rely on the Government to provide insurance against loss since the "insurance coverage" would apply only when the loss was extraordinary in comparison to income.

In addition, several elements of the medical care deduction provision are theoretically inconsistent or unnecessarily complex and can be simplified.

- Medical insurance premiums should be treated the same as any other medical care expense. Present law allows $150 of medical insurance premiums to be deducted without regard to the 3 percent floor on the ground that people with insurance do not incur large unreimbursed medical expenses and so would otherwise be unable to utitize the deduction. This

rationale is inconsistent with the theory underlying the deduction since payment of the premiums is not unanticipated or unavoidable. It is also inconsistent with the fact that individuals who claim the standard deduction are not allowed to deduct medical insurance premiums.

- The separate 1 percent floor on amounts paid for medicine and drugs should be eliminated. Present law imposes the 1 percent floor in order to deny a deduction where amounts expended on medicine and drugs are not extraordinary. A combined floor for medical expenses and casualty and theft losses would achieve the same purpose and the complexity of a separate floor could be eliminated.

- The definition of medical care expenses should be tightened. Frequent disputes arise over the deductibility of expenditures which produce substantial nonmedical benefits. For example, the Tax Court recently sustained a medical expense deduction for a substantial portion of the cost of a $194,000 indoor swimming pool. Disputes such as this can be prevented by restricting deductions to expenses incurred primarily for medical purposes.

General Explanation

Medical care expenses and casualty and theft losses will be deductible only to the extent that, in the aggregate, they exceed 10 percent of adjusted gross income. A casualty or theft loss will be taken into account only to the extent it exceeds $100.

Medical insurance premiums and expenses for medicine and drugs will be treated just like any other medical care expenditures. The special deduction for insurance premiums and the special 1 percent floor for medicine and drug expenditures will be repealed. The definition of medical care expenses which qualify for deduction will be amended so that the cost of facilities, services, and devices will be deductible only if they are of a type customarily used primarily for medical purposes, and are in fact intended primarily for medical use of the taxpayer or a dependent.

Analysis of Impact

Adoption of the new hardship deduction will reduce by 11.1 million, or 83 percent, the number of taxpayers who itemize their medical expenses and nonbusiness casualty and theft losses under current law (see Table IIB-2). Consistent

Table IIB-2

Numbers of Taxpayers Using Present Medical and Casualty Deduction and Proposed Hardship Deduction
(Compared to 1976 Law at 1976 Levels of Income)
(millions of taxpayers)

Expanded Income Class	Proposal Excluding Hardship Proposal				Proposal Including Hardship Deduction		
	Medical and/or Casualty Deduction	Medical Deduction: Insurance Premiums Only	Medical Deduction: Other Medical Expenses	Casualty Deduction	Using Hardship Deduction	Not Using Hardship Deduction but Itemizing	Switching to Standard Deduction
$ 5,000 or less	0.4	*	0.4	*	0.3	0.1	*
$ 5,000 - 10,000	1.3	0.2	1.1	0.2	0.6	0.4	0.3
$ 10,000 - 15,000	2.2	0.4	1.7	0.3	0.5	1.0	0.6
$ 15,000 - 20,000	2.8	0.9	1.9	0.3	0.4	1.8	0.6
$ 20,000 - 30,000	3.9	1.7	2.2	0.4	0.3	3.1	0.6
$ 30,000 - 50,000	1.9	1.1	0.7	0.2	0.1	1.7	0.1
$ 50,000 - 100,000	0.6	0.4	0.1	0.1	*	0.6	*
$100,000 - 200,000	0.1	0.1	*	*	*	0.1	*
$200,000 and over	*	*	*	*	*	*	*
TOTAL	13.3	4.9	8.2	1.5	2.2	8.9	2.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 28, 1978

* Less than .05 million.

with the rationale for allowing these deductions the hardship deduction will be utilized only by individuals whose ability to pay tax has truly been reduced as a result of substantial expenditures which were unanticipated and unavoidable. Over 35 percent of amounts currently deductible on account of medical expenses and casualty and theft losses will continue to be deductible by these individuals. All other taxpayers will be spared the administrative burden involved in claiming and substantiating the medical, and casualty and theft loss, deductions.

Most significantly, these changes will cause 2.3 million taxpayers to switch to the standard deduction. For these taxpayers the burden of compliance will be vastly reduced since they will be relieved of the numerous difficulties encountered in itemizing deductions. In addition, the proposed revision of the medical expense portion of the deduction will simplify the burden of compliance for those taxpayers claiming the hardship deduction.

Table IIB-3 shows the distribution of tax increases by income class for this proposal at 1976 levels of income.

Effective Date

The proposal will be effective for taxable years beginning after December 31, 1978.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Year					
1978	1979	1980	1981	1982	1983
--	1,909	2,119	2,352	2,611	2,898

Footnote

1/ Study prepared under the Taxpayer Compliance Measurement Program of the Internal Revenue Service, Cycle 5 of the individual income tax returns filed phase.

Table IIB-3

Revenue Effect of Hardship Deduction
with 10 Percent Floor

Expanded Income Class	Revenue Increase ($ in millions)	Percent of Total
$ 5,000 or less	1	0.1%
$ 5,000 - 10,000	41	2.9
$ 10,000 - 15,000	143	10.2
$ 15,000 - 20,000	237	17.0
$ 20,000 - 30,000	401	28.7
$ 30,000 - 50,000	308	22.1
$ 50,000 - 100,000	173	12.4
$100,000 - 200,000	53	3.8
$200,000 and over	39	2.8
TOTAL	1,396	100.0%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 28, 1978

DEDUCTION FOR TAXES

Present Law

An individual who elects to itemize deductions on his income tax return is allowed a deduction for the following State and local taxes 1/ even if they are not related to any business activity:

1. income taxes
2. real property taxes
3. sales taxes
4. gasoline taxes
5. personal property taxes

In addition, with certain limited exceptions, all State and local, and foreign, taxes related to business activity are deductible in the year paid or incurred. A taxpayer other than a regular corporation must capitalize and amortize real estate taxes paid during the period real property is under construction.

Reason for Change

The deduction for State and local income taxes is necessary to assure that the aggregate marginal rate of income tax is not confiscatory. The deduction for real property taxes reflects long-standing public policy to encourage home ownership. In addition, the deductibility of these taxes imposes only a small recordkeeping burden on taxpayers. This is not true for other taxes which are currently deductible.

Nonbusiness sales, gasoline, and personal property taxes. In the case of sales taxes, gasoline taxes, and personal property taxes, there are no significant policy reasons to justify an exception from the general principle that people with equal income should pay the same amount of tax regardless of how they spend their income. These taxes are relatively small in amount. For example, a married taxpayer with $30,000 of adjusted gross income who drives 12,000 miles a year for personal purposes reduces his tax liability only by about $30 on account of the gasoline tax deduction and by about $65 on account of the sales tax deduction. Because of their relatively small size, and because a large portion of these taxes is paid by taxpayers who do not itemize deductions, deductibility is not a major factor to a State or local government in determining the rate of tax to impose. The deduction for personal property taxes

does encourage State and local governments to impose personal property taxes on automobiles in lieu of license and similar fees which are nondeductible. There is no policy reason to encourage this shift.

Aside from policy considerations, deductibility of sales and gasoline taxes raises substantial administrative problems. The average taxpayer incurs small amounts of these taxes in hundreds of separate transactions over the course of a year. Maintaining adequate records to calculate and substantiate the deduction would place an enormous burden on taxpayers. Moreover, auditing these records would place an unwarranted burden on the Internal Revenue Service in view of the extremely small amount of revenue generally involved in the deduction claimed on any one return. An Internal Revenue Service study 2/ of 1973 tax returns indicates that of those taxpayers deducting State and local taxes (other than real estate and income taxes) more than 53 percent claimed the wrong amount.

In recognition of these administrative problems, the Service permits taxpayers to use standard tax tables to determine the amount of their sales and gasoline tax deduction. For taxpayers using these tables, there is no direct relationship between the amount of the deduction and the amount of taxes actually paid. The absence of a direct relationship further weakens any policy argument in favor of the deductibility of these taxes. In effect, taxpayers who itemize are being allowed a mini-standard deduction in lieu of deducting the actual amount of taxes paid. This is especially true in the case of the sales tax since the table is based primarily on adjusted gross income. It is also true in the case of the gasoline tax. Although the table is based on miles driven, there is generally no way to check the accuracy of the amount claimed, and many taxpayers claim an average amount regardless of the number of miles they actually drive. In addition, allowing a deduction for the gasoline tax is inconsistent with our national energy policy which seeks to encourage gasoline conservation.

Definition of "taxes". Recently, uncertainty has developed as to whether employees may deduct State unemployment disability fund taxes withheld from their wages. The revenue collected from these taxes is used to provide insurance against loss of wages resulting from injuries or illnesses which are not job related. In several states, the tax is levied only if the employer does not provide private coverage. The Internal Revenue Service takes the position in published Revenue Rulings that these taxes in reality are a nondeductible personal expenditure for insurance coverage. However, the United States Tax Court has disagreed with the Service's position in two cases and has held that these taxes are an "income tax" and so are deductible by employees.

The payor of the unemployment disability fund taxes receives an economic benefit in the form of insurance coverage which is directly related to the amount of the taxes. Amounts received under these insurance policies as compensation on account of injuries or illness are not includible in income. Because of this exclusion, it is inappropriate to allow a deduction for the taxes paid to acquire the insurance coverage. A combined deduction-exclusion creates tax-exempt income, and, therefore, is inconsistent with basic principles of taxation. In addition, regardless of whether these taxes technically constitute an "income tax", it is inequitable to allow a deduction to individuals in one State who acquire the insurance coverage through a State program, while denying a deduction to individuals in another State who acquire their insurance coverage privately.

Business taxes. Taxes related to a business activity generally are deductible in the year paid or incurred even if they constitute part of the cost of a capital asset. In this respect, a deduction is inconsistent with the general principle that the cost of a business asset should be recovered through depreciation over the life of the asset. For example, a person constructing a building for business use can deduct sales taxes imposed on his purchase of building materials even though the other expenses relating to the construction of the building generally have to be capitalized and recovered through depreciation. There is no reason why these taxes should receive special treatment.

General Explanation

State and local sales taxes, gasoline taxes, and personal property taxes not related to a business activity will no longer be deductible. Payments for unemployment disability fund taxes will not be deductible by employees.

Taxes relating to a business activity will be deductible under normal tax accounting principles. If the taxes relate to the acquisition of a capital asset they will have to be capitalized. However, as under present law State and local income taxes and real property taxes generally will be deductible in the year paid or incurred.

Analysis of Impact

Limiting the deduction for taxes will result in an increase of approximately 3.8 million in the number of individual taxpayers using the standard deduction.

Among income groups the greatest increase in tax burden as a result of the proposal will be only 3 percent (a Ø.5 percentage point increase in effective tax rates).

Effective Date

The proposal will be effective for taxable years beginning after December 31, 1978.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	3,908	4,456	5,079	5,790	6,601

Technical Explanation

Section 164(a) will be amended to eliminate the deduction for State and local (and foreign) sales, gasoline, and personal property taxes which are not business related. Section 164(a) will be amended to provide for the future that State unemployment disability fund taxes are not deductible by employees. The amendment will overrule prospectively the decisions in two Tax Court cases: James R. McGowan, 67 T.C. 599 (1976) and Anthony Trujillo, 68 T.C. 670 (1977).

The last sentence in section 164(a) will be eliminated. As a result of this change, business related taxes other than those specifically listed in section 164(a) will be deductible in the same manner as other business expenditures generally. In other words, these taxes will be deductible currently under section 162 or 212 unless they relate to the acquisition of a capital asset in which case they will be capitalized. Taxes specifically listed in section 164(a) (i.e., State and local, and foreign, income taxes and real property taxes) will continue to be deductible when paid or incurred, unless section 189 applies.

Footnotes

1/ Foreign real property taxes and, if the taxpayer elects not to claim a credit, foreign income taxes are also deductible.

2/ Study prepared under the Taxpayer Compliance Measurement Program of the Internal Revenue Service, Cycle 5 of the individual income tax returns filed phase.

IIB-4

DEDUCTION FOR POLITICAL CONTRIBUTIONS

Present Law

Under present law, an individual who elects to itemize deductions on a tax return is allowed a deduction for specified political contributions. The deduction is allowed for the first $100 ($200 on a joint return) of contributions. In lieu of the deduction, an individual, whether or not itemizing deductions, can claim a credit equal to one-half of the first $50 ($100 on a joint return) of contributions. Corporations, estates, and trusts cannot claim the credit or deduction.

Reasons for Change

The tax subsidy for political contributions was intended by Congress to be an incentive for political contributions. In practice, the deduction and credit generally benefit only those few taxpayers who would contribute anyway, and they are used disproportionately by high-income contributors.

The effect of the optional deduction is to provide a greater tax benefit to those taxpayers who itemize, a relatively small group (24 percent of all taxpayers currently and estimated to be less than 17 percent under the other proposals in this package) who generally have higher incomes than nonitemizers. This is illustrated by Table IIB-4 which shows the distribution of the tax credit and the deduction for political contributions by income class for 1975.

With a deduction, high-bracket taxpayers can make the same dollar contribution more cheaply than low-bracket taxpayers. Put another way, the greater the income of the itemizer (the higher the marginal tax rate), the greater the benefit to the taxpayer of the deduction. There is no policy reason for attempting to provide a greater tax incentive to taxpayers with high incomes.

For example, two married couples that both contribute $200 receive different tax treatment if one itemizes. The couple that itemizes and is in the highest marginal tax bracket will receive 2.7 times the benefit of the couple that does not itemize. In a 68 percent marginal bracket (the highest proposed), the couple that itemizes and contributes $200 would receive a tax benefit of $136. The couple that contributes the same amount and uses the standard deduction would claim the tax credit and receive a tax benefit of only $50.

Table IIB-4

Deduction and Tax Credit for Political Contributions
by Income Class -- 1975

Adjusted Gross Income Class ($000)	Credit and Deduction	Tax Credit		Deductions	
	Percent of Returns in Income Class (%)	Number of Returns (000)	Amount of Credit ($000)	Number of Returns (000)	Amount of Deductions ($000)
0 - 10	1.1%	424	7,022	41	2,684
10 - 20	3.3	610	15,428	213	14,740
20 - 30	5.7	302	8,531	177	15,990
30 - 50	10.6	180	4,917	110	11,020
50 - 100	18.4	48	1,463	96	10,501
100 and over	29.4	5	183	50	6,443
TOTAL	2.7%	1,569	37,546	688	61,378

Office of the Secretary of the Treasury
Office of Tax Analysis

November 2, 1977

Source: Preliminary 1975 Statistics of Income.

Moreover, a recent study concludes that tax incentives have had an insignificant impact on the level of contributions to political campaigns, 1/ and merely provide a windfall to high income taxpayers who would contribute anyway. In the past, taxpayers with income of over $20,000 have claimed tax benefits for political contributions more than 25 times as often as taxpayers with income under $5,000. Moreover, within the lower income group, individuals frequently contribute and do not claim the tax benefits to which they are entitled. Among contributors, higher income taxpayers claimed these tax benefits almost three times more often than lower income taxpayers.

In addition, the present option of a credit or deduction unnecessarily complicates both the tax return and the instructions.

General Explanation

The deduction for political contributions will be repealed. The credit for political contributions will, however, remain.

Analysis of Impact

The elimination of the deduction for political contributions will result in all taxpayers receiving equal tax benefits from their political contributions. Contributions to political campaigns will not be greatly reduced. Significant simplification will be achieved. Tax forms and instructions will be shortened. Individuals will no longer need to make alternative computations to determine whether the credit or deduction is more advantageous to them.

Effective Date

The political contributions deduction will be eliminated for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	2	4	2	3	3

Footnote

1/ D.W. Adamany and G.E. Agree, Political Money, 125-128 (1975). This study is based in part upon data compiled in the Twentieth Century Fund Survey, along with data provided by the IRS and the States of California and Oregon, two states which provide tax incentives for political campaign contributions. This is the only published study which considers the impact of tax incentives on political contributions.

IIC

CAPITAL GAINS -- REPEAL OF ALTERNATIVE TAX

Present Law

The tax rate applicable to the net capital gain realized by an individual taxpayer is generally equal to one-half of the taxpayer's regular tax rate. However, an individual taxpayer may elect to pay a 25 percent alternative rate on the first $50,000 of net capital gain. An individual will choose this alternative rate only if his marginal tax rate exceeds 50 percent.

More specifically, if an individual taxpayer has a net capital gain for the taxable year (i.e., net long-term capital gain exceeds net short-term capital loss), the taxpayer can deduct an amount equal to 50 percent of the net capital gain. The 50 percent exclusion in effect makes the tax rate applicable to the gain equal to one-half of the taxpayer's regular rate.

The "alternative tax on capital gains" involves a special computation under which the total tax is the sum of: (1) the tax otherwise payable on all income other than net capital gain for the year; (2) a tax of 25 percent on the first $50,000 of long-term capital gain ($25,000 in the case of a married individual filing a separate return); and (3) a separate tax on the amount of net capital gain, if any, in excess of $50,000, computed at the taxpayer's highest rate brackets after taking into account the deduction for capital gains. In effect, the taxpayer will benefit from a maximum tax of 25 percent on the first $50,000 of long-term capital gain plus the 50 percent deduction for the balance of net capital gain. By choosing the alternative tax, however, a taxpayer must forego regular income averaging.

Prior to 1969, the 25 percent alternative tax was not limited to $50,000. In retaining the alternative tax for that amount of long-term capital gains, the Congress indicated that it thought that taxpayers with relatively small amounts of capital gains should continue to be eligible for the alternative tax. However, the present alternative tax applies whether a taxpayer's capital gains are large or small and, as is indicated below, is useful only for high income taxpayers.

Reasons for Change

The deduction for capital gains provides a significant tax benefit for individual taxpayers, reducing the tax on net

capital gain by 50 percent. The alternative tax, on the other hand, benefits only those taxpayers with the highest incomes. A taxpayer in the 70 percent bracket with $50,000 of capital gain can use the alternative tax to reduce the tax on that income by nearly 65 percent. For example, if a taxpayer has ordinary income of $50,000 which is taxable at 70 percent, the tax on that income will be $35,000. However, if that income is in the form of a net capital gain, the taxpayer will, under the alternative method, be required to pay a tax of only $12,500 on the net capital gain.

The alternative tax is only $5,000 less than the maximum tax on $50,000 of capital gain (70 percent of $25,000, or $17,500, as compared to $12,500). Yet it introduces significant additional complexity into the tax calculation. The alternative tax computations are themselves complex. But, in addition, because taxpayers electing the alternative tax cannot use regular income averaging, they must compute their tax under the two special methods (income averaging and alternative tax) in order to determine which will produce the greater tax savings.

The existence of the alternative tax can also affect the structuring or timing of transactions to maximize the benefit of this special provision. For example, a high-income taxpayer may enter into an installment sale solely to spread any gain over a number of years and thereby multiply the impact of the alternative tax on the transaction. Similarly, a taxpayer who has already recognized long-term capital gains of $50,000 for a year may postpone an additional capital gain transaction until the following year in order to subject the gain to the alternative tax.

General Explanation

In order to make tax benefits for capital gains more uniformly applicable, the alternative tax for noncorporate taxpayers will be eliminated. The deduction for capital gains will remain unchanged.

Analysis of Impact

The proposal will affect only noncorporate taxpayers in marginal tax brackets above 50 percent. For example, it is estimated that for 1976, 88 million tax returns were filed, and 7.4 million reported gains from sales of capital assets. Of those returns, 186 thousand, or 2.5 percent of all returns with net capital gains, used the alternative tax to compute at least some part of the tax liability. Using 1976 levels of income and taking into account the Administration's other proposals, over 78 percent of the net taxable gain taxed under the alternative tax would be reported on returns with expanded incomes of over $100,000. (See Table IIC-1.)

Table II C-1

Capital Gains in Adjusted Gross Income and Capital Gains Taxed at Alternative Rate

(Proposed Law at 1976 Levels of Income)

Expanded Income Class (thousands)	All Taxpayers with Capital Gain or Loss: Number of Returns (thous.)	Amount of Net Gain ($ bil.)	Percent of Total	Taxpayers Electing Alternative Tax: Number of Returns (thous.)	Amount Taxed At Alternative Rate ($ bil.)	Percent of Total
Less than $ 5	910	$ 1.2	6 %	--	--	--
$ 5 - $ 10	1,068	0.9	4	--	--	--
$ 10 - $ 15	1,239	1.2	6	--	--	--
$ 15 - $ 20	1,138	1.6	7	--	--	--
$ 20 - $ 30	1,428	2.6	12	--	--	--
$ 30 - $ 50	980	3.6	17	1	*	*
$ 50 - $100	457	3.6	17	101	$.06	23 %
$100 - $200	116	2.5	12	64	1.4	49
$200 and over	36	3.9	19	19	0.8	28
TOTAL	7,372	$21.0	100 %	186	$2.8	100 %

Office of the Secretary of the Treasury
Office of Tax Analysis

January 6, 1978

* Less than $ 0.5 billion or less than 0.5 percent

Upon repeal of the alternative tax, all long-term capital gains will be treated similarly. All such gains will be taxed at one-half of the ordinary rates. However, high-income taxpayers will no longer receive even more preferential treatment on the first $50,000 of such gains.

It should be recognized that only high tax bracket taxpayers who currently use the alternative tax will be affected. Many taxpayers who would otherwise be eligible to use the alternative tax forego its benefits because they receive even greater benefits from income averaging. Such taxpayers would not be affected by repeal of the alternative tax. Taxpayers who sell small businesses at a large gain generally should fall into this category. 1/

Effective Date

The proposed change will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	140	151	162	174	187

Technical Explanation

The proposal will apply to all gains recognized in taxable years beginning after December 31, 1978. Thus the alternative tax will not apply to the ratable portion of gain recognized by a calendar year taxpayer for 1979 as the result of an installment sale which occurred in 1977. Similarly, the alternative tax will not apply to gain recognized in a transaction occurring within a taxable year to which the proposal applies, even though the transaction is completed pursuant to a binding obligation entered into before the effective date of the proposal.

Footnote

1/ For example, assume that a married individual owns a small business which was sold at the end of 1977 at a gain of $200,000. The business has resulted in taxable income of $60,000 each year for the last five years, including 1977. The taxpayer has no dependent children, had no other income for 1977, and filed a joint return for 1977. In this case, the taxpayer would be in the 53 percent bracket for 1977 if the sale were not made. If the sale at a gain of $200,000 is made, the tax computed at the regular rates (taking into account the deduction for capital gains) is $81,288. The alternative tax computation results in a lesser tax of $80,008, but income averaging produces an even lower tax of $76,840--a saving of $4,448 compared to the tax at the regular rates and a saving of $3,168 compared to the tax computed under the alternative tax.

TAX SHELTERS

INTRODUCTION

The Tax Reform Act of 1976 took some steps toward curbing the continued proliferation of tax shelters. Direct limitations were imposed on certain activities, particularly farm operations, motion pictures, and sports franchises; the partnership rules were tightened to reduce abuse; a rule was introduced to limit deductions in certain activities to the amount the taxpayer has "at risk"; minor changes were made in the tax treatment of real estate, oil and gas and equipment leasing; and the minimum and maximum taxes were changed to have additional impact on tax shelters.

Despite these changes, tax shelter activity has not diminished. Tax shelter promoters have reacted to the 1976 Act by developing a wide range of investments specifically designed to avoid the limitations of the 1976 Act. In 1977, widely advertised tax shelters involved such diverse activities as master phonograph records, lithographic plates, books, Christmas trees and research and development. Securities agencies, brokerage houses, and news media all report tax shelter activity during 1977 far in excess of 1976 levels. The Securities and Exchange Commission (SEC) reports registrations offering a total tax shelter investment of $1.2 billion during the first ten months of 1977, as compared to $690 million during the same period in 1976. The National Association of Securities Dealers (NASD) reports that during 1977, its members made 182 public offerings of tax shelters with total investments of $1.8 billion; during 1976, 196 offerings for a total of $1.2 billion were made. These statistics do not include officially unreported shelter deals (so-called "private placements"), which by some estimates are at least ten times the volume of public offerings. For example, in Ohio the number of registrations of limited partnerships (the majority of which are tax shelters) was 570 in 1975, 779 in 1976, and 931 in 1977.

Under the Internal Revenue Code, taxable income can deviate substantially from economic income. These deviations are frequently a result of deductions being taken into account earlier than the income to which they relate. Such

timing differences create so-called "paper losses", that is, situations in which taxable income during the initial years of an activity is significantly less than true income.

Taxpayers engaged in the activities giving rise to these tax preferences can reduce their tax liabilities directly, or when they cannot, they may realize a portion of the economic benefit of the preferences by selling the tax benefits to others. The investment vehicle used to transfer the tax preferences is often referred to as a tax shelter. Although shelters take a wide variety of forms and include a great diversity of activities, the common characteristic of tax shelters is the generation of "tax losses" which are available as deductions not only against the taxpayer's share of taxable income from the tax shelter investment, but also against his taxable income from other sources, such as his business or profession. Through such investments taxpayers who take no active part in the subsidized activity are able to "shelter" their regular income from tax. The result is that taxpayers with substantial economic income are able to reduce tax liabilities simply by purchasing tax preferences.

Tax shelters may possess as many as three major tax-saving features. The first, as described above, is deferral. A tax shelter generates substantial tax losses in the early years of the investment which are used to reduce the investor's tax liability on his unrelated income. The investment generates taxable income, if any, only in later years. Thus, tax liability on the investor's regular source of income is deferred until income resulting from the tax shelter investment is realized. The economic effect of deferral is equivalent to an interest-free loan from the Federal Government. For the same amount of deductions, the size of the "loan" increases as the investor's marginal tax rate increases.

The tax benefit of deferral may be continued by investing in additional tax shelter investments at the time that the initial shelters begin generating taxable income. The tax losses generated by the newly purchased tax shelters are used to offset the tax liability on the older tax shelters, thereby so extending the period of deferral as to approximate a complete exemption.

The second important element of many tax shelters is leverage. Leverage is the use of someone else's money to finance an investment activity. Frequently, a tax shelter is structured so that an investor, or the investor's partnership, borrows 80 percent or more of the purchase price of the investment. Since an investor is allowed deductions not only with respect to his equity, but also with respect to the borrowed funds, he can greatly increase the benefits of deferral by incurring deductions which substantially exceed his equity investment.

In the most abusive tax shelters, a nonrecourse loan (i.e. a loan for which the investor has no personal liability, directly or indirectly) is provided by the seller of the property in order to finance a highly inflated purchase price. This nonrecourse debt allows the investors to claim inflated deductions without risking their own capital. In many cases the tax savings resulting from the inflated deductions are so great that the investors completely ignore the economics of the underlying business transactions.

A further problem of leveraged tax shelters of this type is that investors frequently fail to report the taxable income which arises when the nonrecourse debt which financed the investment is cancelled. To the extent the Service is unable to discover this failure to report income, the deferral of tax produced by shelters is made permanent. Investors neglect to report this income for several reasons. Promoters of shelters often fail to mention that cancellation of the nonrecourse debt produces income. Also, this taxable income is not accompanied by any cash flow from the investment with which the investor can pay the tax. Finally, it is extremely difficult for the Service to discover on audit that the events which produce this income have occurred.

The third tax savings feature of many tax shelter investments is the conversion of ordinary income into capital gains at the time of the sale or other disposition of the asset used in the tax shelter or of the taxpayer's interest in the shelter. Conversion occurs when the portion of the gain which reflects the accelerated deductions (taken against ordinary income) is taxed as capital gains. (If the taxpayer is in a lower tax bracket in the year of disposition, he effectively "converts" the tax rate as well.) Various "recapture" provisions have been enacted in recent years, the effect of which has been that conversion benefits are not available for many investments.

In order to facilitate the sale of these tax benefits to those not directly engaged in the activity, a limited partnership is most commonly chosen as the investment vehicle for tax shelters. The partnership form is chosen because it allows the immediate flow-through to the investors of the tax preferences and also provides investors with limited liability. Flow-through is available since partners -- unlike shareholders of corporations -- obtain an immediate deduction on their return for their share of partnership tax losses. Moreover, by making the tax shelter investors limited partners, their financial risk -- like that of shareholders -- is limited to their equity in the partnership.

In many cases interests in tax shelter limited partnerships are publicly offered for sale to potential investors throughout the country. As a prerequisite to such public sale the partnerships must comply with applicable Federal or State securities laws, which require protections for the investor-limited partners (e.g., transferability of shares) not commonly enjoyed by limited partners. In fact, in the usual publicly syndicated tax shelter venture the limited partners enjoy the same protections and benefits as corporate shareholders, while receiving the additional benefit (which makes the transaction marketable) of the immediate enjoyment of losses generated by the tax shelter activity.

The marketing of interests in these tax shelter ventures are directed at taxpayers whose marginal tax rates are 50 percent or above. Promotional literature on tax shelter offerings clearly advise potential investors that the primary benefit of the investment is the tax deductions generated in the early years of the investment; the prospect of any future economic gain is clearly of secondary importance. In a recent article on tax shelters published in a leading financial periodical, a tax shelter promoter admitted that:

> We don't even want people to buy our programs based on (the program's) economics . . . . If we find that anybody's going to purchase a program from us based on the expectation or necessity of receiving money, we recommend he not try it . . .

Also, careful examination of the promotional literature demonstrates that typically a substantial part of the investors' initial cash contribution is used to pay promotional expenses, rather than to purchase assets to be used in the tax shelter activity.

The continuing spectacle of high income taxpayers paying little or no tax through the use of tax shelters seriously undermines taxpayer morale. Low and middle income persons who cannot benefit significantly from tax shelters strongly resent the fact that they must bear the greatest burden of taxation, while certain high income taxpayers can obtain extensive tax relief.

Although some tax preferences, such as the investment tax credit (as well as most other tax credits), and the special allowance for percentage depletion of minerals, were enacted or continued in order to encourage investment in certain industries or activities, other preferences are the unintentional by-products of legislative or administrative actions. These include the expensing of periodical circulation costs and research and development expenditures (enacted to resolve disputes concerning the proper tax

treatment of such expenditures), and cash-basis accounting for farms (allowed by the Internal Revenue Service to assist unsophisticated taxpayers in determining their tax liabilities). The cost to the Treasury in foregone revenues is multiplied considerably when these accounting distortions are packaged for "sale" to those not active in the business. Thus, one cannot argue that tax shelter arrangements simply facilitate more complete implementation of the tax benefits intended by Congress. Changes are needed to eliminate tax preferences which neither encourage desired economic activity nor facilitate the proper measurement of income for those engaged in business.

Further, even where investment in intentionally favored activities is concerned, a very serious problem is presented by the illegal or highly questionable enhancement of tax shelters through inflated purchase prices financed with nonrecourse debt. Too often, tax shelter promoters and investors take extremely questionable positions knowing that the substantive and administrative provisions of the Code greatly inhibit the Service's ability to police illegal or questionable tax shelter activities.

Summary of Proposals

(a) The Administration proposes to reduce certain tax preferences directly so that the deduction is more nearly based on the actual economic income or loss of the taxpayer.

Real Estate. Depreciation of real estate will be limited to either (1) straight line depreciation based on a zero salvage value and useful lives determined by the Treasury to be the average useful lives used by taxpayers or (2) depreciation based on the taxpayer's particular facts and circumstances. Taxpayers who use the facts and circumstances alternative would not be permitted to depreciate real estate in any tax year below its current salvage value. However, in order to maintain investment in low income and multi-family housing, this real estate will be depreciated on a more favorable basis.

Accounting by Agricultural Corporations. All farming syndicates which under the Tax Reform Act of 1976 were limited in their ability to deduct the cost of poultry, farm supplies such as feed, and the development costs of fruit and nut trees will be required like corporate farms to use the accrual method of accounting in the same manner as other business corporations. (This proposal which also applies to all corporate farms with gross receipts of more than $1 million is more fully described in the section on corporate preferences.)

Deferred Annuities. Deferral of tax may be achieved by deferring the recognition of income as well as by

accelerating deductions. One type of income deferral shelter involves the purchase of tax deferred annuities by high-income taxpayers as a way (to quote from a promoter's sales literature) to "pile up interest indefinitely, and not pay a penny of taxes until you take your money out -- usually at retirement when your tax bracket is likely to be lower. By not paying taxes on the interest every year, you actually earn extra income with Uncle Sam's money." Such contracts usually permit a purchaser to withdraw earnings, not in excess of amounts previously paid for the contract, at any time on a tax-free basis. Under a recent court decision, it also appears that high-income taxpayers may be able to avoid paying tax currently on the income earned through the annuity even when they are able to direct the investments to be made by the company.

Under the Administration's proposal, insurance companies will be required to report each year to the purchaser of a deferred annuity the actual amount earned on his investment and the purchaser will be required to include this amount in income. This treatment will not apply to one annuity contract per taxpayer, the annual contributions to which do not exceed $1,000.

(b) Direct limitations on tax preferences cannot be accomplished in some instances because the continued Federal subsidy of certain industries is regarded as essential or because a totally accurate matching of deductions against income will produce unduly complex accounting rules. In these cases, proposals are made to curtail abuse. In particular, it is desired to prevent uneconomic, gimmicky investments that waste the supply of venture capital without producing needed goods or services.

Extension of At Risk Rules. The effectiveness of the at risk limitation added by the Tax Reform Act of 1976 (relating to the use of nonrecourse financing) will be enhanced by extending its application to certain closely held corporations and to all activities other than real estate.

Limited Partnerships Treated as Corporations. Those newly formed limited partnerships that have more than 15 limited partners will be classified as corporations for tax purposes.

Partnership Audit. The Internal Revenue Service will be provided with a more effective tool to police partnerships, including tax shelter limited partnerships, by authorizing the Service to audit and make binding tax determinations at the partnership level.

(c) Finally, in order to curtail excessive utilization of tax preferences the Administration proposes

Minimum Tax. The deduction for half of the regular tax paid in the case of individuals will be eliminated; the deduction against preference income will thus be limited to $10,000.

Investment Tax Credit. Currently, the investment tax credit and work incentive (WIN) credit may offset completely the first $25,000 and $50,000, respectively, of tax liability. This offset will be allowed instead only to the extent of 90 percent of tax liability.

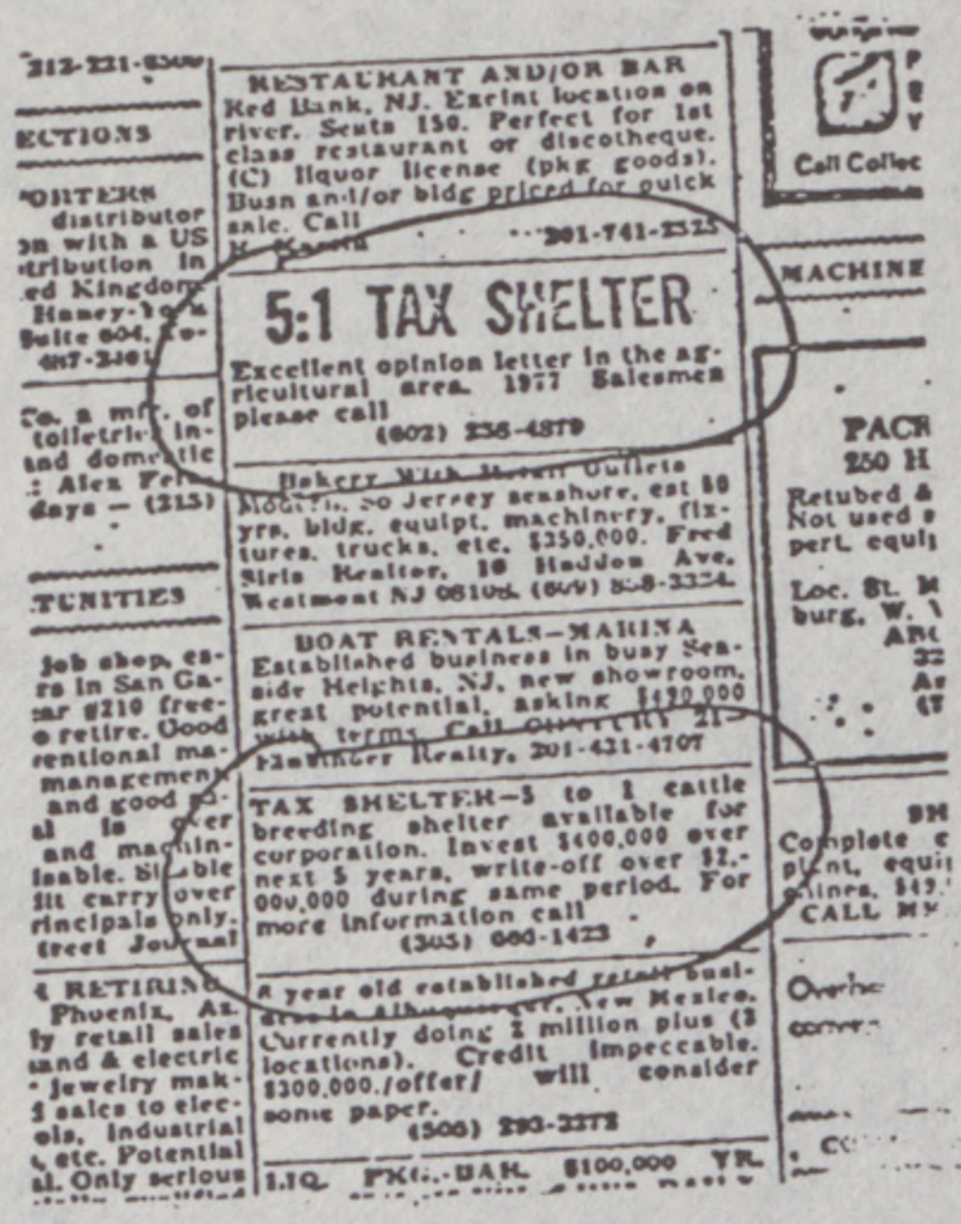
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EXAMPLES OF TAX SHELTER ABUSE

A. The Continuing Tax Shelter Problem

Thousands of high-income taxpayers continue to avoid payment of their fair share of income tax. The most popular techniques by which they do so are generally referred to as tax shelters. Tax shelters -- thought by many to have been eliminated by the 1976 Reform Act -- have continued to thrive during the past year Low and moderate income taxpayers are particularly annoyed when they read of high-income taxpayers utilizing tax shelters or see newspaper advertisements and articles in magazines extolling new tax shelter techniques and their promoters. This publicity undermines compliance generally. Frustrated and angered taxpayers who cannot afford to invest in these tax shelters may resort to their own "tax shelter" devices, such as "forgetting" to report income from a second job.

Sales of tax shelters have become a regular part of business commerce For example, the following advertisements appeared in the Wall Street Journal of December 23, 1977, in the midst of prime tax shelter retail season:



RESTAURANT AND/OR BAR
Red Bank, NJ. Exclnt location on river. Seats 150. Perfect for 1st class restaurant or discotheque. (C) liquor license (pkg goods). Busn and/or bldg priced for quick sale. Call
201-741-2525

5:1 TAX SHELTER
Excellent opinion letter in the agricultural area. 1977 Salesmen please call
(602) 256-4879

Bakery With Haven Outlets
Monmouth, So Jersey seashore, est 50 yrs, bldg, equipt, machinery, fixtures, trucks, etc. $250,000. Fred Siris Realtor, 10 Haddon Ave, Westmont NJ 08108 (609) 858-3324

BOAT RENTALS—MARINA
Established business in busy Seaside Heights, NJ, new showroom, great potential, asking $420,000 with terms. Call owner(s) 21
Hamilton Realty, 201-431-4707

TAX SHELTER—5 to 1 cattle breeding shelter available for corporation. Invest $400,000 over next 5 years, write-off over $2,000,000 during same period. For more information call
(305) 666-1423

4 year old established retail business in Albuquerque, New Mexico. Currently doing 2 million plus (3 locations). Credit impeccable. $300,000./offer/ will consider some paper.
(505) 293-2272

Call Collec

MACHINE

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NTED

AVAILABLE
INTERNATIONAL
BANK
Principals only
Box H-821, Wall Street Journal

400% SHELTER
August 1976 coal lease. Operating mine. Contract miner. 1977 cash flow. For attorney or accountant with large individual or corporate clients. CINEWORLD CORP. John F. Rickert, Pres. P.O. Box 610776 No. Miami, Fla. 33161
(305)891-1181

Sales of tax shelters have become so profitable that major brokerage houses can no longer afford to overlook this source of revenue. An article in the July 25, 1977 issue of Forbes Magazine, page 27, entitled "Gimme Shelter" explains

> Tax shelters are booming again, in good part because inflation, prosperity and our progressive tax laws keep pushing more and more people into brackets where paying really hurts. Given Merrill Lynch's fine reputation, it appealed to customers who wouldn't trust an ordinary tax-shelter deal. "In 1975 we attracted $53 million in [tax shelter] equity investments," Loughlin says, leaning back in his chair. "Last year, $77 million; this year we expect to do over $100 million."
>
> Merrill Lynch is by no means alone. Today nearly every retail brokerage house in the country has discovered the potential of tax shelters as a new source of business.
>
> Sales commissions run from 6% to 8.5% of the money invested, the kind of return that energized all those mutual fund salesmen back in the Sixties and Fifties.
>
> Last year tax shelters attracted at least $2.4 billion. About $1.2 billion of that was in public placements registered with the Securities & Exchange Commission or with state agencies. The other half (or more) is in private placements, which are limited to 35 or fewer investors and which do not have to register with the SEC. Private placements are the province of not only the brokers, but a whole army of lawyers, accountants and promoters—some sharp, some of them just sharks.
>
> This year's take in tax shelters—public and private—could be higher still. The industry's rule of thumb is that anyone who has part of his income in the federal 50% bracket is a prospect. Published Internal Revenue Service data for 1973 (the latest figures) showed 568,849 taxpayers at the 50% level or higher that year. That's a lot of potential business. Since then, many more thousands of rock singers, TV personalities, doctors, airline pilots, lawyers and assorted executives have joined the top brackets.

B. Illustrations of the Problem

Would you invest $65,000 of your own money to buy the rights to a book about the life story of a virtually unknown bodybuilder written by an unknown author? Probably not, unless you determined that the chances of making a profit justified this enormous risk. Tax shelter promoters, however, devise schemes to entice wealthy investors to do exactly this. How? By making Uncle Sam a silent partner in the investment.

In one such tax shelter, the investor invests $65,000 of his own cash. The purchase price for the book, however, is not $65,000 but rather is inflated to $300,000. Does the investor personally owe $235,000? No. The difference is payable only out of a small percentage of the receipts, if any, and only after the investor has been repaid his entire $65,000 cash payment.

Under the terms of the deal, over 1,000,000 copies of the book must be sold before the $300,000 "purchase price" is repaid. The prospectus promoting the deal contains

appraisals from "experts" who, even in their optimistic opinion, place the upward sales limit for the book at 600,000 copies. Thus, even assuming that the appraisals cited by the promoter prove accurate, the projected book sales would repay only two-thirds of the so-called "loan". It is obvious that the "loan" will never be repaid. What then is going on? The answer lies in the purported tax benefits. The investor is encouraged to write-off as rapidly as possible the full $300,000 "cost", thereby giving him tax benefits far in excess of his cash investment. As a result, through tax revenue losses, Uncle Sam has become the major investor in the book.

The key to the shelter is the inflated valuation given to the asset. An asset, such as a book, is difficult to value. Hence, an irresistable temptation is presented to aggressive tax shelter promoters to overstate this value.

Nevertheless, despite difficult questions on valuation, and the near certainty that, if audited, the Internal Revenue Service will contest these aggressive valuations, book shelters have thrived so much so that a major literary (not business) journal felt bound to describe the phenomenon.

The New York Times

Book Review

OCTOBER 2, 1977

BOOK ENDS
By Richard R. Lingeman

The Sheltering Book



Drawing by Elliott Banfield

WEALTHY people about town facing a large tax bite this year are investing money in books as tax shelters. The traditional tax shelters, of course, are oil wells, cattle farms, motion pictures and the like, but reforms in the Internal Revenue Code last year have made books (also master records and song copyrights) suddenly attractive.

The reason is that the Tax Reform Act of 1976 still permits individually owned tax-shelter assets to be purchased with no-risk, non-recourse loans, after eliminating such practices by partnerships. This all gets very technical, but the way it works is that the shelter-seeker buys an assignment of copyright from the author (or publishing house if it owns the copyright), usually for a limited time—say, 15 years—after which copyright reverts to the author. The author is selling his rights to income from the book during that time; in other words, for some cash in hand, he gives up the chance of making even more money in the event the book takes off. The tax-shelter seeker acquires an asset he can depreciate against current income.

The amount the investor pays is supposed to represent the book's value in terms of projected income; such evaluations range from the inflated to the fairly realistic. The I.R.S. can be expected to cast a cold eye on book-shelter evaluations; the practice is so new that it has made no rulings on them as yet. Morton Janklow, a New York lawyer-agent who sees a lot of book-shelter proposals, says that, like any tax shelter, they can be bona fide but "the key element is whether the arrangement was entered into for a legitimate business purpose."

Book shelters can involve the investor publishing the book himself, and getting a distributor, but more common are the tax-shelter promoters who buy up a number of copyrights and offer them around to high-bracket rollers. A typical promoter might offer 30 or 40 books with a total value of over $2 million, of which he will take better than a fourth as his commission with the remainder going about equally to authors and for expenses. "Prices" of individual books we've heard about range from $50,000 on up to $1 million for one recently published, sensational commercial novel.

In many of these deals, the tax benefits are so great that the quality of the asset, such as a book or recording, is irrelevant. All that is needed is the appearance of a bona fide transaction, to avoid disqualification as an outright sham. This fact is well described in an article entitled "Ah, Tax Shelters! What Horrors Are Committed in Thy Name" which appeared in the January 23, 1978 issue of Forbes Magazine.

> Cal-Am dutifully warns you in its sales literature that there may be one big problem: the $125,000 purchase price. The IRS has announced that it will scrutinize tax returns in which the "fair market value" of property is less than the nonrecourse debt used to pay for it. But if $125,000 sounds like too much to pay for a master recording by an unknown artist, sit tight: Cal-Am provides you with two appraisals by experts in the music recording business who will attest to its value.
>
> The IRS, of course, may contest the appraisals—particularly in light of what one record-industry source told FORBES: "I visited Cal-Am several months ago because I thought they were interested in purchasing good master recordings. They looked at me like I was crazy. [A Cal-Am official] said: 'Can you get me records for $1,000 or $1,500 apiece?' And I said to him, 'No, I can't.' He said, 'That's the price scale I'm looking for.' And I said to him, 'That's impossible. You're going to have two cellists banging their cellos together for $1,000.' He said, 'I don't care what we have.'" (Our source adds that a typical cost for producing a good master recording is between $45,000 and $100,000.)

Obviously, reasonable men may disagree over the fair market value of an asset. For tax shelter promoters, however, the possibility of reasonable differences of opinion is the excuse justifying the most favorable, and in many cases outrageous, valuation. One way to deal with this problem is for the Service to hire an army of appraisers. Clearly, this is not desirable. The Administation proposes instead to replace the army of appraisers with a simple rule: an investor can deduct tax losses only to the extent of his economic investment in the activity. In the foregoing example this rule will limit the investor's deductions to $65,000. The value of the tax deductions can then never exceed his personal investment. The investor, therefore, will lose some part of his investment unless the deal produces a profit. Under this rule, it is hard to conceive of a prudent person who would invest $65,000, let alone $300,000 of his own money in this venture. An investor could no longer ignore the strong probability that the book will be a flop. The need for this rule is not limited to book deals. Ingenious promoters have packaged tax shelters involving master recordings as well as lithographic plates of original works of art. Obviously, the only limit is the imagination of the promoters. Thus, the rule extends to virtually all activities.

In many tax shelters an investor makes profits while losing his entire cash investment. This interesting phenomenon can be demonstrated by the projected tax savings supplied by the promoter of a tax shelter involving a lithographic plate of an original work of art. As the attached projection shows, for a cash investment of $25,000,

the promoter projects that the cash value of the tax savings during the first four years of the investment to a taxpayer in the 60 percent bracket would exceed $65,000. Thus, assuming that the projections of the promoter can sustain a challenge by the Service, the investor has received almost a 300 percent return simply by losing his entire investment. Even the medieval alchemists could not so skillfully turn lead into gold.

LLOYD PROBBER & ASSOCIATES

STATEMENT OF PROJECTED OPERATIONS
(Unaudited)

Facts used for this projection

Cash investment over two year period	$ 25,000
Note payable	100,000
Total cost to investor (Note 3)	$125,000
Investment tax credit available	$ 12,500
Tax bracket of potential investor for each year of projection	60%
Note principal and interest amortized (Note 3)	None

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Total
A. Income tax effect (Note 1a)												
Income:												
Gross profit on sales (Notes 1b and 4)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Foreclosure of note (Notes 1c and 3)	-	-	-	-	-	-	-	-	-	-	148,272	148,272
Total income	-	-	-	-	-	-	-	-	-	-	148,272	148,272
Deductions:												
Investment tax credit (Note 1d)	20,833	-	-	-	-	-	-	-	-	-	-	20,833
Depreciation (Note 1e)	13,889	24,691	19,204	14,937	11,617	9,036	7,028	5,466	4,251	1,653	-	111,772
Interest (Note 1f)	1,500	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	61,500
Total deductions	36,222	30,691	25,204	20,937	17,617	15,036	13,028	11,466	10,251	7,653	6,000	194,105
Taxable income (loss)	$(36,222)	$(30,691)	$(25,204)	$(20,937)	$(17,617)	$(15,036)	$(13,028)	$(11,466)	$(10,251)	$(7,653)	$142,272	$(45,833)
B. Cash effect												
Cash savings (cost) from taxable income (loss)	$ 21,733	$ 18,415	$ 15,122	$ 12,562	$ 10,570	$ 9,022	$ 7,817	$ 6,880	$ 6,151	$ 4,592	$(85,364)	$ 27,500
Cash distribution (Note 7)	-	-	-	-	-	-	-	-	-	-	-	-
	21,733	18,415	15,122	12,562	10,570	9,022	7,817	6,880	6,151	4,592	(85,364)	27,500
CAPITAL CONTRIBUTED (Note 3)	12,500	12,500	-	-	-	-	-	-	-	-	-	25,000
Net cash benefit (cost)	$ 9,233	$ 5,915	$ 15,122	$ 12,562	$ 10,570	$ 9,022	$ 7,817	$ 6,880	$ 6,151	$ 4,592	$(85,364)	$ 2,500
Cumulative cash benefit (Note 8)	$ 9,233	$ 15,148	$ 30,270	$ 42,832	$ 53,402	$ 62,424	$ 70,241	$ 77,121	$ 83,272	$ 87,864	$ 2,500	$ -

The assumptions and notes contained in this report are an integral part of this projected statement.

See letter of transmittal and confidential memorandum of Lloyd Probber & Associates

Returning to the book shelter deal described above, let's assume for the sake of this discussion that the valuation is reasonable. At a later time, the book is a flop, and the $235,000 note becomes worthless. What happens? The investor has no personal liability for the note so the only thing the investor loses is the copyright asset. However, under the tax laws, the investor must then report as income the amount of the forgiven loan. As noted in the following excerpt from the recent Forbes article, many investors and promoters suffer from convenient memory lapses at this time.

> . Even if you manage to escape challenge on your deductions and credits by the IRS, you still may have problems. Remember how you paid for the master recording: $20,000 down, $105,000 in a seven-year, nonrecourse note. Let's assume the record has failed to bring in more than a few dollars of income for you at the end of seven years. So you decide to default on the note. If you did, you'd find yourself stuck with a huge tax bill. After all, you signed a note for $105,000, deducted that amount from your taxes, and have now said that you never intend to pay it off. So the $105,000, and possibly more, is suddenly "recaptured" into income the moment your debt is wiped out.
>
> In other words, you'd better have a very big wad of cash ready to hand over to Internal Revenue. But there is a way out. The nonrecourse note is renewable at your option. So you can roll it over for another seven years, and postpone the day of reckoning.
>
> Okay, but at the end of 14 years, you've got the same problem. That point was raised during a meeting with a Cal-Am official, Don Ferrari, who was talking to a group of prospective Cal-Am salesmen. "Some people," Ferrari said with an expression of mock sadness, "will have lapses of memory at the end of 14 years."

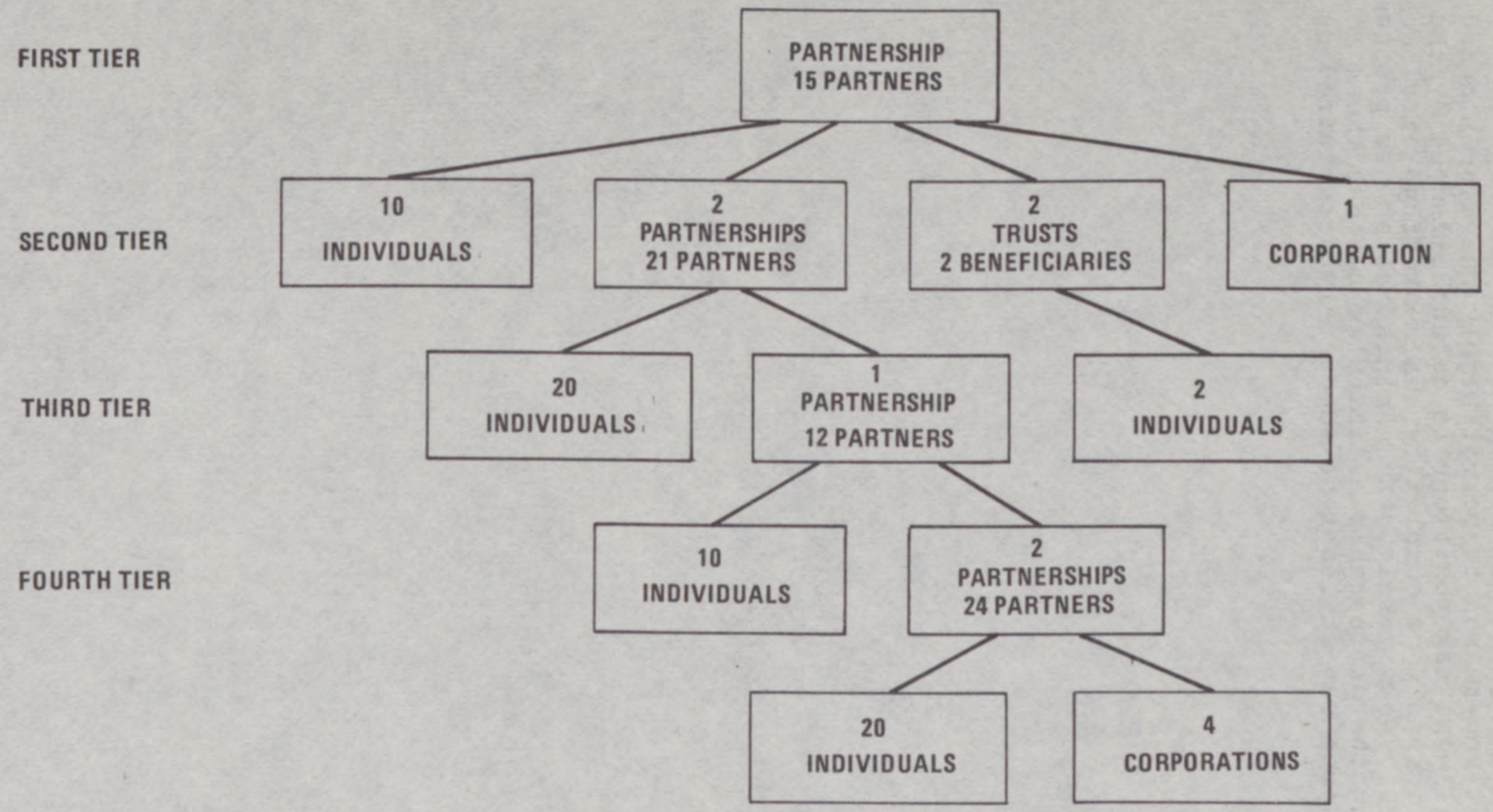
Although the proposed substantive changes will be of enormous assistance in limiting shelter activity, the Service must be able to audit shelters adequately. Many shelter schemes are of such enormous complexity and geographic scope that even the best efforts of the Service are unable to cope fully with the logistical problems presented.

A common practice in tax shelter deals is to "layer" one partnership on top of another in arrangements that involve investors from coast to coast. For example, consider the arrangement illustrated on the following page. This tax shelter which the Service is presently examining contains four tiers of partnerships. The 69 taxpayer partners are scattered throughout the various tiers. There are six partnerships which are mere conduits, although in investigating this tax shelter the Internal Revenue Service must examine the returns of these conduits to identify the actual taxpayers.

Even where the tax shelter partnership is not structured in a multi-tiered arrangement, the mere number or geographic diversity of limited partner-investors makes the Service's audit task extremely difficult. One group of tax shelter cases presently under examination by the Service involves over 20 partnerships, with an aggregate number of limited partner-investors in excess of 1,600. Certain of these

partnerships each have in excess of 400 limited partners who are located from New York to California.

There is no reason to permit highly questionable and sometimes illegal tax positions to go unchallenged by the Service as a result of complexity and subterfuge attributable to taxpayers. As a result, the Administration has proposed streamlining the partnership audit rules so that these complex schemes can at least be adequately scrutinized by the Service.



TOTAL RETURNS	
Individual	62
Corporate	5
Trust	2
Partnership	6
	75

REAL ESTATE DEPRECIATION

Present Law

Present law allows a depreciation deduction for the exhaustion, wear and tear of buildings used in a trade or business or held for the production of income.

A building will experience a gradual loss in value over its life equal to the difference between the cost of the building and its salvage value. This loss in value is a cost of producing the rents or other income from the building. The purpose of the depreciation deduction is to provide an accurate measure of the annual taxable income derived from the building by allocating this cost of producing income over the period during which the income is produced. To accomplish this purpose, the total loss in the value of the building must be allocated year-by-year over the life of the building.

If the entire cost of a building were deducted in the year it was placed in service, there would be large tax savings at the beginning of the property's life that would be offset by taxation of the entire gross income from the property (net of operating expenses) during the remainder of its life. The deduction of all of the anticipated depreciation at the beginning of a building's life would be inappropriate because it would not reflect a current loss in its value.

The opposite policy would be equally inappropriate. If a deduction for the loss in value of a building were permitted only when its amount could be determined with certainty (e.g., when the building was sold), the taxpayer would be required to pay tax on the entire gross income from the property (net of operating expenses) and would receive a refund of the overpaid tax only when a loss was sustained on the building's sale. Taxpayers would properly object that the loss of value occurred during the period of the building's use and should be netted against the income earned during that period, rather than accumulated and deducted in a single year.

The allowance for depreciation is intended to avoid the distortion of income that would result from either of these extremes by permitting annual deductions that reasonably allocate the cost of producing income from the building over the period during which income is produced. Thus, the rate at which a taxpayer recovers his investment in a building

through depreciation deductions is, in general, intended to correspond with the gradual loss of that investment as the property deteriorates physically or becomes obsolete. Under present law the amount of the annual depreciation deduction is a function of three factors:

(1) the estimated useful life of the asset: the length of time it will be used in the taxpayer's trade or business or held for the production of income;

(2) the salvage value of the asset: the amount which the taxpayer estimates will be realized upon sale or other disposition of an asset when it is no longer used by that taxpayer; and

(3) the method of depreciation: the method of apportioning the property's decrease in value from its original cost to its salvage value over its useful life. 1/

Methods of depreciation.

Until 1954 the most common method of depreciating buildings was the straight-line method. Under the straight-line method, which is now required only for used nonresidential real property, the annual deduction for depreciation is a pro rata portion of the difference between a building's cost and its estimated salvage value.

Accelerated methods of depreciation (e.g., the declining balance method) allow more depreciation in the early years of an asset's life and less in later years.2/ These accelerated methods, first permitted on a limited basis by administrative practice in 1946, were specifically authorized by the Congress in 1954, when its primary focus was the depreciation pattern of industrial machinery and equipment. However, these faster methods of depreciation are now generally permitted to be used for all assets, including buildings.

New residential rental buildings may be depreciated at a rate of up to 200 percent of the straight-line rate (or the sum of the years-digits method, which gives approximately the same results). Other new buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential properties can be depreciated at a rate of up to 125 percent of the straight-line rate; only used nonresidential properties are limited to the straight-line method.

Useful life and salvage value.

While depreciation methods for buildings are specified by statute, estimates of useful life and salvage value are made by the taxpayer subject only to the requirement that

they reflect all the "facts and circumstances" bearing on the taxpayer's anticipated use of the property.

The taxpayer must make subjective judgments to estimate both the useful life and the salvage value of a building when it is first placed in service. To the extent that a taxpayer makes a judgment underestimating a building's useful life and salvage value, the taxpayer overstates depreciation during the shorter life claimed, producing premature deductions.

In 1971 Congress requested a Treasury study of the useful lives over which taxpayers were in fact depreciating buildings, intending to establish useful lives for buildings under the class life system of depreciation (Asset Depreciation Range, or "ADR"). The Treasury study, completed in 1974, showed that taxpayers almost always assume salvage values of buildings to be zero and claim useful lives that are significantly shorter than the relevant lives for buildings published previously by the Internal Revenue Service (Rev. Proc. 62-21, 1962-1 C.B. 418). (See Table IID-1.)

Instead of estimating the overall useful life and salvage value of a building, taxpayers may allocate the cost of a new building among its various components (e.g., the building shell, wiring, plumbing, roof, ceiling, flooring) and then may estimate separate useful lives and salvage values for each of these components. It is not uncommon for a single building to be divided into more than 100 separate components.

Reasons for Change

Present law authorizes a reasonable deduction for depreciation to ensure that the annual income derived from a building is clearly reflected. The current procedures for determining depreciation deductions for buildings do not produce depreciation deductions which are reasonable. The use of useful lives and salvage values that are far less than are economically justifiable are combined with the accelerated methods permitted by statute to produce excessive depreciation deductions that distort income and enable taxpayers, especially high-income taxpayers, to avoid taxes.

Straight-line method more appropriate.

Prohibiting use of the accelerated methods of depreciation for real estate is supported by (1) prior Congressional action, (2) studies of actual economic declines in the value of buildings, and (3) the realities of the marketplace.

1. Prior Congressional action.

Accelerated methods of depreciation for real estate were

Table IID-1

Comparison of 1962 Guidelins and
Lives Claimed (In Years)

Building Type	Guideline Lives Under Revenue Procedure 62-21	Average Lives Claimed by Taxpayers (New Buildings Only)	Percentage of Taxpayers Claiming Lives Shorter Than Guideline Lives
Retail (including shopping centers)	50	36	93
Warehouse	60	37	99
Factory	45	37	77
Apartment	40	32	78
Office	45	41	91
Bank	50	43	79

Office of the Secretary of the Treasury
Office of Industrial Economics — January 27, 1978

Source: Office of Industrial Economics, Department of the Treasury, Business Building Statistics (GPO, Washington, 1975).

permitted virtually as an afterthought. When the Congress originally authorized the accelerated methods in 1954, it was primarily concerned with the depreciation pattern of machinery and equipment; the purpose of the accelerated methods was to afford a more realistic timing of depreciation deductions by properly recognizing the early obsolescence of these assets. 3/ Obsolescence may affect the length of building lives as it does those of machinery and equipment. However, experience demonstrates that the technological obsolescence of buildings is not nearly as rapid as that of machinery and equipment.

The potential physical lifetimes of most buildings are extremely long. That is, with reasonable maintenance, there is no physical reason that most buildings cannot remain in service for hundreds of years, as many buildings currently in use attest. In spite of the physical durability of buildings, they are frequently removed, abandoned, or converted to another use, most often for reasons that are social, cultural, and political, rather than physical. These changes occur gradually. The rapid technological changes in the fields of computer technology, electronics and production machinery, for example, do not equally affect real estate.

The legislative history indicates that in authorizing accelerated methods of depreciation the Congress did not consider the different pattern of the loss in value of buildings compared to that of machinery and equipment. The allowance of the accelerated depreciation methods for buildings simply happened, and was not intended as a device to stimulate real estate construction.

In 1969 the Congress recognized the distinction between the depreciation pattern of buildings and that of machinery and equipment. The Tax Reform Act of 1969 restricted the use of the accelerated methods of depreciation for buildings. Further recognition that the Congress has viewed the straight-line method as a more appropriate one for buildings is provided both by the recapture rules and by the definition of tax preference items.

The recapture rules, enacted in 1964, generally require that the portion of gain realized on the disposition of a building equal to the excess of accelerated over straight-line depreciation be recognized and taxed as ordinary income rather than as capital gains. The excess of accelerated over straight-line depreciation is also considered an item of tax preference for purposes of the minimum and maximum taxes, introduced in 1969.

2. Studies of actual declines in value.

Recent studies of the actual economic depreciation pattern of real estate unequivocally conclude that any method of tax depreciation for buildings that yields deductions more accelerated than those produced by the straight-line method over the lives presently in use is unjustifiable.

A study conducted for the Treasury in 1970 investigated the actual economic depreciation (in constant dollars) of real estate. This study concluded that allowable tax depreciation--even on the straight-line method over useful lives of 40 to 60 years--greatly exceeds the actual economic depreciation of both office and apartment buildings:

"For both office and apartment buildings we find that the tax depreciation rules--even after the 1969 revision--confer substantial subsidies. For example, the true depreciation of office buildings in the first year is less than one-tenth of that allowed under straight line depreciation. Indeed, true depreciation for office buildings falls short of that allowed by the straight line method for each of the first 45 years of the office building's useful life. We calculate that on a before tax basis, the straight line depreciation allowed by the law yields a subsidy of 18 percent of the purchase price while double declining balance adds approximately 10 percent more.

"The results are similar for apartment buildings. In the first year, true depreciation is less than one-fourth of that allowed under the straight line method and true depreciation does not exceed the tax allowance until after the passage of 40 years. The straight line tax depreciation methed confers a subsidy of 14 percent while accelerated methods can double this. In both industries a reverse sum of the years digits method would approximate true depreciation." 4/

Another Treasury study compared tax and economic depreciation (in constant dollars) on the basis of the extensive data collected in connection with the Treasury's 1974 ADR survey of lives actually being used to depreciate buildings. 5/ This study also concluded that even straight-line depreciation, given current lives in use, greatly exceeds economic depreciation.

3. Realities of the marketplace.

The inappropriateness of accelerated methods of depreciation for buildings is clearly demonstrated by the disparity between the implied rates of decline in building values and the lending practices of major financial institutions. These institutions lend hundreds of millions of dollars each year, accepting buildings (and their sites) as security. These lenders must be concerned with the true rates of depreciation of the properties they take as collateral. If a property depreciated more rapidly than the loan was repaid, the lender would find the value of the collateral to be insufficient to recover the unpaid balance of the loan in the event of default.

The behavior of equity investors in buildings also clearly demonstrates that accelerated depreciation is unrealistic. These investments, if the investors' tax depreciation schedules are to be believed, have rates of return that are not only well below prevailing market rates, but that are sometimes even negative. These points are illustrated by the following example.

Example

Assume an investor purchases a newly constructed office building and its site for $1 million. The site has a value of $120,000. The investor finances the purchase with $250,000 of his own funds and a loan of $750,000 from an insurance company. The loan has an interest rate of 9 percent per annum, will be amortized over 22 years and is secured by the property. The building is fully rented and generates $104,051 annual revenues, net of operating expenses. 6/

The financial results for the first five years are shown in the following table. Depreciation is shown under both the

150 percent declining balance and straight-line methods based on a 30-year useful life.

	150% Declining Balance	Straight-line
1. Operating income before interest and depreciation	$ 520,255	$ 520,255
2. Mortgage amortization	71,390	71,390
3. Depreciation	199,072	146,665
4. Interest	325,753	325,753
5. Cash flow (item 1 less items 2 and 4)	123,112	123,112

The depreciation deducted under the 150 percent declining balance method in the first five years is almost three times as great as the mortgage amortization required by the lender. If the depreciation deductions accurately reflected true depreciation, the lender's margin of safety (i.e., the excess of the property's value over the loan balance) would be reduced from 33 percent to 18 percent. To maintain the 33 percent margin of safety, the lender would anticipate no more than approximately $95,000 of economic depreciation over the five-year period. In contrast, tax depreciation computed on the basis of the 150 percent declining balance method is $199,072.

To calculate the investor's before tax rate of return, assume that the property will be sold after ten years. The annual cash flow from the property is $24,623. If the 150 percent declining balance method with the 30-year useful life accurately reflected true depreciation, the property would sell for $646,890 after ten years. From the proceeds of the sale, the investor would have to repay the remaining balance on the mortgage of $568,767. The net cash from the sale would be $78,123. Given that the investor committed $250,000 when the property was purchased, the rate of return on the investment is 4.17 percent. This is an unrealistically low figure for rates of return to equity investors in an environment where mortgage rates are 9% and higher. If investors truly anticipated rates of return of this size, no investment in buildings would occur. Clearly, in order to earn a reasonable return on equity, the sales value, and hence the undepreciated basis at the end of ten years, should be substantially higher than that implied by presently allowable deductions. Even straight-line depreciation over a 30-year useful life provides a rate of return of only 6.53 percent. A similar example for apartment buildings for which the investor uses 200 percent declining balance depreciation produces a negative rate of return.

Need for guideline lives.

The Treasury has consistently attempted to make the calculation of depreciation for all kinds of property simple, uniform and administrable by providing guideline systems for the determination of useful lives. Guideline lives which taxpayers may elect and not have challenged by the Internal Revenue Service have generally been established for most depreciable property, but are not currently used for buildings.

The present facts and circumstances test for determining building depreciation is a cumbersome and inexact process that produces widely varying depreciation allowances. There is no evidence that these variances reflect actual differences in declines in value. In addition to being inequitable, the present system is also costly for both taxpayers and the government.

Uniform guideline lives for real estate would (1) provide simplicity, certainty, and relieve the administrative burdens imposed by the facts and circumstances test, and (2) ensure that similarly situated taxpayers are treated consistently.

1. Facts and circumstances foster disputes.

Under the facts and circumstances test, taxpayers must estimate useful lives and salvage values of buildings in the year they are first used in a trade or business or held for the production of income. The facts and circumstances test thus requires both taxpayers and the Internal Revenue Service to predict technological, social, cultural, and political events to determine a reasonable allowance for depreciation.

It is not surprising that under this subjective standard, requiring numerous judgments on which reasonable persons could differ, disputes frequently arise over the appropriate useful lives of buildings. A 1977 report prepared by the General Accounting Office (GAO) on ways in which the tax laws could be simplified identifies disputes over useful lives of depreciable property as one of the tax issues most frequently in controversy. 7/ These disputes, involving basically factual issues, require taxpayers and the government to devote substantial time, effort and expense to the determination of a mutually acceptable useful life.

It is unreasonable, and as demonstrated by the empirical testing of the depreciation rules that have been used for buildings to date, virtually impossible, to base economically justifiable rates of tax depreciation on these taxpayer-by-taxpayer predictions.

2. Facts and circumstances inequitable.

Prohibiting use of accelerated methods of depreciation for real estate is insufficient by itself to prevent unrealistic depreciation deductions that distort income and produce artificial losses. In fact, depreciation on real estate tax shelters currently being sold to high-income taxpayers is frequently computed under the straight-line method to avoid the unfavorable impact of the excess of accelerated over straight-line depreciation under the minimum and maximum taxes and the recapture rules. These taxpayers are able to obtain the benefits of unrealistically large depreciation deductions without resorting to the accelerated methods by playing the "audit lottery" and by using the component method of depreciation.

The audit lottery: Internal Revenue Service audits indicate that, in the absence of objective guidelines, many high-income taxpayers are taking aggressive "tax return positions" in claiming useful lives far shorter, and salvage values much lower, than are justified by the facts and circumstances.

These taxpayers have little to lose by claiming short useful lives and low salvage values. In the event the taxpayer's return is not selected for audit, the excessive depreciation deductions produce artificial losses that reduce the taxpayer's tax liability. The odds are that the taxpayer's return will not be audited.

On the other hand, if the taxpayer's return is audited and his estimated life challenged, the taxpayer merely regards the estimated useful life on the return as a "first offer" to the Internal Revenue Service. (The Internal Revenue Serivce rarely asserts penalties in these cases, since the taxpayer will be able to argue that the tax return position is justifiable under the facts and circumstances.) In the absence of objective guidelines, these disputes become negotiations between the taxpayer and the Service to arrive at a useful life that will be mutually acceptable. Because the government cannot afford to allocate significant resources to litigate these basically factual issues, which would have little or no value as precedents, disputes over the useful lives of buildings are almost always settled administratively.

Thus, instead of similarly situated taxpayers being treated equally, the facts and circumstances test ensures that aggressive taxpayers--not necessarily those who experience the most rapid depreciation of their buildings--will take the largest depreciation deductions.

Component depreciation: The use of the component method to depreciate buildings has become increasingly popular in

recent years--particularly in tax shelter real estate deals. This recent popularity may be explained in part by the fact that, in actual practice, component depreciation results in the acceleration of deductions into the early years of a building's life that are far greater than are justified by the facts and circumstances. One of the principal reasons for this unwarranted acceleration of deductions is that the abuses of the facts and circumstances test are compounded under the component method.

Taxpayers divide a building into its component parts and then assign useful lives to those parts that are unreasonably short. For example, the longest lived component of a building is its structure or "shell." Taxpayers using the component method frequently assign a life to a building shell equal to the life the Treasury previously suggested for that type of building in Revenue Procedure 62-21 (e.g., 45 years for office buildings). However, the previously suggested lives were composite lives; that is, they were averages of all building components of which the shell was only one. The shell life was 67 years. It is clearly inappropriate to use the shorter composite building lives for shells. Since the shell of a building ordinarily accounts for approximately one-half of a building's cost, an underestimation of its useful life greatly accelerates depreciation deductions for a building.

In addition to assigning the lowest possible lives to a building's components, to further accelerate depreciation deductions taxpayers allocate disproportionately large portions of a building's cost to the shorter-lived components. For example, it is common practice for an owner of a new building to assign the entire cost of the plumbing contract to a separate component called "plumbing", and then to assign a short life to that account on the ground that the fixtures will be replaced after a few years. However, a large part of the cost of installing plumbing in a building is associated with the permanent piping within the building. This piping ordinarily will have a useful life equal to that of the structure itself.

A sample of a few of the many cases which have come to the attention of the Internal Revenue Service shows that taxpayers are using component depreciation to claim unrealistically large deductions on the basis of unjustifiably short building lives. (See Table II D-2.)

TABLE II D-2

Examples of Abuse of the Component Method
(In Years)

Type of Building	Approximate Cost	Normal Life Estimated by IRS Engineer	Composite Life Claimed by Taxpayer under Component Method
Apartment	$1,200,000	40	10
Apartment	1,000,000	40	15
Apartment	1,000,000	40	15
Apartment	981,000	40	15
Apartment	1,300,000	40	15
Apartment	800,000	40	20
Apartment	1,000,000	40	18
Office	635,000	45	17
Office	375,000	45	17
Industrial	130,000	45	16
Industrial	65,000	45	13
Industrial	31,000	45	16
Industrial	31,000	45	20
20 Motels	35,000,000	35 - 40	24 - 27
Shopping Center	1,850,000	40	20
Shopping Center			
1st Phase	1,900,000	35 - 40	19
2nd Phase	6,000,000	35 - 40	16

Office of the Secretary of the Treasury
Office of Tax Analysis

January 24, 1978

These abuses of the component method cannot be handled effectively by audit enforcement procedures. In an audit involving the depreciation claimed for a large building, the sheer complexity of examining a very large number of components, frequently in excess of 100, makes it virtually impossible for the agent to thoroughly examine the accounts in the limited time available. A related problem is that many large buildings are owned by partnerships. A single taxpayer may be a member of several partnerships; consequently, examination of one return necessitates consideration of complex depreciation schedules for many large buildings.

Real estate shelters.

The excess of tax depreciation over true economic depreciation in the early years of a building's life produces deductions that both offset income earned from the property during these years and shelter other income of the taxpayer.

Real estate tax shelters have been labelled and are sold as a lucrative means for high-income taxpayers to shelter their income from other sources. The Tax Reform Act of 1976, which cut back somewhat on real estate tax shelters, also encouraged their growth by leaving them relatively untouched in comparison with other tax shelters.

The increased popularity of real estate shelters was noted in a recent article entitled "Outwitting Uncle Sam: Despite 'Reform', Tax Shelters Continue to Thrive":

> "Owing to restrictions imposed by the 1976 act on other programs, real estate has become more popular than ever as a haven. It is the only major shelter using non-liability financing for tax deductions which has been allowed to continue the practice and to utilize partnerships to receive the benefits. Accordingly, money has been pouring into real estate shelters, especially in the Sunbelt where industrial growth is strong." 8/

General Explanation

Under the proposal, taxpayers will be able to elect one of two ways to depreciate buildings. Under the first option, taxpayers will depreciate their buildings based on zero salvage value and the average useful lives now claimed by taxpayers as determined by the Treasury study requested by Congress in 1971. These lives are listed in Appendix A. Taxpayers who make this election will be required to use the straight-line method of depreciation. It is anticipated that most taxpayers will elect this option.

22-302 O - 78 - 10

The second option is one which maintains the integrity of the guideline system while affording a meaningful alternative for taxpayers whose buildings rapidly decline in value. Under this option, a taxpayer will be permitted in any year to depreciate a building to its current salvage value, based on a facts and circumstances test. The determination of current salvage value, below which a taxpayer may not depreciate a building, will be made annually and will be the building's fair market value. The taxpayer will have the burden of establishing the fair market value of the building.

More advantageous methods of depreciation will be provided for low-income and new multi-family housing. After 1982, the advantage for new multi-family housing and used low-income housing will be eliminated and that for new low-income housing reduced.

The proposal will provide simplicity and certainty to taxpayers and will substantially relieve the administrative burden imposed upon both taxpayers and the government under the facts and circumstances test. Under the guideline life option, taxpayers will receive uniform deductions and will know in advance of investing in real estate the depreciation allowances that will be permitted. Under the facts and circumstances option, the relevant facts, namely the property's current fair market value, will be ascertainable without resort to subjective judgments as to uncertain future events.

Analysis of Impact

The proposed changes in tax depreciation rules for buildings will help correct abuses of the tax system with little impact on the underlying process of capital formation in real estate. The proposal particularly impacts on high-income passive investors in real estate syndications. A reduction in the volume of this kind of financing will have little effect on real estate capital formation because real estate syndicate promotions are largely predicated on the marketing of tax losses. They often attract investors unqualified to judge the long-term economics of real estate projects and consequently finance projects which, even including the tax benefits, fail to yield a normal rate of return. These investments are socially wasteful and adversely affect the long-run health of real estate markets.

Because the real estate industry is highly competitive, in the long-run the proposal may be expected to result in higher market rentals. However, the increase in market rentals required to maintain after-tax returns on real estate investments will be quite small. On the basis of recent data on operating costs, mortgage financing terms, site-building cost ratios, and taking into account the proposed changes in

both the tax rates and the real estate depreciation rules, it is estimated that increases in market rentals will be only 1.2 percent for shopping centers and 0.7 percent for office buildings. For housing (other than low-income housing), the increase in required rentals will be 1.4 percent during the period through 1982 when declining balance depreciation at 150 percent of the straight-line rate is permitted, and an additional 1 percent thereafter.

Moreover, recent studies have concluded that current depreciation practices for real estate may even induce a shortening of the economic lives of buildings. Based on the 1970 study conducted for the Treasury, Taubman and Rasche found that a shift from the accelerated to the straight-line method would lower the supply of office space by only a very small amount, in part because the economic lives of buildings would be lengthened by a few years. They estimated that the use of accelerated rather than straight-line depreciation diverted more resources to the office building market, but less than one-sixth of these resources were made available to renters in additional space. "Even if it were true that subsidies were justified, it is impossible to justify a type of subsidy that causes so much pure waste," they concluded. 9/ The same general effect occurs with respect to apartment buildings.

Revenues lost through real estate shelters (from accelerated rather than straight-line depreciation, expensing rather than capitalizing construction period interest and taxes and failure to recapture excess depreciation) are remarkably inefficient tax expenditures. The recent study of real estate tax shelters by the Congressional Budget Office finds that only about 40 to 60 percent of the revenue lost by the government--estimated at $1.3 billion annually--goes to the builder/developer and thus to help reduce rental costs. The balance of the revenue loss does not produce compensatory increases in the flow of financial capital. Part of this inefficiency is attributable to the fact that investors frequently are in higher tax brackets than the pricing of the shelter reflects. Consequently, the highest bracket taxpayers receive windfalls. The remainder of the tax expenditure is absorbed by the costs of organizing syndicates and marketing the shares.

In addition to being inefficient, almost all of the current tax expenditure supports investment in buildings other than low- and moderate-income housing, such as office buildings, shopping centers and luxury apartments. The CBO Shelter Study estimated that only 11 percent of the government's $1.3 billion annual expenditure on real estate tax shelters assists low- and moderate-income rental housing construction. Approximately 35 percent subsidizes office buildings, shopping centers and other commercial buildings and the remainder (54 percent) subsidizes middle- and upper-income rental housing.

It is essential that, given the inefficiency of tax shelters, tax and nontax subsidies for housing be reviewed and coordinated. It is equally important, however, that there be no major changes in this segment of the industry while the review is completed. Consequently, accelerated depreciation deductions will be continued generally through 1982 for specific housing areas.

Effective Date

The proposal is generally effective for buildings acquired after December 31, 1978.

In the case of used low-income and new multi-family housing, the limitation to the straight-line method of depreciation will be effective for buildings acquired after December 31, 1982. The limitation to the 150 percent declining balance method of depreciation for new low-income housing will also be effective for buildings acquired after December 31, 1982.

In the case of construction begun prior to the relevant date (January 1, 1979 or January 1, 1983), the new rules will not apply if original use of the building begins with the taxpayer.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	101	299	490	672	849

Technical Explanation

Taxpayers will be permitted to depreciate buildings on the basis of zero salvage values and the average lives now in use as determined by the Treasury study requested by Congress in 1971. Appendix A lists these lives by classes of buildings and also lists the lives of building components.

Taxpayers who make this election will be required to use the straight-line method of depreciation for their buildings, including buildings depreciated under the ADR system of depreciation. Although taxpayers will be able to use lives

longer than the guideline lives, except under the facts and circumstances option described below, there will be no allowance of lives shorter than the guideline lives. For the few buildings for which ADR classes are established, the ADR life will be used.

As an alternative to using the average useful lives and straight-line method, a taxpayer will be able to elect on his tax return to use a facts and circumstances test that will permit a depreciation deduction in any year sufficient to decrease the basis of the building to its fair market value as of the end of the year.

By limiting depreciation to the current fair market value of the property, taxpayers and the Internal Revenue Service will not have to speculate as to the effects of future events on the value of the property. The determination instead will be made under the facts and circumstances which exist at the time the deduction is claimed.

Once the facts and circumstances test is elected for a structure a taxpayer has constructed or acquired, the taxpayer will not be permitted to change to the guideline system.

The facts and circumstances option may be illustrated by the following example. Assume a calendar year taxpayer purchases a building for $500,000 on January 1, 1981; the taxpayer will be allowed a depreciation deduction for 1981 of $25,000 as long as the taxpayer can establish that the fair market value of the building on December 31, 1981, is not greater than $475,000. If the fair market value of the building remains at $500,000 during 1981 no depreciation deduction will be allowed. The fair market value will be determined by reference to objective standards, including the current sales price of comparable structures and the amount of rental income the building produces.

The component method of depreciation will not be permitted for new or used buildings. Prescribed guideline lives will be required for components placed in service after the original construction or acquisition of a building by a taxpayer. The useful lives in Appendix A are based on averages of lives used by taxpayers using the component method as well as by taxpayers using composite building lives. Consequently, the shorter building lives that are produced by the component method already have been taken into account.

Used buildings.

The guidelines shown in Appendix A are based on taxpayer estimates of useful lives for new buildings. Detailed

examination of the Treasury Department data shows that taxpayers who purchase buildings that are less than 6 years old assign them useful lives which are roughly the same as those assigned to new buildings. The useful lives assigned by taxpayers decline gradually for older buildings, but stabilize at approximately 75 percent of the period assigned to new buildings.

Therefore, based on the Treasury survey, the depreciation period for used buildings not older than 5 years will be the same as that for new buildings of the same class. The depreciation period for buildings older than 5 years but younger than 22 years will be the guideline life for new buildings of the same class less 1.5 percent of that guideline life for each year of the building's age in excess of 5 years. For buildings 22 years or older at the time of acquisition, the depreciation period will be 75 percent of the life for new buildings in that class. Useful lives computed under these rules will be rounded to the nearest half year. For example, if a taxpayer acquires a 20 year old building that had an original guideline life of 35 years, under the guideline life option the building will have a useful life of 27 years.

Subsidized housing

Low-income and new multi-family rental housing will not be limited to straight-line depreciation for buildings acquired before January 1, 1983. Until 1983, new low-income housing will be allowed a depreciation deduction based on the 200 percent declining balance or sum of the years-digits method and new multi-family rental housing will be allowed a depreciation deduction based on the 150 percent declining balance method. Used low-income housing will continue to be depreciated on the 125 percent declining balance method.

After 1982, multi-family and used low-income housing will be limited to the straight-line method, and new low-income housing will be allowed a depreciation deduction based on the 150 percent declining balance method.

For purposes of these rules, low-income housing will be defined as it was most recently by the Congress in applying the special recapture rules (section 1250 of the Code). Rental housing will be defined by reference to section 167(j)(2)(B) of the Code; multi-family dwellings will be multiple dwelling housing with more that four apartments.

Taxpayers who own subsidized housing and elect to use the facts and circumstances test will not be permitted a depreciation deduction in any year which will decrease the basis of the property below its current fair market value.

Footnotes

1/ For example, if upon purchase of a building for $10 million a taxpayer estimates that he will use the building for 30 years, estimates salvage value at the end of that period to be $4 million and uses the straight-line method of depreciation, the taxpayer will take depreciation deductions of $200,000 each year ($6 million divided by 30). Salvage value limits the depreciation deduction either by reducing the amount subject to depreciation, under the straight-line method, or by setting a floor below which no depreciation deductions may be taken, under a declining balance method.

2/ Under the 200 percent declining balance method, for example, a taxpayer is permitted a depreciation deduction up to twice the straight-line rate applied to the unrecovered cost (i.e., cost less accumulated depreciation for prior taxable years).

3/ Congressional Research Service, "Study of Legislative History of the Rapid Depreciation Provision," in Congressional Record, March 1, 1974, at 4948; Congressional Budget Office, Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives (GPO, Washington, May 1977), at 22-23 (hereafter "CBO Shelter Study").

4/ This study was conducted for the Treasury by Paul Taubman and Robert Rasche. See, e.g., Taubman and Rasche, "Subsidies, Tax Law, and Real Estate Investment," 5 Economics of the Federal Subsidy Programs 343 (1972), Joint Economic Committee.

5/ This study was conducted for the Treasury in 1974-1976 by Charles R. Hulten and Frank C. Wykoff.

6/ The assumptions concerning the terms of the financing and the income from the building are derived from the American Council of Life Insurance, Investment Bulletin, No. 766, August 26, 1977.

7/ Letter Report to the Joint Committee on Taxation from the Comptroller General, U.S. General Accounting Office, "Tax Issues Generating a Significant Level of Controversy" (Report No. GG7-78; June 15, 1977).

8/ Barron's, September 19, 1977, p. 20.

9/ Taubman and Rasche, supra, at 360.

APPENDIX A

PROPOSED BUILDING GUIDELINE CLASSES AND DEPRECIATION PERIODS

Buildings

Two groups of classes are provided for buildings. The first group includes complete buildings. The appropriate class for a given building is determined by the predominant use of the building. However, certain types of buildings which are explicitly covered by other asset guideline classes (such as farm buildings, service stations, railroad station and office buildings, and telephone central office buildings) are not included in these classes. For these buildings, their ADR class lives will be used.

The second group of classes includes replacement building components. The appropriate class for a given component is determined by the type of component, without regard to the type of building of which it is a part.

Buildings--Complete

These classes include structural shells of buildings and all original components thereof, such as machinery and equipment that serves heating, plumbing, air conditioning, illumination, fire prevention and power requirements; machinery and equipment for the movement of passengers and freight within buildings; interior partitions, both fixed and movable; floor and wall coverings, doors, windows, ceilings and other items of interior finish; and associated land improvements. (Land improvements which constitute the principal asset of a taxpayer in a given location, to which buildings are incidental, such as golf courses and race tracks, are not included.) These classes also include structural shells and all original components of building additions which expand the floor space of the existing buildings to which they pertain.

Office buildings (including bank buildings)

Office buildings--three or fewer floors above ground 30

Office buildings--more than three floors above ground 40

Industrial buildings

Factories

Includes all buildings directly related to manufacturing processes on contiguous parcels of land 35

Repair garages and shops

Includes all buildings housing equipment for repair of industrial machinery or vehicles (except those directly related to manufacturing processes, which are included in the factory building classification). Includes new car dealership buildings 30

Storage buildings

Warehouses

Includes all buildings used for storage of consumer goods, machinery, raw materials, foodstuffs (except grain elevators), or finished manufactured goods 35

Grain elevators 40

Retail buildings

Includes buildings in which goods, including prepared food, are sold to the public.

Retail buildings--less than 50,000 square feet of indoor floor space on contiguous parcels of land 30

Retail buildings--50,000 or more square feet of indoor floor space on contiguous parcels of land 35

Service buildings

Theater buildings. 35

Recreational services buildings (except stadia and arenas) 30

Medical services buildings
Includes nursing homes, hospitals, clinics, and physicians' and dentists' office buildings. 35

Common carrier passenger terminals (except railroad stations) 25

Other service buildings

Includes buildings in which other services are provided for the public, such as barber shop buildings, appliance repair buildings, laundry and dry cleaning buildings (except central laundry and dry cleaning plants, which are included in the factory classification), and photographic studios 30

Residential buildings

Single-family and two-family dwellings. . . 30

Apartment buildings--three or fewer floors above ground 30

Apartment buildings--more than three floors above ground 35

Hotels and motels--three or fewer floors above ground 30

Hotels and motels--more than three floors above ground 35

Buildings--replacement components

Includes all capitalized expenditures for building components for existing buildings (except roof coverings) 20

Roof covering

Includes felt and asphalt, corrugated metal, plastic, shingle, or other types of weather-proofing membranes 15

MINIMUM TAX FOR INDIVIDUALS

Present Law

To ensure that individuals 1/ with large amounts of economic income do not take excessive advantage of special deductions or exclusions under the Code, a minimum tax of 15 percent is imposed on the amount of items of tax preference in excess of the greater of $10,000 or one-half of a taxpayer's regular tax liability. The items of tax preference subject to the minimum tax include:

1. Special provisions which accelerate deductions for depreciation including the excess of accelerated over straight line depreciation on real property.

2. The amount by which the deduction for percentage depletion exceeds the basis of the property.

3. Itemized deductions (other than medical and casualty deductions) in excess of 60 percent of adjusted gross income.

4. The excluded one-half of capital gains.

Reasons for Change

The minimum tax, which was introduced into the Code by the Tax Reform Act of 1969, initially reduced the number of nontaxable high income persons (returns with $200,000 or more of adjusted gross income (AGI)) from 300 or 1.62 percent of all returns in their income class in 1969, to 111 or 0.73 percent of all returns in their income class in 1970. However, in later years, the trend was reversed. The number of nontaxable returns increased from a low in 1971 of 82 or 0.45 percent of all returns in the income class to highs of 244 and 230 (0.78 and 0.67 percent) in 1974 and 1975 (see Table IID-3). Congress reacted to this development by strengthening the minimum tax provisions in the Tax Reform Act of 1976. The number of nontaxable high income returns is expected to be substantially reduced as a result of the 1976 Act. (Data for 1976, the first year the 1976 Act applies, will be available April 1978.)

Table IID-3

Number and Percentage of Nontaxable Income Tax Returns
with Adjusted Gross Incomes of $200,000 or over

Year	Number of Returns	Percent of All Returns with AGI of $200,000 or over
1966	154	1.26%
1967	167	1.07
1968	222	1.15
1969	300	1.62
1970	111	0.73
1971	82	0.45
1972	108	0.47
1973	164	0.64
1974	244	0.78
1975	230	0.67

Office of the Secretary of the Treasury
Office of Tax Analysis

January 11, 1978

Source: Statistics of Income

However, the problem of untaxed preference income is not limited to nontaxable returns. For example, in 1974 for each nontaxable return with AGI of $200,000 or more, there were more than four returns with equally high incomes and effective tax rates of less than 10 percent. 2/ The minimum tax under current law does not affect those taxpayers who make excessive use of preferences but who have a large regular tax liability. The current offset against preferences equal to one-half of regular tax paid allows persons who pay a regular income tax to avoid any tax on preferences. It thus undermines an important purpose of the minimum tax--the imposition of a fair share of the tax burden on taxpayers receiving large benefits from certain tax preferences. Clearly, two individual taxpayers with preferences of $100,000 each will have very different minimum tax liabilities under present law if one has a regular tax liability of $200,000 and the other has none. To impose the same burden on both of these taxpayers, the offset to the minimum tax base for one-half of the regular tax liability must be repealed.

The offset for regular tax liability also distorts the impact of the minimum tax on those taxpayers using this offset instead of the $10,000 exclusion. In effect, preferential deductions, such as excess itemized deductions, are subjected to a higher rate of tax than preferential exclusions, such as the exempt portion of capital gains. 3/ There is no indication that this result was intended by Congress.

Thus, the proposal deletes the offset for one-half of an individual taxpayer's regular tax liability. No changes will be made in the basic description of preference items, although some (accelerated depreciation on real estate) would be affected by reason of other proposals.

In one respect, however, the minimum tax would be liberalized for individual taxpayers. Application of the minimum tax to the sale of a principal residence could create an undue hardship inconsistent with the purposes of the minimum tax. At present, the Code allows a taxpayer to avoid completely any current tax on gain from the sale of a principal residence when he buys another principal residence of at least equal value within a prescribed period of time. If a taxpayer is unable to take advantage of that provision, the regular tax on the gain should not be augmented by the minimum tax. Thus, capital gains from the sale of a principal residence will be excluded from the minimum tax base.

General Explanation

The basic structure of the minimum tax will be retained,

but the offset for one-half of regular tax liability would be repealed in the case of individuals.

In the case of the sale of a principal residence, all recognized capital gain will be excluded as an item of tax preference. However, a taxpayer will not be able to use this exception to avoid the minimum tax on the sale of a substantial amount of land surrounding a principal residence. Thus, for example, upon the sale of a ranch, including the seller's principal residence, only a reasonable portion of the land adjacent to the residence will be covered by the principal residence exclusion.

Analysis of Impact

Eliminating the half-tax offset for individual taxpayers will raise taxes by $228 million on a total of 91 thousand taxpayers, virtually all of whom will have expanded incomes (adjusted gross income plus tax preferences and less investment interest to the extent of investment income) of over $50,000 (see Table IID-4).

Table IID-4

Effect of Eliminating the Half-Tax Offset for Individuals

Expanded Income Class	Number of Returns With Increased Minimum Tax (Thousands)	Amount of Increased Minimum Tax ($ in Millions)
$ 50,000 to $100,000	15	$ 4
$100,000 to $200,000	47	47
$200,000 and over	29	177
	91	$ 228

Office of the Secretary of the Treasury
Office of Tax Analysis

December 22, 1977

Effective Date

The changes in the minimum tax would be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	284	306	329	353	380

Footnotes

1/ The minimum tax with some modifications also applies to corporations; the tax as it applies to corporations will not be changed under this proposal.

2/ Office of Tax Analysis, Department of the Treasury, High Income Tax Returns: 1974 and 1975, March 1977.

3/ If an individual taxpayer already subject to the minimum tax on itemized deductions incurs additional expenses which are itemized deductions, the amount of the taxpayer's preference items will increase by the amount of the expenses. At the same time, the taxpayer's tax liability will decrease. Therefore, the amount to which the minimum tax rate is applied will increase by more than the amount of the additional deduction, since, for taxpayers not using the $10,000 exclusion, the minimum tax is imposed on the difference between total preferences and one-half of total regular tax liability. On the other hand, a larger capital gain will increase the taxpayer's regular tax liability, and thus the amount subject to the preference tax will increase by less than the additional preference from the capital gain transaction.

AT RISK

Present Law

A significant attack on tax shelters was made by the Tax Reform Act of 1976 through enactment of the "at risk" rules. Generally, the at risk rules have been effective. However, there are some weaknesses in the rules, and promoters have designed tax shelters to exploit these weaknesses.

A taxpayer is allowed to deduct the purchase price of an asset over the life of the asset. The higher the purchase price, the larger the deductions. Ordinarily, arm's length negotiations between a buyer and a seller assure that purchase price equals fair market value. A buyer does not want to pay more than the property is worth; a dollar of tax deduction does not offset a dollar of economic loss. Abusive tax shelters, however, are able to create highly inflated purchase prices, and thus highly inflated tax deductions, through the use of nonrecourse debt, i.e., debt that entails no personal liability on the part of the borrower. Nonrecourse debt allows investors to claim inflated deductions without risking their own capital. The seller is not risking any funds in making the loan since the loan is part of the purchase price that is paid to him. Also, the seller does not incur additional tax liability on account of the inflated purchase price because under acceptable methods of tax accounting the seller can report his gain pro rata as cash is received.

For example, in a typical shelter of this type, an individual taxpayer would purchase the distribution rights to a book for $100,000. The rights might be worth considerably less. The individual would pay $20,000 out of his own capital and borrow the remaining $80,000 from the seller on a nonrecourse basis. The seller would report his gain only as cash was received. The nonrecourse loan would be payable to the seller solely out of the receipts from the distribution of the book. The investor would deduct the full $100,000 purchase price even though he had invested only $20,000. For a taxpayer in the 60 percent bracket, these deductions would have an after-tax value of $60,000, or three times his actual cash investment. The taxpayer could thus obtain a substantial return on his investment without regard to any expected economic profit from the activity.

Even if income were never realized from distribution of the book, the taxpayer would not suffer the full economic

22-302 O - 78 - 11

loss represented by his tax deductions. The loan would be "repaid" by reconveying the book rights to the seller-lender. Assuming that the rights were fully depreciated, this "repayment" of the loan would produce taxable income for the investor equal to the outstanding balance of the loan. In such circumstances, many investors fail to report what they call "phantom" income. On audit, it may be difficult for the Internal Revenue Service to detect this income because the taxpayer does not receive any cash in the year the income arises. Even if the investor pays the taxes he owes, he still obtains the benefits of deferral from the time he claims the deduction to the time he reports the income. Furthermore, he can attempt to increase the period of deferral by extending the term of the loan. Frequently, a delayed repayment date has no business purpose and is designed solely to provide the investor with the benefits of deferral, or the opportunity to evade reporting the income entirely.

The new at risk rules effectively identify tax shelters that are based on inflated purchase prices, and prevent investors in those shelters from deducting tax losses that they can never bear economically.1/ The at risk rules limit deduction of tax losses to the amount of a taxpayer's economic investment in an activity. Any tax losses in excess of the amount of such investment cannot be deducted until the taxpayer's economic investment in the activity increases. For example, in the tax shelter described above the investor would be able to deduct only $20,000, which is the amount of his own capital at risk.

Under present law, the at risk rules apply to investments in all activities except real estate. However, the at risk rules generally do not apply if a taxpayer invests in an activity directly (and not though a partnership). The at risk rules apply to direct investments only if they are made in movies, farming, leasing of property other than real estate, or oil and gas.

For the most part, the at risk rules do not apply to corporations. However, they do apply to personal holding companies and to Subchapter S corporations. In addition, they apply to a corporation which invests in an activity (other than movies, farming, leasing of property other than real estate, or oil and gas) through a partnership.

There are several theories on which the Internal Revenue Service can attack tax shelter transactions that are not subject to the at risk rules. The success of the attack, however, depends on establishing elusive facts, such as the fair market value of unique property. Because of this, attacking these shelters under present law through an expanded audit program is difficult, expensive, and relatively unproductive. 2/

Reasons for Change

The at risk rules can be an effective means for dealing with certain tax shelter abuses that cannot be adequately dealt with on a case by case basis. They do not interfere with legitimate business transactions because they do not prevent a taxpayer from deducting losses that could possibly reduce his real wealth. There are, however, three weaknesses in the present at risk rules.

First, although they apply to all activities except real estate, the at risk rules do not apply to direct investments in most activities. Tax shelter promoters have exploited this weakness extensively and developed a wide range of investments suitable for direct ownership. For example, the following investments were widely advertised for direct sale to individual owners at the end of 1977: master phonograph records, lithographic plates, books, 3/ Christmas trees, coal mining, gold mining, and research and development. These investments were generally priced within the reach of upper middle class taxpayers. For example, a gold mine was sold by the square foot.

Second, the at risk rules generally do not apply to corporations. One leading member of the tax bar has commented on this as follows:

> "It is difficult to find any logical reason for this favored treatment of corporations. It probably arises from the perception (clearly erroneous) that it is individuals who reap the maximum benefit from tax shelters, and from the view (equally erroneous) that tax shelter syndicates do not generally include corporate limited partners. . . .If the Act is successful in closing the tax shelter syndication market to many individuals, the purveyors of tax shelters eventually will saturate the corporate market.
>
> Tax shelter investments are as available to corporations as ever. To the extent individuals have been effectively legislated out of this market, the corporate investors should have less competition and therefore better terms. Of course, many corporations seeking tax shelter investments may be (and are) privately and very closely held. Indeed, tax shelter holds much attraction for those with section 531 problems; accumulated earnings are available to buy shelter. Publicly owned corporations, with the exception of financial institutions and insurance companies which represent the principal market for equipment leasing tax shelters, generally have not indulged in pure tax shelter transactions." 4/

Under present law, the at risk rules do apply to personal holding companies. Personal holding companies are more likely than most other corporations to invest in tax shelters because they are closely held. Five or fewer shareholders must own more than 50 percent of the stock of a personal holding company. A closely held corportion may be able to pass the benefits of a tax shelter through to its shareholders, if the shareholders are also employees. 5/ Thus, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Even if the controlling shareholders are not all employees, tax shelters may be used to defeat the accumulated earnings tax. 6/

On the other hand, these opportunities are generally not available to widely held corporations. Few employees of a widely held corporation are able to control the timing and amount of their compensation, and no shareholder is likely to be able to control the corporation's investment policy. In addition, few widely held corporations are subject to the accumulated earnings tax. Further, a widely held corporation is unlikely to enter into a transaction that has no economic substance because such a transaction may be challenged either by shareholders or the Internal Revenue Service. A widely held corporation generally is subject to frequent audits by the Internal Revenue Service and to the public disclosure requirements of the Securities and Exchange Commission.

It has been common for widely held corporations to invest in only one kind of tax shelter--equipment leasing. However, equipment leasing by corporations has the desirable effect of making the tax incentives to new investment more efficient. Typically, the lessee does not have enough income to make full use of these tax incentives (chiefly the investment credit and accelerated depreciation). On the other hand, the lessor (typicaly a bank) does have enough income. The equipment lease allows the lessor to realize the benefit of the tax incentives, and to pass at least part of the benefit along in a form that the lessee can use--lower rents. Because the same corporate tax rate applies to both the lessee and the lessor, the tax benefit is no greater than Congress intended it to be. However, if the lessor is a closely held corporation, there can be an abuse. As previously explained, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Where this is so, and where the shareholders are in tax brackets above the maximum corporate rate, the tax benefits will exceed those which Congress intended to provide. Thus, equipment leasing by a closely held corporation may lead to tax abuse, even though equipment leasing by a widely held corporation is generally a desirable activity.

Although widely held corporations have made limited use of other tax shelters thus far, they may enter the market after other taxpayers have been excluded by these proposals. The Administration will continue to monitor tax shelter activity and will propose further expansion of the rules in this area if new abuses develop.

The third weakness in the at risk rules is that, if read literally, they require the taxpayer to be at risk only for the brief moment that the deductions are allowed. Therefore, it may be possible to defeat the at risk rules by careful timing. For example, in 1979 an investor puts $100,000 at risk and deducts $60,000. In 1981, the investor withdraws $90,000 of his original investment. Although the remaining $10,000 could not support a deduction of $60,000, the investor may have succeeded in circumventing the at risk rules.

General Explanation

Under the proposal, the at risk rules will extend to all activities except real estate. They will apply whether an investment is made directly or through a partnership. In addition, the at risk rules will extend to all closely held corporations (i.e., to all corporations that have five or fewer controlling shareholders). Further, a special provision will be added to prevent taxpayers from using careful timing to circumvent the at risk rules.

Nonrecourse loans have traditionally been used to finance the purchase of real estate. They are used for legitimate financial reasons and not to avoid taxes. Therefore, the at risk rules will not be extended to real estate. The Administration is, however, making other proposals to deal with certain real estate tax shelters.

Effective Date

The proposed changes will apply to transactions entered into after December 31, 1978.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	14	10	8	5	6

Technical Explanation

The Internal Revenue Code now contains two different sets of at risk rules. The first set (section 465 of the Code) applies to four activities--movies, farming, leasing of property other than real estate, and oil and gas. It applies whether an investment in one of these four activities is made directly or through a partnership. The second set of at risk rules (section 704(d) of the Code) applies to all other activities, except real estate. However, it applies only to investments that are made through a partnership (and not to those that are made directly). The Administration proposal will extend the first set of rules (section 465) to all activities except real estate. Therefore, the second set of rules (section 704(d)) will become unnecessary and will be repealed.

The at risk rules will also be extended to apply to all closely held corporations (i.e., all corporations in which five or fewer shareholders own more than 50 percent of the stock). Thus, the at risk rules will apply to any corporation that meets the stock ownership test for a personal holding company, regardless of the source of the corporation's income. On the other hand, the at risk rules will be restricted to Subchapter S and closely held corporations, and will not apply to other corporations in any circumstances.

In addition, a new provision will be added to ensure that taxpayers cannot use careful timing to circumvent the at risk rules. This provision will require a taxpayer to recognize income if three conditions are met. First, the taxpayer has deducted losses from an activity. Second, the taxpayer reduces the amount that he has at risk in the activity during a subsequent taxable year. Third, the losses taken as deductions exceed the amount remaining at risk. (For this purpose, the amount at risk is not reduced by losses.) If these three conditions are met, the taxpayer must recognize income to the extent that the losses taken as deductions exceed the amount remaining at risk. For example, a taxpayer buys a movie for $100,000 in cash and deducts losses of $60,000 in 1979. In 1981, he borrows $90,000 on a nonrecourse loan secured by the movie. At the end of 1981, the taxpayer has only $10,000 remaining at risk in the movie (disregarding the losses sustained in 1979). Therefore, he must recognize $50,000 7/ (i.e., $60,000 - $10,000) of income 8/ in 1981.

Footnotes

1/ The at risk rules are also effective against tax shelters that transfer deductions from a low bracket taxpayer to a high bracket taxpayer. For instance, in the example in the text, the at risk rules would limit the buyer's

deductions even if the purchase price of the book equalled fair market value. This limitation is necessary to prevent tax abuse if, for example, the seller is a corporation in the 44 percent tax bracket and the buyer is an individual in the 68 percent tax bracket.

2/ In Rev. Rul. 77-110, 1977-1 Cum. Bull. 58, the Internal Revenue Service stated that the basis of a movie does not include the portion of the purchase price paid with a nonrecourse loan made by the seller and secured by the movie, if the fair market value of the movie does not approximate the amount of the loan. Aggressive tax shelter promoters have either disregarded the ruling or else relied upon highly questionable appraisals, and continued to sell this type of investment.

3/ In Rev. Rul. 77-397, I.R.B. 1977-44, the Internal Revenue Service stated that the at risk rules do apply to the direct acquisition and leasing of master phonograph records. In News Release IR-1921 dated December 23, 1977, the Service announced that the principles of Rev. Rul. 77-397 apply to similar arrangements involving books, lithographic plates, musical tapes and similar property. Aggressive tax shelter promoters, however, have taken the position that the ruling is incorrect and have continued to sell these investments. In this area, the proposed legislation will be a helpful confirmation of existing law.

4/ Martin J. Rabinowitz, Some Reflections on the Social and Economic Impact of the Tax Reform Act of 1976, 31 The Tax Lawyer 163, 171-172 (1977).

5/ A simple example illustrates the possible advantages. Assume Mr. A, a taxpayer in the 60 percent marginal bracket, is the sole shareholder of corporation X and that in year one X has $20,000 of taxable income before payment of a bonus to A.

Case 1. At the end of year one, X distributes the $20,000 to A as a bonus. X is allowed a $20,000 deduction and has no taxable income for the year. A pays $10,000 of tax (the maximum tax on earned income) and invests the remaining $10,000 in a bond that yields 10 percent before tax. In year two, A will earn $1,000 in interest on the bond and pay $600 of tax, leaving him with $10,400 after tax.

Case 2. X invests in a tax shelter that produces $20,000 of deductions in year one and a matching $20,000 of income in year two. The deductions allow X to reduce its taxable income to zero in year one, so that it has $20,000 of cash and no tax liability. X invests the $20,000 in a bond that yields 10 percent before tax. At the end of year two, X has $2,000 of income from the bond plus $20,000 of income from the tax shelter. X pays the $22,000 to A at the end of

year two as salary and owes no corporate tax. A will pay $11,000 of tax (the maximum tax on earned income) and be left with $11,000.

In Case 2, A's investment yield on his $10,000 of after tax salary is $1,000 rather than $400 as a result of the use of a tax shelter at the corporate level.

6/ If a corporation has an unreasonably large accumulation of earnings, it may be subject to an accumulated earnings tax. The tax is up to 38-1/2 percent of the corporation's taxable income (after certain adjustments). However, if a corporation invests in tax shelters and reduces its taxable income, it can escape the accumulated earnings tax. Further, by using its earnings to invest in tax shelters the corporation can make it difficult for an IRS agent to detect accumulated earnings. The agent might find it hard to distinguish between investments in tax shelters and the corporation's regular business assets merely by examining the books of the corporation.

7/ The $50,000 recognized in 1981 recaptures the losses taken as deductions in 1979. Thus, in effect, the taxpayer is denied a deduction for these losses. However, the taxpayer will be permitted to deduct these losses if he increases his amount at risk in the movie in 1982 or any later year.

8/ The $50,000 recognized in 1981 will have the same character as the losses deducted in 1979. For example, if the losses were capital losses, the $50,000 recognized in 1981 will be a capital gain.

CLASSIFICATION OF LIMITED PARTNERSHIPS

Present Law

The Internal Revenue Code currently provides definitions of the terms "partnership" and "corporation." The term "partnership" is defined to include most syndicates, groups, pools, joint ventures, and other unincorporated organizations. The term "corporation" is defined to include associations, joint-stock companies, and insurance companies. These definitions are, however, very general. As a result, in determining whether an organization is properly classified as a partnership or corporation for tax purposes, the principal source of law is the decision of the Supreme Court in Morrissey v. Comissioner, 296 U.S. 344 (1935). The existing regulations draw upon the rationale of this decision in describing corporate and noncorporate characteristics.

In addition, the existing regulations provide that an organization formed as a partnership under local law will not be classified as a corporation for tax purposes unless it has more corporate characteristics than noncorporate ones. This "preponderance" test was adopted in response to the decision in United States v. Kintner, 216 F. 2d 418 (9th Cir. 1954), in an effort to keep unincorporated organizations from obtaining the benefits of corporate pension plans. As a result of this long-standing bias in the regulations, organizations formed as partnerships under the Uniform Limited Partnership Act are nearly always classified as partnerships for tax purposes. This bias was recently criticized by the Tax Court in its decision in Philip G. Larson, 66 T.C. 159 (1976). In that case the Court found that the tax shelter partnership before it more closely resembled a corporation on the basis of the criteria set forth in the Supreme Court's decision in Morrissey. The Court concluded, however, that the existing regulations compelled classification of the organization as a partnership.

Under present law, partnerships are not treated as taxable entities. Each partner is taxed on his share of the partnership income, and each partner is allowed to deduct his share of any partnership losses. Consequently, partnerships are an effective means for joint participation in tax shelters. On the other hand, corporations (except for certain electing corporations with a limited number of shareholders) are taxed as separate entities. Losses sustained by a corporation do not reduce the shareholders' income. Thus, corporations are generally not as effective a

means for joint participation in tax shelters.

Reasons for Change

Syndicated partnerships are being used as the vehicle for many thousands of tax shelters. These tax shelters are advertised in daily newspapers throughout the country. For example, advertisements of a 200% "year end" real estate shelter, a "400% coal shelter," and a "5 to 1 cattle breeding shelter" all appeared in the Wall Street Journal on Thursday, December 22, 1977. Such flagrant exploitation of tax shelters has done much to destroy public confidence in the tax law. Moreover, many publicly marketed shelters owe their success to a widespread misunderstanding of the tax law. Often, participants in tax shelters do not understand that for each artificial deduction they take today, they must include an equal amount in income at some future time. Many participants claim the deductions but fail to report the income.

In addition, a syndicated partnership is, to all intents and purposes, the equivalent of a corporation. The limited partners are not responsible for the debts of the partnership and have no voice in its day-to-day management. As a practical matter, moreover, the syndicated partnership has the same ability to maintain its existence as a corporation, and a limited partner has the same ability to transfer his partnership interest as he would stock in a comparably sized corporation. Were it not for the long-standing bias in the existing regulations, these partnerships would be classified as corporations under the criteria enunciated by the Supreme Court in the Morrissey decision. Because substantive differences between a syndicated partnership and a corporation are minimal, the same tax rules should apply to both.

Further, the Internal Revenue Code treats a partnership largely as an aggregate of individuals. Many limitations, deductions, and credits must be calculated separately by each partner. The tax effect of distributions depends on each partner's adjusted basis in his partnership interest. Special allocations of partnership income and losses and of particular items of income, gain, loss, and deduction can be made, as can special elections affecting the depreciable basis of assets with respect to a particular partner. These features of partnership taxation were intended to offer flexibility, and to preserve some degree of individuality, for the members of small partnerships. In the case of large syndicated partnerships with many passive investors, however, they complicate the law and are both unnecessary and inappropriate.

General Explanation

The proposal will treat a partnership formed after the effective date as a corporation for tax purposes if the partnership has more than 15 limited partners. However, the proposal will not apply to a partnership if substantially all (i.e., more than 90 percent) of the partnership's assets consist of new low-income housing. The Administration plans to study present methods of subsidizing low-income housing. So long as a special benefit is provided to new low-income housing through accelerated depreciation, it would be inappropriate to apply the proposal to such a partnership.

Under the Administration's proposals, the maximum number of limited partners in a partnership--15--will be the same as the maximum number of shareholders in a Subchapter S corporation. Thus, a business organization, whether it is formed under local law as a corporation or a limited partnerhsip, will be allowed conduit tax treatment if it is owned by 15 or fewer passive investors.

Effective Date

Generally, the effective date will be December 31, 1978. However, if substantially all of a partnership's assets consist of housing, the effective date will be December 31, 1982. (As stated above the proposal does not apply to a partnership if substantially all of its assets consist of new low-income housing.)

The proposal will apply to any partnership formed after the effective date. In addition, the proposal will apply to a partnership formed on or before the effective date in two circumstances. First, it will apply if the number of limited partners increases after the effective date. Second, it will apply if a limited partner contributes money or property to the partnership after the effective date (unless the contribution is made pursuant to a binding agreement entered into on or before the effective date). For this purpose, a partner will not be treated as making a contribution merely because the partnership retains some or all of its earnings.

Revenue Estimate

The proposal has a negligible effect on tax liabilities.

Technical Explanation

If a partnership has more than 15 limited partners, it will be treated as a corporation for tax purposes. Once a partnership is classified as a corporation, it will always be treated as a corporation (regardless of any subsequent decrease in the number of limited partners). In applying these rules, the term "partnership" will include any unincorporated organization availed of for investment purposes or for the joint production, extraction, or use of

property. It will be immaterial whether the organization is a joint venture for joint profit, and it will be immaterial whether the organization seeks to elect under section 761(a) not to be treated as a partnership.

Generally, the term "limited partner" will mean a partner whose liability is limited under local law to the amount of his investment (including amounts he is contractually obligated to invest). Five additional classes of investors will also be treated as limited partners. First, if a Subchapter S corporation is a partner in a partnership, then each shareholder will be treated as a limited partner. Second, if a grantor trust is a partner in a partnership, then each person who is treated as an owner of the trust will also be treated as a limited partner. Third, if a partnership is a general partner in a second partnership, then each limited partner in the first partnership will be treated as a limited partner in the second partnership. Fourth, if a partnership is a limited partner in a second partnership, then each partner (whether limited or general) in the first partnership will be treated as a limited partner in the second partnership. Fifth, if a partner assigns his interest in a partnership, and if the assignee includes a share of the partnership income or losses in his own income, then the assignee will be treated as a limited partner. However, a person who is both a general partner and a limited partner will be treated as a general partner for tax purposes, and will not be counted toward the ceiling of 15 limited partners. In addition, a partner who performs full-time personal services for the partnership (or who has performed such services for 36 months or longer) will not be counted toward the ceiling of 15. Further, a husband and wife will not be counted as more than one partner.

In certain circumstances, a partnership could be recognized as such for a period of time, and then be reclassified as a corporation. For example, a partnership with 15 limited partners will be reclassified as a corporation when a 16th limited partner is added. Whenever a partnership is reclassified as a corporation, the partners will recognize gain under section 357(c) of the Code to the extent that the partnership's liabilities exceed its assets.

AUDIT OF PARTNERSHIPS

Present Law

Partnerships are not subject to Federal income taxation. Although the items of income, gain, loss, deduction and credit are computed at the partnership level, they are taken into account separately by each of the member partners. The partners are liable for any Federal income tax in their individual capacities. Partnerships are required only to file an annual information return, which sets forth the items of income, deduction, and credit and includes the names, addresses, and distributive shares of the partners as well as any other information required by regulation.

Since the partnership is not a taxable entity, there is no administrative mechanism for making tax adjustments at the partnership level. Nor is the partnership subject to civil penalties for failure to file, or late filing of, a partnership return. Although the Service may examine partnership books and records in consultation with one or more general partners, the Service must audit each partner separately with respect to partnership matters, even though each such audit may involve the same substantive partnership determinations. 1/ For example, whether a partnership has correctly computed its depreciation allowance for the taxable year, and whether partnership allocations have been properly made, must be separately determined for each member of the partnership. A settlement arrived at by one partner with an agent is not binding on any other partner or on the agent who deals with such partner. Similarly, a judicial determination of a partnership tax dispute may be conclusive only as to those partners who are parties to the proceeding. Thus, each separate deficiency or overpayment attributable to the partnership may be the subject of a separate administrative proceeding, and, at the option of each partner, the subject of a separate judicial proceeding.

Reasons for Change

Present law does not permit the Service to make adjustments to partnership tax items at the partnership level that are binding on the partners. The result is a multiplication of administrative effort and, in some cases, a proliferation of lawsuits to decide the same issue.

The fact that partnership issues are ultimately

determined at the taxpayer level may impose a substantial administrative burden on the Service since it is required to control each taxpayer's return individually while the partnership matter is being determined. Once a partnership issue is raised, the Service must locate and review the partnership return while placing the partner's return in "suspense" pending completion of the partnership audit. Often, the partner return and the partnership return will be filed in different districts. Occasionally, there may be different locations for the partner return, partnership return, principal office or place of business of the partnership, partnership books and records, principal partnership asset and principal general partner. In addition, items relating to a partnership may be reported on an individual return even though the partnership return has not as yet been filed.

Once a partnership return has been selected for review, a decision must be made as to whether an examination of the partnership books and records is warranted. In many cases, where it appears that little or no benefit would accrue from an examination, the audit process ends with review of the partnership return. If an examination is required, the partner who signed the return will be contacted, and arrangements made to conduct the examination. At the same time, the Service must identify, locate, notify and obtain waivers of the individual statute of limitations from each partner. This may be an extremely difficult process. The Service must frequently proceed on the basis of incomplete, inaccurate, or out of date information supplied on the partnership return. Taxpayer-partners may reside in many different Internal Revenue districts. The partnership under examination may itself be a partner in another partnership, and may include as partners other partnerships, as well as corporations, trusts and estates.

If the Service cannot locate the ultimate partners and obtain waivers, the partnership review may be futile since the limitations periods may close for many of the partners. Even if the Service is successful in locating a partner, the partner may refuse to provide a waiver, thereby forcing the Service to issue a deficiency notice for some partners but not for others. As a result, with respect to the same partnership matter, there may be partners who have waived the statute of limitations period, partners who have refused to provide waivers and, therefore, received deficiency notices, and partners who could not be located and whose limitations period closed.

Any partner may separately litigate a partnership issue at any time. A partner need only refuse to extend the statute of limitations, forcing the Service to issue a statutory notice of deficiency. The partner then has the option of proceeding in Tax Court, or paying the deficiency

and contesting the Service's position by means of a claim for refund.

In the case of a contested audit of a large partnership, waivers of the individual statute of limitations will be obtained for as many partners as possible while a limited number of "test" cases proceed through litigation. This "suspensing" of partner returns keeps the returns open for all issues, until the partnership issues are settled. Each separate return represents a separate case requiring individual control and separate pleadings. Joinder is possible with the agreement of the partners, but has not proven particularly effective.

An administrative or judicial determination arrived at with respect to one partner generally does not preclude another partner from challenging the same issue. Partners are free to challenge partnership level determinations and, in effect, reopen the partnership audit in their local districts. Thus, it is impossible to obtain one final binding administrative determination of a tax issue arising from a partnership. This may result in lack of uniformity and consistency.

Current partnership audit rules, therefore, produce two generally undesirable consequences. First, in order to audit a partnership, the Service must separately control each tax return which includes an item attributable to that partnership. Second, even if the Service successfully initiates and manages a partnership audit, each partner may separately determine where and when his partnership matter will be determined.

The problems of effectively auditing partners of partnerships have been present for a long time. However, these problems have been vastly compounded by the widespread use of partnerships in the tax shelter area. The large number of partners involved in syndicated, and often interrelated, tax shelter partnerships makes Service efforts to ensure compliance with the tax laws extremely difficult under existing administrative and judicial procedures.

The size of partnerships, measured by number of partners, has grown dramatically in recent years. Although the total number of partnerships increased by only 16.3 percent in the 10-year period from 1966 through 1975, the average number of partners per partnership increased by 52.6 percent during the same period.

This expansion in size of partnerships is attributable to a rapid increase in the number of very large partnerships. Table IID-5 indicates where this growth has occurred.

Table IID-5

Growth in Size of Partnerships*/

Number of Partners Per Partnership:	2-4	5-10	11-50	51-100	101-500	501 or more	Total Number of Partnerships
Number of Partnerships:							
Year							
1975	909,704	103,434	54,941	2,860	1,610	545	1,073,094
1974	911,951	96,672	49,137	2,328	1,803	377	1,062,268
1973	899,238	90,384	45,505	2,056	1,559	350	1,039,092
1972	867,604	80,200	40,620	2,013	1,266	309	992,012
Percentage change, 1972-1975	4.9	30.0	35.5	42.1	27.2	76.4	8.2

*/ All figures are estimates based on samples from 1972. Data by number of partners available only

During the period 1972 through 1975, the total number of partnerships grew by only 8.2 percent. The larger partnerships, however, proliferated much more rapidly. The largest growth occurred in partnerships with 501 or more partners, which increased by 76.4 percent during the four-year period.

These large partnerships are most often involved in coast-to-coast tax shelter activities. For example:

- o One promoter has put together over 35 partnerships involving over 55,000 partners, for an average of over 1,500 partners per partnership. One of these partnerships has more than 7,500 partners.

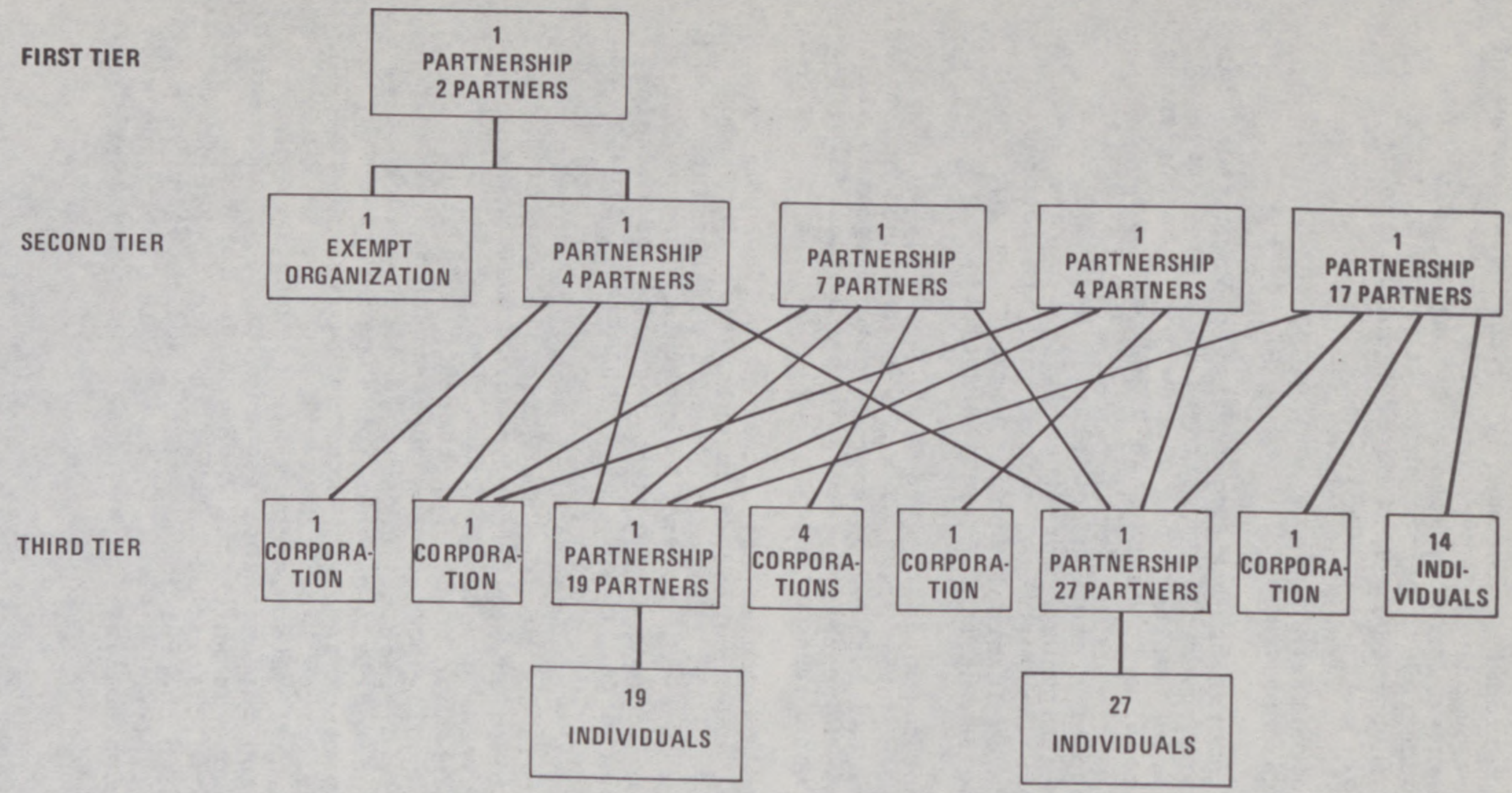
- o A group of promoters established over 350 partnerships with more than 3,000 separate limited partner interests. The investors are located in all seven Internal Revenue regions, and in 52 out of the 58 Internal Revenue districts.

- o Another promoter created over 20 partnerships involving over 5,000 separate investments and more than 1,600 limited partner investors located all across the country. Some of the partnerships have more than 400 partners.

Size alone is not the only troublesome factor. Partnerships may be "pyramided" in multi-tiered arrangements of enormous complexity. Examples of such arrangements appear on the following pages. Tiering is possible since partnerships may include as partners not only individuals, but other partnerships, as well as corporations, trusts, and other entities.

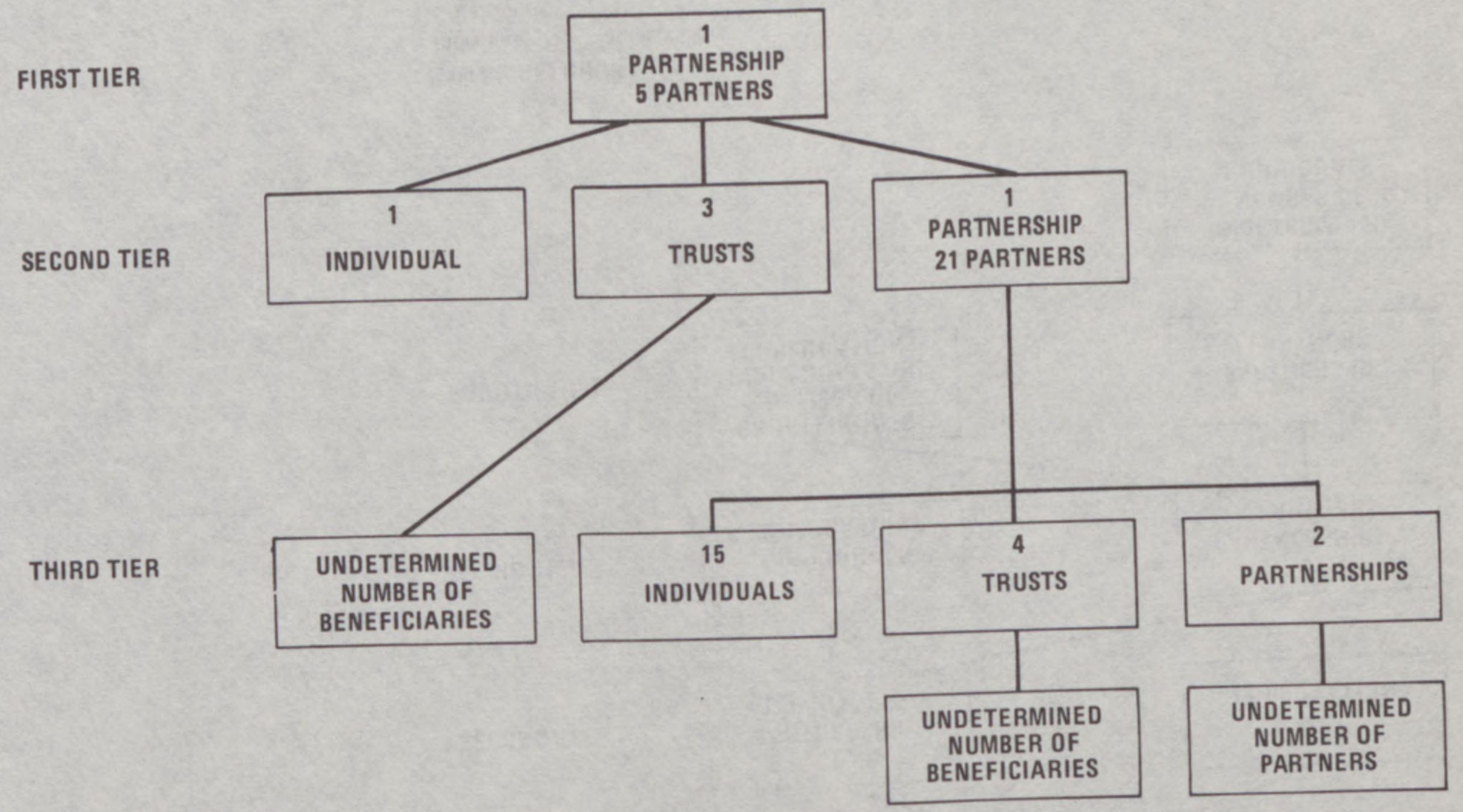
If a trust is a partner, an additional layer of complexity is added as beneficiary returns must be identified, located, and controlled. Worse still, is the partner that turns out to be a partnership. In such arrangements, usually part of tax shelter schemes, tracing may be extremely difficult. Once it is discovered that an entity being audited is a partner, or that a partnership includes as a partner another partnership, it may take many months to identify completely the next partnership tier. New partnership identification numbers are frequently only "applied for" and partnerships frequently file in districts other than the one in which their address is located. Moreover, in a multi-tier situation, the audit will not always begin with the top tier. If the audit begins elsewhere, as it frequently will, the Service must cope with expanding and controlling the audit as upper- and lower-tier entities are identified.

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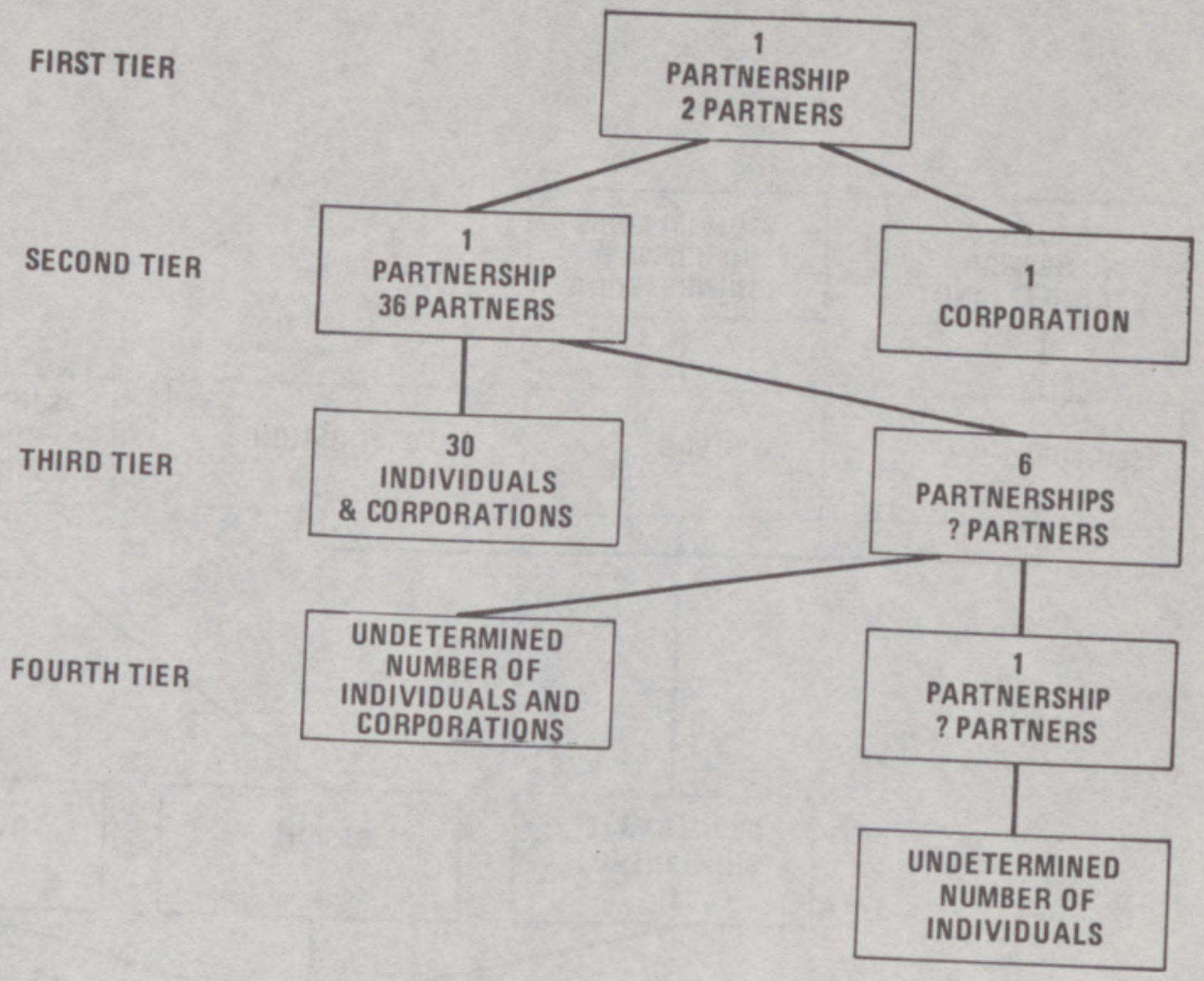
TOTAL RETURNS

Partnership	7
Others	69
	76



TOTAL RETURNS

Individuals	at least 16
Trusts	at least 7
Partnerships	at least 4
	at least 27



TOTAL RETURNS

Individual & Corporate	at least 80
Partnership	9
	at least 89

For example, the Service recently conducted a limited coordinated tax shelter program designed to examine a total of less than 100 partnerships in four primary tax shelter areas: motion pictures, farm operations, real estate, and oil and gas. This limited program resulted in the administrative nightmare of examining the tax returns of approximately 450 partnerships and 23,100 investing partners. In addition, over 50,000 other returns with similar issues were examined. These results highlight the fact that through the partnership rules, a virtually limitless number of taxpayers may be involved with a single partnership. The initial audit sample of less than 100 partnerships required almost 450 partnerships to be audited because of partnership tiering. Such multi-tiered arrangements substantially increase the Service's burden of locating individual partners and auditing their returns within the requisite statute of limitations period.

It has become increasingly clear that tax shelters have proliferated in significant part because promoters and investors believe that there is little risk that the Service can muster an effective audit against the investors in the shelter. Thus, highly creative and ingenious tax positions which are often taken by a tax shelter limited partnership and which are questionable under the law can go unchallenged because of the necessity to audit separately each and every member of the partnership within the requisite limitations periods. If, however, partnerships were audited at the partnership level, potential investors in tax shelters would have to take into account the very high probability that their investments will be subject to close scrutiny by the Service. Given the fact that under current law, most shelter investors do not take the possibility of extensive IRS audit seriously, it may be expected that the full implementation of this proposal will have a significant impact on shelter activity.

General Explanation

Under the proposal, the partnership will be treated as an entity for purposes of the audit of partnership-related issues, including administrative settlement and judicial review. The Service will make determinations at the partnership level of the correct amount of partnership taxable income or loss, and the partners' distributive shares of partnership items. This determination will be conclusive, and the individual partners, as well as the Service, will be precluded from seeking any further substantive review. As under current law, the member partners will remain subject to any changes in tax liabilities resulting from a determination of these issues, but a subsequent audit of a partner's return will be limited to the correct mathematical application of the partnership level determination.

In order to facilitate the audit at the partnership level, each general partner will be presumed authorized to act for the partnership. However, all partners will be accorded the status of interested parties and allowed to participate in all aspects of administrative proceedings.

In order to ensure that all partners have a fair opportunity to participate in the administrative and judicial determination of partnership tax matters, the Service will be required initially to notify each partner that the partnership's books and records are being examined. At the conclusion of the administrative proceeding, either by settlement or ultimate disagreement, the Service will be required to issue a notice of final administrative determination to the partnership, and to notify each member of the partnership accordingly.

The partnership level determination will be subject to the statute of limitations at the partnership level based upon the limitations rules now in effect generally. Any waiver of the period may be consented to by any general partner. Once the statute of limitations has run at the partnership level, the partnership's return becomes final, and there can be no adjustment of items on a partner's return attributable to the partnership. Discrepancies between the partner's return and the partnership's return will then be treated as mathematical errors. Assessments of tax or claims for refund at the partner level based on a final determination at the partnership level may be made at any time within one year after the partnership level determination has become final. Thus, the partnership statute of limitations automatically keeps the partner statute of limitations open for changes attributable to the partnership.

The entity approach extends to initiating changes in partnership items. A partnership will be permitted to initiate a redetermination of partnership items by simply filing an amended partnership return within the partnership's limitations period. However, individual partners will not be permitted to initiate a partnership level redetermination, or to file individual claims for refund based upon partnership matters if the claims are inconsistent with the partnership return.

The partnership may seek judicial review of a final partnership determination, or bring an action for redetermination upon denial of, or inaction with respect to, a partnership-initiated proceeding. This judicial proceeding must be brought in the name of the partnership. The action may be brought in the Tax Court, Federal District Court, or Court of Claims. All partners will be provided an opportunity to participate in the judicial proceeding.

Current law and procedures will generally continue to apply to the review of nonpartnership matters. Such matters may be resolved separately from partnership matters.

It is anticipated that the audit of the partnership will be conducted in the district in which the principal place of business or principal office of the partnership is located. While this may cause inconvenience to some partners under certain circumstances, this provision is essential in order to consolidate the partnership level audit effectively.

Since a meaningful audit at the partnership level places great emphasis on the partnership return, the timely and proper filing of such return should be encouraged. The complete absence of civil penalties under current law for late filing and failure to file is inconsistent with this objective. Thus, under the proposal, the partnership return will be treated as a tax return rather than as an information return. Late filing and failure to file partnership returns will be subject to penalties. As under current law, the return must be filed in accordance with the location of the partnership's principal office or principal place of business.

Effective Date

Existing partnerships. Partnerships existing as of January 1, 1979 will be subject to the rules of this proposal starting with the second taxable year of the partnership beginning after December 31, 1978.

New partnerships. All partnerships formed after December 31, 1978 will be subject to the rules of this proposal.

Revenue Estimate

The proposal will have a negligible effect on tax liabilities.

Footnote

1/ Present law does not require a separate administrative or judicial proceeding for each partner. Any set of partners may voluntarily join together at any stage from district conference through judicial appeal, and consent to a mutually binding determination. However, the Service cannot require any group of partners to join together in a single proceeding and subject themselves to a mutually binding determination.

TAX-SHELTER ANNUITIES

Present Law

A typical annuity contract provides for the issuing life insurance company, in return for a purchase price paid either in a lump sum or in installments, to make periodic payments to the purchaser, usually from the time of retirement until death. 1/ Annuities may be classified broadly into two main groups: immediate annuities and deferred annuities.

The purchaser of an immediate annuity begins to receive annuity payments on, or shortly after, the date the annuity is purchased.

Under a deferred annuity, the purchaser begins to receive annuity payments at a time significantly after the date on which the contract was purchased. Payments under a deferred annuity generally commence when the annuitant attains a given age (e.g., 65). Between the time the premiums are paid and the commencement of annuity payments (the "accumulation period"), the premiums (after deduction of expenses) are invested by the company and earn interest. These earnings may be reinvested by the company, distributed to the purchaser as dividends or, in some instances, may be withdrawn at the purchaser's election.

At the end of the accumulation period the premiums and accumulated interest (less expenses, withdrawals and dividends) constitute a fund that may be used to purchase an annuity at rates originally guaranteed by the insurance company. In lieu of using the fund to acquire an annuity, the purchaser almost always has the option of receiving the amount in the fund as a lump sum cash payment (the "cash option"). The purchaser of a deferred annuity generally does not lose access to the invested funds; in most cases the contract grants the purchaser the right to withdraw his premiums and accumulated interest, in whole or part, at any time before the commencement of annuity payments.

Under present law the interest earned on the premiums deposited in a deferred annuity is not taxed to the purchaser during the accumulation period. Instead, a ratable share of this interest is taxed to the recipient as each annuity payment is received (or is taxed in full on receipt of a lump sum cash payment). The purchaser is thus permitted unlimited deferral of income taxes on the accruing interest until the end of the accumulation period (unless the contract is surrendered before that date).

The rules for taxing dividends and cash withdrawals from annuity contracts during the accumulation period are also favorable. Cash withdrawals and dividends are deemed to come first from principal and are thus tax-free. Only after the purchaser has made withdrawals and/or received dividends in an amount greater than the aggregate premiums paid will such distributions be taxable. In effect, a policyholder may withdraw amounts equal to all or a substantial portion of the interest earned tax-free.

Reasons for Change

Traditionally, most annuity contracts purchased by individuals were immediate annuities. The annuity was viewed as a safe, conservative but low-yielding investment purchased by individuals who wished both to provide for income during their retirement and to ensure against the possibility of outliving their assets.

Where deferred annuities were sold, it was typical for the issuer to guarantee both the rate of interest, usually limited by state law and quite low, at which the principal would grow during the accumulation period and the rates at which an annuity could be purchased at the end of that period. Although taxes were not imposed during the accumulation period, the relatively low yields and high expenses (or "loading" costs) rendered deferred annuities unattractive to high-income taxpayers by comparison with other investment alternatives (e.g., municipal bonds).

In recent years the traditional role of the deferred annuity as a retirement income vehicle has changed dramatically. Emphasizing the combined benefits of tax deferral during the accumulation period, cash options providing for lump sum settlements and the tax-favored treatment of contract withdrawals, brokers and other promoters have been actively marketing deferred annuities to high-income taxpayers as tax shelters. The transformation of retirement annuities into tax shelters was summarized in a recent article in the financial press:

> "HIGH TAX-DEFERRED YIELDS ON ANNUITY POLICIES GIVE THEM FRESH APPEAL TO SOME INVESTORS
>
> * * *
>
> "As everybody knows by now, you can't outperform the stock market. Bond prices may fall. Commodities are risky. Tax shelters are leaky. Gold pays no interest. Savings-account earnings are taxable. So where's the smart money going these days?
>
> "Well, some of it is going into one of the

oldest and dowdiest 'investments' around.

"Insurance. That right. Specifically, insurance that yields a return as high as 7% or 8% with income taxes deferred for as long as you tie up your money.

"This insurance is known technically as a single-premium deferred annuity contract. The name is a little misleading. You may buy a contract and add to your investment by paying more than one premium, and you may buy a contract without ever committing yourself to a lifetime annuity.

* * *

"A tax lawyer with no particular ax to grind says, 'If you need to balance your investments with a fixed-income vehicle, and if you can get 8% that accumulates tax-deferred, then you're in real good shape with this kind of annuity.'

"'Annuities have been in existence a long time,' Shearson Hayden Stone observes. 'Traditionally they carried very low yields of 2.5% - 3% and high sales charges, perhaps as much as 70% of the initial amount invested, and were therefore a poor investment.' That is not, Shearson hastens to add, the kind of annuity now being offered -- 'a modern new deferred annuity which features high guaranteed interest rates.'" 2/

Instead of being sold by insurance salesmen, tax-shelter annuities are being promoted aggressively by stock brokers as a means to accumulate tax-free income. The annuity feature and the provision for income during retirement play a distinctly subsidiary role in the marketing of these annuities. The following promotional literature illustrates their predominantly tax-shelter nature:

"HOW TO POSTPONE TAXES LEGALLY AND EARN INTEREST ON UNCLE SAM'S MONEY . . . With An Investment That Never Goes Down, Always Goes Up, And Is Guaranteed Against Loss.

"If you're successful enough to be in a tax bracket that forces you to share at least 35% of your top dollars with the I.R.S., you deserve something better than congratulations. You need an investment that not only is safe, with good earning rates, but which also allows you to keep more of the interest you earn than you can with regular savings accounts, CD's, or

other investments that do not provide you tax-favored interest benefits.

"Tax deferred annuities have become enormously popular with successful people because the Internal Revenue Code permits you to pile up interest indefinitely, and not pay a penny of taxes until you take your money out--usually at retirement when your tax bracket is likely to be lower. By not paying taxes on the interest every year, you actually earn extra income with Uncle Sam's money!

"To demonstrate how beneficial this tax postponement can be to you, just see what happens when the same amount of money is put into a tax-deferred annuity and a savings account, both at the same rate of interest and for the same length of time -- assuming a continuing interest of 7 1/2 % per year for the entire period illustrated. ($30,000 is used here only as an example. You can put in as little as $5,000, or as much more as you wish.)

	BANK SAVINGS ACCOUNT		TAX-DEFERRED ANNUITY
Age	35% Tax Bracket	50% Tax Bracket	
30	$ 30,000	$ 30,000	$ 30,000
40	$ 48,288	$ 43,351	$ 61,830
50	$ 77,725	$ 62,644	$127,435
60	$125,106	$ 90,524	$262,648
65	$158,722	$108,819	$377,066

"Your money is safe because it is guaranteed by a legal reserve life insurance company. Your cash value (never less than your total payments) may be withdrawn in whole or part at any time. However, as with bank certificates of deposit, withdrawals may be subject to surrender charges.

"And you can take out any part of the money you put in and pay no taxes; while the balance of your principal and all accumulated interest continues to grow tax-free . . . ."

In addition to being more attractive than taxable investments, the high interest rates at which tax-shelter annuities are being offered may actually make them more attractive to some high-income taxpayers than investments in tax-exempt municipal bonds. 3/ For example, if a taxpayer who anticipates being in a 35 percent or lower bracket during retirement invests $30,000 in a deferred annuity bearing interest at a rate of 7 1/2 percent and elects to receive a lump sum cash payment after 20 years, he will realize a return of $87,535 after taxes and expenses. 4/ Municipal bonds of comparable security and maturity would bear interest at approximately 5 1/4 percent per annum. 5/ Thus, an investor who purchased $30,000 of such bonds, and invested the resulting tax-exempt income in additional tax-exempt bonds, would accumulate only $83,476 on his investment after 20 years.

What is perhaps an even more serious abuse of the tax treatment traditionally afforded retirement annuities is presented by a variation of the deferred annuity known as a "wraparound" or "investment" annuity. This device permits a taxpayer to defer paying tax on income from existing investments, such as bank accounts or common stocks, by the simple expedient of "wrapping" an annuity around these investments. The nature of the wraparound or investment annuity, and the dangers inherent in the existing situation, were recently summarized in a financial journal:

"Keystone Custodian Funds manages over $1.7 billion in mutual funds, but the product that has the company most excited at the moment comes from the company's insurance subsidiary, Keystone Provident Life. The product is called the investment annuity or 'wrap-around' annuity. Keystone is joining a growing number of companies offering this instrument.

"The investment annuity resembles other annuities save for this crucial difference: You determine what securities make up the annuity. In effect, the wraparound allows you to take an existing investment, use it to 'buy' an annuity and thus defer taxes on all interest and dividends.

"Say you have $100,000 of 8.7% American Telephone & Telegraph bonds due in 2002. By wrapping it around an annuity, your account can collect $8,700 a year, and you pay no income taxes until you actually begin collecting on your plan, which can be, if you wish, decades hence.

"'For anyone in the 30% income bracket or higher,' says W. Thomas Kelly, chairman of the First Investment Annuity Co. of America, which invented the product,

'this is something to be seriously looked at.'" 6/

Although the Internal Revenue Service has ruled that these so-called "investment annuities" do not qualify for tax deferral as annuity contracts (Revenue Ruling 77-85, 1977-1 Cum. Bull. 12), under a recent court decision, if sustained, it is possible that these devices can be used by high-income taxpayers to defer tax on their investment income while retaining the same, active control over their investment portfolios as though the annuity never had been purchased. See Investment Annuity, Inc. v. Blumenthal, No. 77-810 (D.D.C. November 9, 1977), notice of appeal filed (D.C. Cir. January 3, 1978).

The ability to defer tax on otherwise taxable investments (such as long-term certificates of deposit) by simply "wrapping" them in what looks like an annuity could turn the deferred annuity into the exclusive method for high-income taxpayers to purchase investment assets. This possibility has not been overlooked by promoters, as evidenced by the following excerpts from sales literature for wraparound annuities:

"HOW DO YOU WANT YOUR INTEREST, WITH OR WITHOUT CURRENT TAXES?"

* * * *

"YOU NO LONGER NEED TO PAY CURRENT TAXES ON INTEREST AND DIVIDEND INCOME WHEN YOU UTILIZE THE BENEFITS OF A TAX-DEFERRED INVESTMENT ANNUITY.

"Unlike other annuities, the investment annuity allows the owner to direct the investment of the funds within his personal custodian account. You may choose from a broad list of accepted assets. This permits you to use our high interest yielding certificate accounts as well as stocks, bonds and mutual funds."

* * * *

"NOW YOU CAN DEFER INCOME TAXES ON CURRENT INTEREST AND DIVIDEND INCOME ON YOUR SAVINGS ACCOUNTS AND OTHER ASSETS. ($10,000 MINIMUM)

"The key is a tax-deferred Investment Annuity. Under Section 72 of the IRS Code, certain tax advantages are available to holders of an Investment Annuity contract.

"The Investment Annuity is a policy for long range

financial planning ($10,000 minimum).

"The annuity policy permits the owner to direct the choice of permitted investments and to change investments, both before and during retirement."

The recent growth in sales of deferred annuities has been dramatic, reflecting the appeal the foregoing abuses have for the investing public. It is at least partly because the rules governing taxation of deferred annuities have not been revised, while the rules governing taxation of other investment vehicles (such as long-term certificates of deposit and original issue discount bonds) have, that the deferred annuity has acquired such substantial recent popularity. Deferred annuities are now virtually the only remaining, widely-available investment vehicle that enables investors to defer taxes on regularly recurring investment income.

Moreover, the current abuses have had undesirable side effects. For example, there has been a substantial diversion of savings into deferred annuities and away from commercial banks, savings and loan associations and other forms of saving. The magnitude of the shift was noted in a recent journal:

"So far in 1977, Americans are shifting funds into these tax-delaying devices at an annual rate of between 800 million and 1 billion dollars, one expert estimates. That's about seven times more than just three years ago.

"The total is expected to soar even higher. People are looking for places to reinvest billions of dollars they socked into savings certificates carrying unusally high rates of interest that were issued in 1973 by banks and other lending institutions and started maturing around the middle of this year.

"Most funds for deferred annuities in the past two years have been coming from cashed-in stocks, bonds, mutual funds and savings accounts. But some families have even mortgaged their houses and put the proceeds into the annuities." 7/

This shift in the flow of savings, induced solely by unwarranted differences in tax treatment, is undesirable.

The current abuses of the deferred annuity also pose a serious threat to the elaborate rules designed by Congress over the past 40 years to safeguard qualified retirement plans, most recently in the Employee Retirement Income

Security Act of 1974. These rules prevent employers from discriminating against lower paid or non-owner employees. However, by purchasing a deferred annuity a self-employed person can obtain tax deferral similiar to that available through a qualified retirement plan (e.g., a Keogh Plan), thereby providing generously for his own retirement without providing retirement benefits for his employees. This may be a particularly attractive option in conjunction with an Individual Retirement Account ("IRA"). An IRA may be established by any individual not covered by a qualified plan. Like a deferred annuity, earnings in an IRA are not taxed currently to the owner. In addition, contributions to an IRA, like those to a qualified plan, are deductible. However, to avoid the use of IRAs by self-employed persons to circumvent the non-discrimination rules applicable to qualified plans, Congress has generally limited annual contributions to an IRA to a maximum of $1,500.

This use of a deferred annuity was publicized in a recent article:

> "Virtually everyone is eligible for the tax break [available through a deferred annuity]. You do not have to work for a company that lacks a pension plan, as you do in order to set up an IRA--an Individual Retirement Account. And if you are self-employed, you do not have to provide pensions for your employees as you do when you establish a so-called Keogh Plan.
>
> "Those features have brought a surge of popularity to the 'nonqualified deferred annuity,' so labeled because it does not qualify as an IRA under the pension-reform law." 8/

Thus, a further reason for revising the current tax treatment of deferred annuities is to forestall their use by self-employed persons as a way to provide for their own retirement with tax-deferred income, while avoiding the expense of providing retirement benefits for their employees.

General Explanation

The proposal will correct the current abuse of using deferred annuities as tax shelters without interfering with their traditional role as investments that ensure retired persons against the risk of outliving their income.

The tax deferral afforded income earned during the accumulation period of a deferred annuity will be eliminated. Income earned during the accumulation period will be taxed currently to the policyholder. This change will apply to all deferred annuities, including variable annuities and the so-called "wraparound" or "investment" annuities. Taxation of earnings annually to each policyholder will bring the tax

treatment of these contracts into line with that applicable to similiar investments such as certificates of deposit and original issue discount bonds. The change will not, however, apply to deferred annuities purchased or provided under a tax-favored retirement plan, such as a qualified retirement plan or an individual retirement annuity.

In recognition of the fact that the traditional deferred annuity can play a legitimate role in planning for retirement, the proposal will permit an individual to designate a single deferred annuity contract, the annual contributions to which may not exceed $1,000, as one for which the tax deferral of present law would continue. The $1,000 annual limitation on contributions should preclude the use of designated contracts by high-income taxpayers as tax shelters, and by self-employed persons as a means to avoid providing retirement benefits for their employees.

The present law treatment of cash withdrawals and dividends from annuity contracts as tax-free returns of principal will be changed. Under the proposal, withdrawals and dividends distributed during any year will be treated as taxable to the extent of untaxed accumulations of income as of the end of the year of distribution; only after these distributions have exhausted the previously untaxed income will they be considered tax-free returns of principal. Loans from the issuing company to the holder of the annuity contract will be treated as distributions for this purpose.

Effective Dates

Income earned after December 31, 1978, and during the accumulation period (i) of non-qualified deferred annuity contracts issued after January 31, 1978, or (ii) on contributions made after January 31, 1978, to non-qualified deferred annuity contracts issued before February 1, 1978, will be taxed currently to the purchaser.

Dividends, cash withdrawals and loans made by the issuing company to the contract holder after December 31, 1978, and during the accumulation period of any non-qualified deferred annuity contract, will be treated as taxable distributions to the extent of the accumulated untaxed income as of the end of the year of the distribution, regardless of when the contract was issued or the income was earned.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	12	26	40	57	80

Technical Explanation

A. In General

Income earned during the accumulation period of a deferred annuity contract will be taxed to the policyholder in the year credited to his account or otherwise earned. A deferred annuity contract will be defined to include any annuity contract under which the annuity payments commence more than one year after payment of the initial premium. However, it will not include an annuity purchased or provided under a tax-favored retirement plan, such as a qualifed pension or profit sharing plan or an individual retirement annuity, or an annuity purchased with amounts excludable from income under section 403(b) of the Internal Revenue Code.

The issuer of a deferred annuity will be required to report to both the contract holder and the government the amount of interest or other earnings paid or credited in connection with the contract each year. These reporting requirements should not pose significant problems for the life insurance companies that issue annuities.

Owners of the annuity contracts will be required to include in their taxable incomes each year the amount of income reported to them by the company. Amounts taxed to the owner during the accumulation period will be added to the investment in the contract and will not be taxed again when the contract is surrendered or annuity payments are received.

In the case of variable annuities the holder will be taxed only on current investment income, whether or not distributed. No change is proposed in the treatment of realized gains or losses from the sale or other disposition of assets held by the issuer of a variable annuity.

For all deferred annuity contracts, including designated contracts (described below) and contracts issued before February 1, 1978, any dividends distributed or other withdrawals will be treated as having been made first out of accumulated and untaxed income as of the close of the year of

22-302 O - 78 - 13

distribution and, to the extent thereof, as taxable during that year. Loans after December 31, 1978, by the issuing life insurance company to the holder of a designated contract or a deferred annuity contract issued before February 1, 1978, will be treated as taxable distributions to the extent of the previously untaxed income under the contract as of the end of the year in which the loan was made.

B. Designated Contracts

An individual will be permitted to designate a single deferred annuity contract, the earnings on which will remain eligible for tax deferral during the accumulation period. The individual will be required to designate the contract as one qualifying for deferral by informing the issuer at the time the contract is purchased. The designated contract must be separate from any other annuity contract held by the same purchaser. The maximum annual premium under a designated contract will be limited to $1,000 per year.

The only contracts that may qualify as designated contracts will be those in which the issuing life insurance company guarantees the purchaser both a return of the aggregate premiums paid in (less any applicable loading or surrender charges) plus the lower of (i) the maximum rate of interest that may be guaranteed under state law for the duration of the contract, or (ii) the rate actually offered for the duration of the contract. Any contract whose value depends, in whole or part, on the value of an underlying investment fund or segregated asset account will not be eligible for designation.

While unwithdrawn interest on a designated contract will be excludable from income, any dividends or other withdrawals from, or loans from the issuer of, a designated contract will be treated as coming first from accumulated and untaxed income and, to the extent thereof, as taxable during the year received.

As in the case of all deferred annuities, the issuing company will be required to report to both the government and the holder of a designated contract the earnings credited to the contract each year. The reporting form will identify the interest earned on a designated contract as being excludable from gross income during the accumulation period. This reporting requirement will ensure that each holder has purchased only a single designated contract and that the contributions thereunder do not exceed the $1,000 annual limitation.

The interest earned during the accumulation period of a designated contract will not be added to the policyholder's investment in the contract, and therefore will be taxed when received by the policyholder as annuity payments or in a lump sum.

C. Existing Contracts

The proposed elimination of tax deferral during the accumulation period of non-qualified deferred annuities will apply to contracts issued before February 1, 1978 only to the extent that the holder makes additional contributions to the contract after that date. Where additional contributions are made after January 31, 1978, subsequent earnings credited to the holder's account will be apportioned between those allocable to prior contributions (the earnings on which will not be taxed currently) and to subsequent contributions (the earnings on which will be taxed currently).

However, dividends, cash withdrawals and loans made by the issuing company to the contract holder after December 31, 1978 will be treated as taxable distributions to the extent of the accumulated and untaxed income as of the end of the year of the distribution, even if such income was earned and credited to the contract before February 1, 1978.

Footnotes

1/ The annuity payments may be made by the company for the life of an individual (a "single life annuity"), for the lives of more than one individual (a "joint and survivor annuity"), or for a specified period of time (an "annuity certain"). The individual during whose lifetime the annuity is payable is called the annuitant and is usually the purchaser of the contract.

2/ Wall Street Journal, May 2, 1977, page 32, Col. 1.

3/ These contracts are offered at interest rates as high as 7 to 8 percent despite the fact that state law reserve requirements applicable to life insurers prevent them from guaranteeing rates in excess of 3-1/2 to 4 percent for the duration of the contract. These limits have been circumvented by the combination of a guarantee of an underlying rate of 3-1/2 to 4 percent for the life of the contract, with an additional 3 to 4 percent guaranteed for shorter periods of time. Even though the full interest rate is not guaranteed for the life of the contract, the sales literature often represents that the purchaser can expect the combined interest paid each year to compare "very favorably to rates then being paid by other fixed money plans."

4/ At 7-1/2 percent compounded annually, $30,000 invested in a deferred annuity would grow in 20 years to $127,436.

Assuming surrender charges of 7 percent (or $8,921), the investor would receive a lump sum of $118,515. Taxes on the gain of $88,515 ($118,515 - $30,000) at 35 percent would amount to $30,980, leaving after tax proceeds of $87,535 ($118,515 - $30,980). If the taxable gain of $88,515 in one year pushed the taxpayer into a bracket higher than 35% he could elect to receive the $118,515 in periodic payments over several years.

5/ The 1977 annual average interest rate on tax-exempt general obligation bonds with a maturity of 20 years and rated AAA by Moodys was 5.21 percent. The 1977 annual average interest rate on such bonds with a rating of AA was 5.36 percent.

6/ Forbes Magazine, May 1, 1976, p. 86.

7/ U. S. News and World Report, October 10, 1977, page 91.

8/ Ibid.

EMPLOYEE BENEFITS

INTRODUCTION

The Internal Revenue Code provides favorable tax treatment for certain forms of compensation. If salary is paid in cash, it will be deductible by the employer and taxable immediately to the employee. However, compensation in other forms, while continuing to be deductible by the employer, may be either excluded entirely from tax by the employee or taxed only at a later date. This tax treatment can be justified only as a means of encouraging compensation to be paid in certain forms so that individuals, particularly lower income employees, will be assured of protection against certain contingencies -- sickness, disability, retirement -- which are particularly difficult to plan for at low income levels.

The tax law falls short of this goal. For life insurance and health plans, there is no requirement that employees at all levels be benefitted. Retirement plans ostensibly must not discriminate in favor of officers, shareholders, or other highly paid individuals to qualify for favorable tax treatment. Nevertheless, under current law too much of the tax subsidy of these arrangements (termed "qualified" plans) can inure to the benefit of the highly paid, and too little to the benefit of the low paid.

Moreover, exclusion and deferral of income are obviously of greater benefit to those taxpayers with high marginal rates. As the tax benefits expand, they seriously interfere with the goal of a progressive tax system and are increasingly unfair to those persons not employed by employers who provide compensation in the favored form.

The Administration proposes to reduce the disparate tax treatment which is based solely upon the form in which compensation is provided. Where such disparity remains, the Administration proposes to assure that it serves a public purpose by requiring that a greater proportion of the tax benefits inure to rank-and-file employees, compared with present law. Thus, the Administration proposes

-- assuring that a greater portion of the benefits from tax-favored qualified retirement plans will inure to the benefit of the lower-paid by modification of the rules by which such plans interrelate with Social Security.

-- requiring as a condition for obtaining favorable tax treatment that group-term life insurance and health and disability plans not discriminate in favor of officers, shareholders, or the highly paid.

-- repealing the $5,000 exclusion for death benefits paid by the employer.

-- taxing unemployment benefits for those with total income in excess of $20,000 per year ($25,000 in the case of a joint return).

QUALIFIED RETIREMENT PLANS AND SOCIAL SECURITY

Present Law

In General--Retirement plans can be classified as two principal types -- "defined benefit" plans and "defined contribution" plans. A defined benefit plan provides that an individual will receive a specified amount upon retirement; a defined contribution plan provides that specified amounts will be set aside each year, and the employee will eventually receive those amounts plus the earnings on them.

These plans qualify for advantageous tax treatment only if they do not discriminate in favor of officers, shareholders, or highly paid persons. The income tax benefits -- which include current deductions for employers, exclusion of the contributions from employee income, and tax exemption for income earned by the retirement fund -- are designed to induce employers to provide pensions. The objective of the anti-discrimination rule is to insure that employers in fact provide pensions for persons at all levels of their workforce, rather than primarily for officers, shareholders, or highly paid persons. When it first established the anti-discrimination rule in 1942, the House Ways and Means Committee reported:

> "The present law endeavors to encourage the setting up of retirement benefits by employers for their employees and in pursuance of this policy permits employers to take as a deduction amounts irrevocably set aside in a pension trust or other fund to provide annuities or retirement benefits for superannuated employees. This provision has been considerably abused by the use of discriminatory plans which either cover only a small percentage of the employees or else favor the higher paid or stock-holding employees as against the lower-paid or non-stock-holding employees. Under the present law, it is contended the officers of a corporation may set up pension plans for themselves and make no provision for the other employees. Such actions are not in keeping with the purpose of this provision.
>
> "The coverage and nondiscrimination requirements would operate to safeguard the public against the use of the pension plan as a tax-avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes." 1/

Specifically, under current law, a plan must provide rank-and-file employees with at least the contributions or benefits expressed as a percentage of pay that are provided

for officers, shareholders, or the highly paid. For example, if an employer contributes 10 percent of pay, or $10,000, to a defined contribution plan for an employee earning $100,000, the employer must also contribute 10 percent of pay on behalf of a lower-paid employee -- for example, $1,200 if the employee earns $12,000 -- in order for contributions not to be discriminatory. However, the law permits an exception to the percent-of-pay rule in the case of plans which take Social Security into account. This process is called "integration".

Specifics of Integration -- An employer is permitted to "count" its employer contributions to the Social Security system in determining whether its plan discriminates in favor of officers, shareholders, or highly paid persons. Thus, employer contributions to a qualified plan may be heavily weighted in favor of higher-paid employees. For example, under a defined contribution plan an employer can contribute 7 percent of pay in excess of the Social Security wage base ($17,700 for 1978), which for an employee earning $100,000 amounts to $5,761. The plan would not be considered discriminatory even though the employer does not contribute anything to the qualified plan for an employee earning less than the wage base, because the employer will be deemed to have contributed 7 percent of pay up to $17,700 to Social Security for all employees. The deemed contribution rate of 7 percent does not depend upon the rate of tax under Social Security, which is currently below that level.

This type of plan is an "excess" plan, because the employer contributes only an amount determined by reference to the employee's pay in excess of the integration level. As the integration level increases, the opportunity to reduce coverage under an excess plan also increases. It is estimated that, beginning in 1981, 94 percent of all employees will earn less than the Social Security wage base, which for that year will be $29,700 (with automatic adjustments thereafter).

The more common type of integrated defined contribution plan is the step-rate plan, which provides some percentage of pay up to the integration level and a higher percentage of pay (but not more than 7 percent higher) above that level. For example, for 1978 an employer can contribute 5 percent of pay up to the Social Security wage base and 12 percent of pay in excess of the wage base for the $100,000 employee, amounting to $10,761, while under this formula a contribution of not more than $600 would be required for the $12,000 employee (5 percent of $12,000).

Defined benefit plans may be integrated in a similar fashion, although they are integrated on the basis of benefits rather than contributions. The rules for integration of these plans are even more complicated than the rules for defined contribution plans.

Integration is widely used. The Congressional Research Service concluded in 1974 that 60 percent of tax-qualified pension plans in existence at that time, covering approximately 25 to 30 percent of participants in the private pension system, were integrated with Social Security. 2/ Integration may be even more popular today given the substantial increases in Social Security taxes and the mandated wider coverage for lower income workers under the Employee Retirement Income Security Act of 1974 (ERISA).

Reasons for Change

Notwithstanding the anti-discrimination requirements and the major reforms under ERISA, retirement plans still afford substantial tax advantages which are more beneficial to a person in a higher tax bracket, because the higher-paid person, for whom more dollars are contributed, defers paying tax on more dollars, and also because deferral provides a greater tax subsidy per dollar for persons in higher tax brackets. Although the degree of difference varies from case to case, under one set of reasonable assumptions, the tax subsidy increases the pension benefit by 140 percent for an executive with a starting salary of $100,000, while the subsidy increases the benefit by only 60 percent for the employee with a starting salary of $10,000. 3/

The disparity is even greater in an integrated plan. An employer making the same dollar contribution (e.g. $5,922) to a private plan would distribute much more to the highly paid person, and much less to lower-paid persons, if the plan were integrated. 4/ Table IIE-1 illustrates how an integration provision affects the distribution of employer contributions to a plan, to the detriment of lower-paid employees.

Table IIE-1

Effect of Integration on Constant Employer Contribution

Salary of Employee	Defined Contribution Plan in 1978 Total Contribution of $5,922	
	Not Integrated (4.08%)	Integrated (7% above $17,700)
$ 10,000	$ 408	$ 0
15,000	613	0
20,000	817	161
100,000	4,084	5,761
Total Employer Contribution	$ 5,922	$ 5,922

The first Social Security law antedated the first nondiscrimination requirement for qualified plans. By the time the Treasury Department proposed a nondiscrimination requirement which was enacted as part of the Revenue Act of 1942, several large plans already existed which integrated benefits with Social Security. Consequently, integration was first developed at a time when there was undoubtedly concern about disturbing large, existing pension plans which had been established before there were nondiscrimination requirements.

Today, however, the integration of pension plans with Social Security is a widely used tax device which can result in lower-paid persons receiving inadequate retirement benefits. Integrated plans often are sold, particularly to smaller employers, on the assumption that such plans either exclude or provide relatively small benefits for lower-paid employees earning below the Social Security wage base. Employers are encouraged -- before they provide <u>any</u> private retirement income for lower-paid persons -- to provide retirement income at higher levels of pay equivalent, on a percent-of-pay basis, to the benefit provided by Social Security for those with lesser earnings.

The above approach therefore suggests two assumptions. First, it assumes that it is more important to provide after retirement the same percent of pre-retirement pay at all income levels than it is to provide minimum benefits for

lower-paid persons. In fact, however, the percentage of pre-retirement earnings that are essential to fulfill basic needs after retirement decreases as earnings increase. Second, and the logical extension of the first assumption, the current tax system implies that Social Security is adequate for lower-paid persons (but not for higher-paid persons), so that only a higher-paid person's retirement income need be tax subsidized through a private plan. In fact, however, if Social Security were adequate for rank-and-file employees, there would be no need for a tax subsidized private pension system at all. If Social Security is not adequate, one must question the extent to which tax benefits must flow disproportionately to higher-paid persons, often to the total exclusion of the rank-and-file, in order to encourage adequate retirement pay at all levels of the workforce.

The inequity in the current system of Social Security integration has been recognized by Congress. Congress has imposed severe limitations on the use of Social Security integration in plans that benefit owners, such as Keogh plans for the self-employed, and it has prohibited integration in plans designed especially for rank-and-file employees--employee stock ownership plans. Further, during the consideration of ERISA, Congress, through the Conference Committee, voted a freeze on further integration as a temporary measure prior to full consideration of the integration question after a two-year Congressional study. Because of last minute opposition, the freeze was deleted by a concurrent resolution of the Congress.

Integration has been defended by employers on the grounds that, without it, they would have to provide more than 100 percent of pre-retirement pay to lower-paid persons in order to provide an adequate percent of final average pay to higher-paid persons. Employers also contend that the cost of an apparently excessive deferred benefit (i.e., one in excess of 80 percent or 100 percent of final average pay) results in lower current wages for lower-paid persons, and that it unnecessarily lowers their pre-retirement standard of living. One could see some justification for these arguments if, in fact, the employer and Social Security together provided a reasonable percentage (such as 80 percent) of final average pay for the $10,000 employee. But, under the current integration system, there is no requirement that employers provide any specified percentage of final average pay to lower-paid persons.

Social Security integration also has been justified, not on the grounds of encouraging rational public policy, but on the grounds that employers should be able to "count" their contributions to Social Security as part of their overall retirement programs. But there is only a small correlation between an employee's benefits under Social Security and the

amount an employer contributes for that employee. The Social Security benefits of a current employee are not directly funded by his or her employer. Rather, such benefits are largely funded by employer and employee contributions paid after the worker has retired; that is, the Social Security system is essentially on a pay-as-you-go basis.

The basic integration rules, in addition to encouraging inequity, are exceedingly complex; integrated plans, therefore, are less easily understood by participants than are other plans. As the Social Security wage base and benefits have changed over the years, so, too, have the numerous rules which coordinate the Social Security wage base and basic benefit with the way in which a plan can be integrated. Complications also result because plans almost always provide more than retirement benefits (for example, there may be disability and death provisions) and because benefits may be paid at different ages and in different forms (for example, a lump sum distribution or life annuity). The integration rules have elaborate actuarial adjustments for these ancillary benefits and variations as they relate to each type of plan.

General Explanation

The principal abuse of integration is that it uses tax subsidies to permit, and even encourage, benefits to be paid to very highly paid persons while paying none at all to lower-paid persons. The Administration proposes to end this abuse, while still permitting employers to use integration to limit retirement benefits so that benefits from Social Security and private pensions do not exceed a certain percent of pay. This could be accomplished by allowing plans to integrate only if they provided a specified minimum benefit designed to provide full replacement of pre-retirement earnings. This approach, which would add another layer of complexity to the existing integration rules, would entirely deny the benefits of integration to those plans which did not set full replacement as a goal. The proposal, however, does not go this far but rather provides a formula for integration which would approximate the ideal result while, at the same time, virtually eliminating the complexity of integration.

The basic integration rules will be replaced with a formula establishing a maximum ratio of contributions or benefits above and below the integration level. More specifically, so long as a plan provides X percent below the integration level, it could provide up to 1.8 times X percent above that level. In a defined contribution plan, for example, an employer could contribute 9 percent of pay on wages above the plan's integration level if it contributed 5 percent of pay on wages below the integration level.

A similar rule will apply to the type of plan that "offsets" the Social Security benefit against the plan benefit. The offset (or negative part of the formula) will be governed by the positive part of the formula. Specifically, a plan could offset the same percent of Social Security benefits as the percent of final average pay used to compute the plan's gross benefit. That is, a plan could offset by 50 percent of the Social Security benefit if it provided for a benefit of 50 percent of final average pay.

Analysis of Impact

The integration rules proposed here will substantially affect only plans which tend to be highly discriminatory in favor of higher-paid persons by excluding or virtually excluding the rank-and-file. For example, a plan under which an employee received nothing on pay up to the taxable wage base ($17,700 in 1978) and 7 percent of pay in excess of the taxable wage base will no longer qualify. On the other hand, plans designed to provide for the retirement of employees at all levels rather than as a tax shelter for a few highly paid individuals will generally continue to meet the integration tests. For these plans, any required changes will generally be relatively minor.

Tables IIE-2 through 7 show some common formulas under current law and under the proposal and how these formulas will affect employees at different wage levels.

Table II E-2

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan A--Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay)[1] for Employees with Final Average Pay[2] in 1982[3] of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 0% up to $11,004 of compensation; 18% over $11,004						
Private pension benefits only	0%	5%	11%	14%	15%	16%
Private pension and social security benefits	54%	41%	30%	25%	23%	22%
Plan under Proposal: 10% up to $11,004 of compensation; 18% over $11,004						
Private pension benefits only	10%	12%	15%	16%	17%	17%
Private pension and social security benefits	64%	48%	34%	27%	25%	23%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-3

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement,
Selected Private Pension Plans Under Present Law and
Under the Integration Proposal

Integrated Defined Benefit Plan B--Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 3/ of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 0% up to $11,004 compensation; 36% over $11,004						
Private pension benefits only	0%	10%	23%	28%	31%	32%
Private pension and social security benefits	54%	46%	42%	39%	39%	38%
Plan under Proposal: 20% up to $11,004 of compensation; 36% over $11,004						
Private pension benefits only	20%	24%	30%	32%	34%	34%
Private pension and social security benefits	74%	60%	49%	43%	42%	40%

Office of the Secretary of the Treasury **January 25, 1978**
Office of Tax Analysis

1/ **Assumes employees retire at age 65 in 1982 with 35 years of service with employer.**

2/ **Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.**

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-4

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan C -- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 3/ of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 16 1/2% up to $11,004 of compensation; 54% over $11,004						
Private pension benefits only	17%	26%	40%	46%	48%	50%
Private pension and social security benefits	71%	62%	59%	57%	56%	56%
Plan under Proposal: 30% up to $11,004 of compensation; 54% over $11,004						
Private pension benefits only	30%	36%	45%	49%	50%	51%
Private pension and social security benefits	84%	72%	64%	60%	58%	57%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-5

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement,
Selected Private Pension Plans Under Present Law and
Under the Integration Proposal

Integrated Defined Benefit Plan 1/-- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 2/ for Employees with Final Average Pay in 1982 3/ of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 52 1/2% up to $11,004 of compensation; 90 over $11,004						
Private pension benefits only	53%	62%	76%	82%	84%	86%
Private pension and social security benefits	107%	98%	95%	93%	92%	92%
Plan under Proposal: 50% up to $11,004 of compensation; 90% over $11,004						
Private pension benefits only	50%	61%	75%	81%	84%	86%
Private pension and social security benefits	104%	97%	94%	92%	92%	92%

Office of the Secretary of the Treasury **January 25, 1978**
Office of Tax Analysis

1/ **Assumes employees retire at age 65 in 19 with 35 years of service with employer.**

2/ **Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.**

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-6

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan E--Offset Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 of-- 3/					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 50% of final average pay, offset by 83 1/3% of primary insurance amount.						
Private pension benefits only	5%	20%	34%	40%	44%	45%
Private pension and social security benefits	59%	56%	53%	52%	52%	51%
Plan under Proposal: 50% of final average pay, offset by 50% of primary insurance amount						
Private pension benefits only	23%	32%	40%	44%	46%	47%
Private pension and social security benefits	77%	68%	59%	55%	54%	53%

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January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patters of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-7

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement,
Selected Private Pension Plans Under Present Law and
Under the Integration Proposal

Integrated Defined Benefit Plan F--Offset Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 3/ of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 100% of final average pay, offset by 83 1/3% of primary insurance amount.						
Private pension benefits only	55%	70%	84%	90%	94%	95%
Private pension and social security benefits	109%	106%	103%	101%	101%	101%
Plan under Proposal: 100% of final average pay, offset by 100% of primary insurance amount.						
Private pension benefits only	46%	64%	81%	89%	92%	94%
Private pension and social security benefits	100%	100%	100%	100%	100%	100%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

The new rules will apply only to benefits accruing after the effective date, so that even if an employer chose to increase benefits for some employees, the employer would not be required to fund any increased benefits for periods prior to the effective date.

Also, because elaborate rules will no longer be necessary, administrative costs will decrease for all integrated plans. For instance, the current rules provide different types of adjustments for different types of plans, different benefits, and persons retiring in various years. The proposal will require only minor adjustments in such cases.

Effective Date

The new formulas will apply to benefits accrued for plan years beginning after December 31, 1979.

Revenue Estimate

It is not possible to project the revenue impact of this proposal; the proposal may have a negligible impact on revenues. Some employers would change their plans by providing higher benefits for rank-and-file employees; others might shift their costs by providing somewhat lesser benefits for higher-paid persons to meet the need for more benefits for the lower-paid. It is also possible that the simplified rules and the provision of minimum benefits would encourage some employers to integrate previously nonintegrated plans.

Technical Explanation and Transition Rules

In general -- The current rules relating to Social Security integration will be replaced with a rule under which a plan will not be viewed as discriminatory in favor of officers, shareholders, or highly compensated employees merely because it provides benefits or contributions in the form of:

> X percent of total compensation not in excess of a specified integration level, plus no more than
>
> 1.8 times X percent of total compensation in excess of that level.

The rule will apply to both defined contribution and defined benefit plans and to plans providing unit or flat benefits. The X factor will be specified by the employer.

Adjustments for any pre-retirement ancillary benefits, post-retirement annuity forms, early retirement benefits, or employee contributions will be required only to the extent these features are internally inconsistent. For example, an

X percent/1.8X percent plan will not have to adjust if employee contributions are Y percent up to the integration level and 1.8Y percent in excess of that level (e.g., 3.0 percent and 5.4 percent). If, however, employee contributions are a constant percentage of all compensation, an adjustment will be required. Also, a plan will not have to adjust if the annuity is payable in the form of a 10-year certain and continuous benefit, so long as the annuity both above and below the integration level is paid as a 10-year certain and continuous benefit. And no adjustment will be required even though some plans might use different types of compensation (career average pay, final average pay, etc.), so long as the same type is used to compute benefits both above and below the integration level.

Each separate plan of an employer will be required to satisfy the new rules, or all plans maintained by an employer can be aggregated to satisfy these rules. Thus, for example, if an employer maintains an integrated plan and a nonintegrated plan, contributions or benefits under both plans can be aggregated to determine whether the new integration requirements are satisfied. (However, aggregation will be limited to plans which provide similar degrees of retirement security. For example, a profit sharing plan allowing discretionary withdrawals of employer contributions prior to death, disability, or other separation from service could not be aggregated with a pension plan, since the two plans do not provide similar degrees of retirement security.) Further, as under present law, a plan which does not satisfy the integration rules might nonetheless be nondiscriminatory under the particular facts and circumstances.

Excess plans -- The integration level for a defined contribution or a defined benefit excess plan will be computed in much the same manner as is provided under the current rules. For plans which use the Social Security wage base to measure the integration level (such as a profit sharing plan), the maximum permissible integration level for a particular year will continue to be the Social Security wage base for that year as determined under the Social Security Act. These are fixed amounts ranging from $17,700 to $29,700 for 1978 through 1981, with automatic adjustments after 1981. A plan will not be permitted to use a higher integration level with a smaller spread between the percentage of contributions above and below the higher level. That option would introduce significant complexity and would reintroduce the problem existing under the current rules of disproportionately large benefits for a very highly compensated participant.

For plans using an integration level based upon covered compensation, the Internal Revenue Service will provide new tables of covered compensation. These tables will not take

into account the newly enacted indexing provisions of the Social Security Act, since the future level of indexing cannot be precisely forecast during any current year. The table amounts will be maximums; a plan will not be able to use a higher level of covered compensation by adopting a smaller benefit spread.

Offset plans -- Offset plans maintain a different benefit structure and, therefore, will use a different rule. An offset plan will be permitted to reduce the gross benefit provided under the plan (the plan benefit before reduction for Social Security, usually expressed as X percent times final average pay) with that portion of the Social Security primary insurance amount (PIA) equal to the same percent of the gross benefit percentage. That is, a plan will be permitted to offset up to 50 percent of Social Security if it applies the offset against a gross benefit of 50 percent of compensation, or a plan can offset 100 percent of Social Security if it applies the offset against a gross benefit of 100 percent.

The rule for offset plans will apply to both unit benefit and flat benefit plans. No adjustments will be required for pre-retirement ancillary benefits, post-retirement annuity forms, or early retirement benefits. However, the plan benefit derived from employee contributions will have to be subtracted from the gross benefit before determining the size of the allowable offset. Adjustments for form of pay will have to be made only if compensation other than final average pay is used. In that case, the employee's gross benefit will be determined and divided by final average pay to ascertain the equivalent X.

Transition rules -- The new formulas will apply only to benefits accrued after the effective date. Benefits accrued up to that date can be frozen at their levels under current law. In the case of a final average pay excess or step-rate plan, the benefits can be prorated, based on years of participation, to determine benefits accruing before and after the effective date. Alternatively, the benefit accrued up to the effective date, as if the employee terminated on that date fully vested, can be used to determine pre-effective date accruals. Similar proration rules will apply to offset plans. However, in lieu of these proration rules, a plan can provide a minimum total benefit for each employee (other than a 10 percent shareholder) equal to the employee's benefit computed under the plan as in effect immediately prior to the effective date, determined as though the employee's compensation continued until retirement or severance at the same rate as immediately prior to the effective date.

These transition rules are the same as those currently in use for transitions from the rules in effect prior to

July 5, 1968. The grandfather rules permit a gradual phase-in of the new integration requirements.

Footnotes

1/ The Revenue Bill of 1942, H. Rep. No. 2333, 77th Cong., 2d Sess., 50-51 (1942).

2/ Raymond Schmitt, "Integration of Private Pension Plans with Social Security," Issues in Financing Retirement Income, Studies in Public Welfare Paper No. 18, prepared for the use of the Subcommittee on Fiscal Policy of the Joint Economic Committee, U.S. Congress (Washington, 1974), pp. 173-200.

3/ The executive receives an after-tax pension of $85,145, compared with $14,713 for the lower-paid worker. The executive's pension includes $53,625 in tax subsidy, compared with only $5,655 for the lower-paid worker. Assumptions: Nonintegrated, 15% defined contribution plan; participation ages 35 to 65; 6% annual interest; 4% annual salary increases; joint returns; both employees have outside income equal to deductions and exemptions. The percent of tax subsidy is the ratio of the after-tax pension with tax benefits compared to the after-tax pension without tax benefits. "With tax benefits," 15% goes into a qualified plan; "without tax benefits," the same amount, reduced by taxes paid, goes into a savings account at 6% annual interest.

4/ Note that even in a nonintegrated plan, most of the dollar amount of the contribution, and therefore the tax benefits, goes to the highly paid person, because nondiscrimination is based on a percent of pay.

MEDICAL, DISABILITY, AND LIFE INSURANCE PROVIDED BY EMPLOYER

(1) PLANS WITH FIXED BENEFITS

Present Law

An employee can exclude from gross income the medical, disability, and group term life insurance benefits provided under plans maintained by his or her employer, even though the employer can deduct plan contributions 1/ and even though such a plan (referred to hereafter as a welfare plan) discriminates in favor of the highly paid. Retirement plans, on the other hand, do not receive favorable tax treatment if they so discriminate. Similar nondiscrimination requirements apply to qualified group legal services plans and supplemental unemployment compensation plans.

Reasons for Change

Under current law, an individual cannot deduct the premiums paid for life and disability insurance, and premiums for medical insurance are usually only partially tax deductible. Thus, the exclusion for benefits provided under an employer-sponsored plan affords more favorable tax treatment for those covered than is available for those who must purchase individual coverage.

Non-taxation of certain forms of income is obviously of greater benefit to those in higher marginal tax brackets and interferes with the policy of a progressive income tax. This departure from normal tax policy can be justified only as a means of securing protection for a wide group of employees. There is no reason to favor plans which cover only a highly paid group--persons who can more readily provide for themselves than can rank-and-file employees.

Current law has led to two particularly abusive situations. First, unfunded medical reimbursement plans can be established to cover primarily the stockholders or officers of a corporation. Although such a plan may cover one or a small number of rank-and-file employees for the purpose of countering an argument by the Internal Revenue Service that distributions constitute dividends, it results in clear discrimination against rank-and-file employees. Second, a corporation having a single dominant employee (who

is also the sole or majority shareholder) can adopt a funded or unfunded plan solely to make that employee's health insurance premiums or medical expenses fully deductible.

In the course of auditing returns, Internal Revenue Service agents have found numerous cases of medical plans providing coverage primarily, or only, for employee-shareholders and officers of the employer. The following are some specific instances of this problem reported by IRS auditors:

(1) Corporation A established a medical plan for its three officer-shareholders. No other employees were covered. Over a three year period, $54,000 in medical bills for officers and their families were paid by the corporation. Over $46,000 of this amount was for the majority shareholder and the shareholder's family.

(2) Corporation B established a medical plan covering both officer-shareholders and some other employees, but with small amounts of coverage for the other employees. Over an eight year period during which the corporation expended $21,794 in connection with the plan, $18,604 was for the officer-shareholders.

(3) Corporation C adopted a medical reimbursement plan for all corporate officers, including the person who owns 100 percent of the corporation's stock. The corporation employs a number of other employees, none of whom are covered by the plan. The child of the 100 percent shareholder will require institutional care for life. The expenses of the child average $8,000 annually. The 100 percent shareholder is in the 50 percent income tax bracket and would not be able to deduct a significant part of the medical expenses because of the 3 percent floor applicable to individuals. The plan discriminates seriously against rank-and-file employees, and the sole shareholder, through control of the corporation, is able to circumvent the limitations on medical expense deductions for individuals.

(4) In a similar situation, corporation D adopted an accident and heath plan for the benefit of the individual who is both the sole shareholder and the sole employee of the corporation. Since there are no other employees, the plan is not actually discriminatory. However, the sole shareholder is in a position in which the limitations on the medical expense deduction for individuals would result in no allowable deduction. The adoption of the plan by the corporation causes a deduction to be available where it would not be available for the ordinary taxpayer who is not able to use a business entity to deduct medical expenses.

The cases cited here are not isolated. Furthermore, these schemes are being actively promoted, as witness an

advertisement in the January 17, 1978, Wall Street Journal entitled "Introducing...The Ultimate Tax Shelter" by Ted Nicholas. Mr. Nicholas, who promotes his book on the advantages of incorporated businesses, writes:

> "There are still other advantages. Your own corporation enables you to more easily maintain continuity and facilitate transfer of ownership. Tax-free fringe benefits can be arranged. You can set up your health and life insurance and other programs for you and your family wherein they are tax deductible. Another very important option available to you through incorporation is a medical reimbursement plan (MRP). Under an MRP, all medical, dental, pharmaceutical expenses for you and your family can become tax deductible to the corporation. An unincorporated person must exclude the first three percent of family's medical expenses from a personal tax return. For an individual earning $20,000 the first $600 are not deductible."

General Explanation

Under the proposal, special tax benefits will continue to be fully available with respect to an employer's medical, disability, or group term life insurance plan only if the plan satisfies certain minimum participation standards designed to prevent discrimination, and if the plan does not discriminate with regard to the benefits it provides. Thus, the plan could not discriminate in favor of officers, shareholders, or highly paid employees -- i.e. the so-called prohibited group, consisting of the same employees who are members of the prohibited group under the qualified retirement plan provisions. If benefits are provided under a discriminatory plan, employer contributions to the plan allocable to members of the prohibited group will be includible in the gross incomes of all covered members of the prohibited group. Exclusions for rank-and-file employees will continue to apply.

In addition, in order to deny special tax benefits for what is essentially an individual purchase of insurance, a limit will be established on the portion of the benefits provided for employee-owners. Similar conditions were applied to group legal services plans under the Tax Reform Act of 1976.

Effective Date

The new rules for welfare plans will apply for taxable years of employers beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
(Including proposal on Cafeteria Plans described below)
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	32	33	34	35	36

Technical Explanation

Plans Covered -- The proposal will apply to group term life insurance plans and accident and health plans which now receive favorable tax treatment under sections 79, 105, and 106 of the Internal Revenue Code. Benefits under these plans include term life insurance; payments during permanent or temporary disability; hospitalization, medical, and surgical benefits; and dental care. However, if any of these benefits are provided under a qualified retirement plan, the retirement plan rules will continue to apply.

Prohibited Group -- Discrimination in favor of a prohibited group of employees, consisting of officers and shareholders of the employer and those who are highly compensated, will not be permitted. This same definition of the prohibited group now is used for qualified retirement plans.

Ir. the qualified plan area, there were previously attempts to circumvent the nondiscrimination requirements by artificially dividing a single business into two corporations under common control, with the members of the prohibited group employed by one corporation and the rank-and-file employees employed by the other corporation. The corporation employing the prohibited group would then establish a retirement plan, contending that the rank-and-file employees did not have to be covered by the plan because they were not employed by that corporation. ERISA attacked this problem by treating all employees as employees of a single employer when their employers are under common control. This will occur whether the employers are corporations, partnerships, or a mixture of those or other types of entities. The ERISA common control rules will apply to welfare plans.

Participation Standards -- (a) Waiting Period. A plan will not be able to provide more stringent conditions on

participation for rank-and-file employees than for members of the prohibited group. For example, a member of the prohibited group could not become a participant immediately upon employment if a member of the rank-and-file could participate only after one year of employment.

A plan should not be required to provide immediate coverage, since adverse selection against the plan could result. On the other hand, too long a waiting period could unduly favor the prohibited group, the members of which often will have more years of service at the inception of the plan. Therefore, a plan will not be discriminatory merely because it requires up to three years of actual employment before commencement of participation. Moreover, the plan could defer participation until the first day of the plan year beginning after the date on which an employee completed three years of employment.

A welfare plan can also meet the participation requirements by satisfying the ERISA participation rules for qualified plans (section 410(a) of the Code).

(b) Permanence. If a welfare plan provides coverage for members of the prohibited group, it will be nondiscriminatory only if it constitutes a permanent program. The test for permanence will be applied in the same fashion as the similar test is applied to qualified plans under section 401(a) of the Code. That is, a welfare plan will be presumed to be permanent at the time it is established. If the plan is terminated within a few years and in the absence of a business necessity, it may be held to be discriminatory from its inception. This rule is designed to preclude the establishment of a plan primarily for the purpose of benefitting a member of the prohibited group, with termination occurring after that member or a beneficiary has received a significant portion of the total benefits provided under the plan.

(c) Eligible Group. Qualified retirement plans historically have been subject to alternative tests for nondiscrimination in coverage. Under the rules in effect since 1942, a qualified plan will not be discriminatory if the plan provides benefits for: (a) 70 percent or more of all employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding employees who have not satisfied the plan's qualifying minimum age and service requirements, or (b) a group which the Service finds to be nondiscriminatory. These coverage tests will apply to welfare plans. As under ERISA, nonresident aliens and employees covered by collective bargaining agreements (if there is evidence that welfare benefits were the subject of good faith bargaining) can be excluded from consideration in determining whether the

coverage requirements are satisfied. Also, if a welfare plan is maintained pursuant to a collective bargaining agreement, the plan will automatically be viewed as nondiscriminatory with respect to eligibility (and benefits). The latter is not the rule under ERISA.

Benefit Standards -- A plan cannot discriminate on the basis of benefits. With regard to benefits (such as disability or life insurance) which are generally designed to replace wages, discrimination generally will not occur where benefits are proportionate to compensation. Thus, for example, a plan will be able to provide twice as much life insurance coverage for an employee in the prohibited group whose compensation is double that of a member of the rank-and-file.

In the case of health benefits (such as hospitalization, surgical, and medical benefits), the plan will have to provide the same benefits, dollar for dollar, for all employees and, where applicable, for members of employees' families. However, some plans provide options under which the level of benefits will vary with the level of contributions made by participating employees. Discrimination generally will not occur where the same employee contribution buys the same level of benefits and all employees have the same opportunity to make every level of employee contributions allowed under the plan. Discrimination will exist where there is employer coercion or if not more than an insignificant portion of the rank-and-file employees can reasonably afford the higher contributions. Discrimination will not exist merely because a significant number of rank-and-file employees choose to make smaller contributions and therefore receive smaller benefits or merely where, because of family status, a significant number of rank-and-file employees elect cheaper single-only coverage, whereas prohibited group employees make larger contributions and receive family coverage.

Limits on Benefits for Owner-Employees

Not more than 25 percent of the employer contributions can be used to purchase benefits for a class of individuals each of whom owns (directly or indirectly) an ownership interest of more than 10 percent. For example, assume that two individuals each own 50 percent of the stock of a corporation which employs both of them and one other individual. If contributions used to provide benefits for the shareholders exceed 25 percent of the total employer contributions under the plan, allocable employer contributions will be includible in the gross incomes of the shareholders even though all three employees are covered by the plan. (In the case of benefits which are generally designed to replace wages, this test can be applied on the

basis of benefits rather than contributions.) A similar general rule applies to qualified group legal services plans, but at a level of 5-percent ownership. Implementation of this rule at the level of 10-percent ownership matches the level at which the stricter rules for Keogh plans covering owner-employees become applicable.

In the case of an unfunded medical reimbursement plan with 25 or fewer participants, this limitation will be based on amounts of reimbursement rather than contributions. If such a plan has more than 25 participants, the test for discrimination in benefits will be based on benefits promised under the plan.

Determinations by Internal Revenue Service -- The Internal Revenue Service will not make advance determinations regarding whether a welfare plan is nondiscriminatory. Determinations regarding discrimination will be made on audit and will be applied retroactively only if the Internal Revenue Service further determines that the employer did not make a reasonable effort to meet the discrimination requirements or that the permanence requirement has not been satisfied. Alternatively, the plan will not be viewed as discriminatory for a past plan year if, within a reasonable time after the Internal Revenue Service determination, the plan can be (and is) made nondiscriminatory for the plan year.

(2) CAFETERIA PLANS

Present Law

Some plans provide only a single type of benefit, such as medical benefits, or various types of benefits in proportions fixed by the terms of the particular plan. Those plans are subject to the nondiscrimination proposal described above. Other plans, known as "cafeteria plans," are structured differently. These plans provide that a participant may designate how an employer contribution on the employee's behalf should be spent. In some cases, the participant may have the employer contribution paid, in whole or in part, in cash. If the participant's only choice is among benefits which, considered individually, would not result in the inclusion of any amount in gross income, the availability of the choice will not create immediate income. However, different rules apply if the participant may choose among benefits and at least one of those benefits, if offered separately (e.g., cash or group term life insurance in excess of the excludable amount), would immediately be includible in gross income.

As a result of ERISA, an employer contribution to a cafeteria plan in existence on June 27, 1974, must be included in a participant's gross income only to the extent that the participant elects to apply the contribution to a taxable benefit. If the plan was not in existence on June 27, 1974, the employer contribution will be includible in the participant's gross income to the extent that the participant could have elected to apply the contribution to a taxable benefit or benefits. These rules apply with respect to employer contributions made before January 1, 1978. ERISA does not provide specific guidance for contributions made thereafter.

Reasons for Change

A cafeteria plan may discriminate in favor of highly compensated employees of the employer. This can occur in either of two ways. First, rank-and-file employees may be excluded from coverage under the plan. Second, the plan may cover rank-and-file employees and provide for the allocation of employer contributions proportionate to compensation. In such cases, a rank-and-file employee often may obtain adequate medical benefit coverage only by designating most or all of that allocation to pay for medical benefits, which are typically the most expensive benefits provided under the plan. Since members of the prohibited group receive larger allocations of employer contributions, they are able to purchase the same level of medical coverage plus other tax-favored benefits which are not available, as a practical matter, to the rank-and-file participants.

The state of the law regarding cafeteria plans for the future is unsettled. Moreover, even under pre-1978 law, the tax treatment of a participant could differ significantly depending upon whether the plan was in existence on June 27, 1974.

General Explanation

If a cafeteria plan does not discriminate in the distribution of tax-free benefits between the rank-and-file and the prohibited group (officers, shareholders, and highly paid), then an employer contribution allocated to the account of a participant will be includible in the participant's gross income only to the extent that the participant designates all or part of the contribution to be used to purchase taxable benefits.

The nondiscrimination test will require that the plan give employees an equal opportunity to select tax-free benefits (nondiscriminatory coverage). Also, in practice rank-and-file employees could not disproportionately elect to receive taxable benefits in cash or otherwise (nondiscriminatory distribution).

Nondiscrimination generally could be measured with respect to contributions or benefits. However, a cafeteria plan providing health benefits will not be viewed as non-discriminatory merely because each employee is allocated an equal percentage of pay. Such a plan will have to demonstrate either that overall benefits do not discriminate in favor of the prohibited group or that health benefits are provided equally and that contributions for other benefits represent an equal percentage of pay.

If a cafeteria plan discriminates in favor of the prohibited group, all employer contributions to the plan allocated to members of the prohibited group will currently be includible in the gross incomes of all covered members of the prohibited group. Rank-and-file participants will include only the amounts they designate to be used to purchase taxable benefits.

Effective Date

The new rules for cafeteria plans will apply for taxable years of employers beginning after December 31, 1978.

Technical Explanation

Plans Covered -- The proposal will apply to those welfare plans which allow a participant to designate, to any extent, the amount of allocable employer contributions which may be used to purchase any particular kind of benefit.

Benefit and Contribution Standards.--For cafeteria plans which do not provide health benefits, a two-step test will apply for determining nondiscrimination. First, the plan will have to be nondiscriminatory on the basis of either contributions or benefits. A plan satisfying the coverage requirements generally applicable to welfare plans and allocating an equal percentage of pay to each participant will meet this test.

Additionally, the plan will have to be nondiscriminatory in operation with respect to the allocation of taxable contributions or benefits. The plan will be discriminatory if the allocation of contributions to taxable benefits made by rank-and-file employees is significantly higher, as a proportion of the total allocation of contributions made by those employees, than the allocation of contributions made by members of the prohibited group. Any differences attributable to different family situations will be disregarded for this purpose. Alternatively, this measurement can be made on the basis of benefits by applying the nondiscrimination test applicable to plans not of the cafeteria type.

Although measurement of discrimination can be made on the basis of either contributions or benefits, the same basis for measurement will have to be used for both parts of the two-step test.

For a cafeteria plan providing health benefits, the test will be somewhat different if the plan chooses to determine nondiscrimination on the basis of contributions. Since non-discrimination in health benefits under a welfare plan must be determined without regard to compensation, a cafeteria plan which allocated to participants an amount equal to a specified percentage of pay to be used for health and other benefits will be considered discriminatory. Therefore, in addition to an allocation based on a percentage of pay, there will have to be an equal dollar allocation sufficient to enable lower-paid employees to purchase basic health benefits without precluding them from obtaining other benefits under the plan. Basic health benefits will generally be the amount of health coverage selected by the majority of the prohibited group in a similar family situation.

Footnote

1/ In the case of group term life insurance, the exclusion is limited to contributions for insurance not in excess of $50,000. There is also a limit on the amount of disability benefits which may be excluded from income.

22-302 O - 78 - 15

EMPLOYEE DEATH BENEFITS

Present Law

Up to $5,000 of the death benefits paid by an employer because of the death of any employee can be excluded from the gross income of the employee's beneficiaries or estate. This exclusion applies to direct payments and to less direct payments, such as lump sum distributions from qualified retirement plans.

Reasons for Change

The value of an exclusion varies directly with an employee's marginal tax rate. For individuals with income below taxable levels, it obviously is of no significance whether certain compensation is exempt or not. On the other hand, at a 50 percent or higher bracket, nontaxable benefits are equivalent to twice the amount of cash or more. It is, therefore, directly contrary to the principles of a progressive tax system to exempt compensation from tax.

The death benefit exclusion is largely a benefit for wealthy individuals, not only because their marginal income tax rates are the highest but also because they are more likely to receive death benefits which equal or exceed the full amount of the exclusion. Lower-paid individuals receive smaller death benefits, if any.

Further problems have arisen where courts have allowed an employer to deduct an amount which is, in essence, a death benefit but, at the same time, the recipient has been allowed to treat the payment as an excludable gift.

General Explanation

In many cases, a death benefit is clearly designated as such by the death benefit plan or other plan under which it is provided. In such cases, the exclusion for death benefits paid by employers will be eliminated.

In other cases, the status of a benefit as a death benefit or gift is not as clear from the terms of the plan or arrangement under which payment is made. A payment will be treated as a death benefit in any case in which it is occasioned by the death of an employee and deducted by the employer. However, if the employee owns more than a 10 percent ownership interest in the employer or is an officer,

any payment occasioned by the employee's death will be treated as a death benefit whether or not deducted by the employer. In either case, the amount viewed as a death benefit will be includible in gross income by the recipient.

The beneficiaries of employees at all income levels, including lower-paid employees, will continue to receive the protection of the exclusion for life insurance proceeds.

Effective Date

The elimination of the death benefit exclusion will apply to benefits paid after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	32	32	33	33	34

Technical Explanation

A payment made by an employer to the surviving spouse or other beneficiaries of a deceased employee is often claimed by the recipient to be excludable as a gift. Sometimes this occurs even though the employer claims a deduction not allowable in the case of a gift. Under the proposal, if an employer claims a deduction for the payment, the payment will be includible in the gross income of the recipient or recipients. The fact that the employer considered the payment to be an expense deductible for income tax purposes would indicate that the payment was not viewed as a gratuitous transfer. Also, if the deceased employee owned more than a 10 percent ownership interest in the employer or was an officer, the payment will be includible in the gross income of the recipient whether or not deducted by the employer.

It is not clear under present law whether benefits payable under a self-insured plan (perhaps payable from a separate trust) are excludable from income as life insurance proceeds. Such a plan could be subject to serious abuse. For example, an employer might set up a self-insured life insurance plan for a non-discriminatory group of employees, with the expectation that benefits will be provided primarily upon the death of the controlling employee. If the

controlling employee were to die shortly after the plan was established, the benefits payable to his or her beneficiaries might exceed the total assets of the plan. Then, the employer would make an additional, deductible contribution to the plan to cover the balance of the benefits due. If the plan were treated as one providing death benefits, up to $5,000 would be excluded. If it were treated as a plan of life insurance, nothing would be includible in gross income by any individual. After payment of benefits to the beneficiaries of the controlling employee, the plan could be discontinued. Under the proposal it will be clear that payments under a self-insured arrangement are not life insurance and, thus, they will be fully subject to tax.

II E-5

UNEMPLOYMENT COMPENSATION BENEFITS

Present Law

Compensation in the nature of wage replacement for periods of unemployment is paid through a wide variety of public and private programs and plans, each of which may differ as to sources of funding, and eligibility for and amounts of benefits. The income tax treatment of unemployment benefits also varies, depending primarily upon whether the source of the benefit is a government program or a private plan.

In general, unemployment compensation received pursuant to government programs is, by administrative decision, excludable from gross income. By comparison, unemployment compensation received from employer financed unemployment benefit plans or from the general funds of a union (accumulated from regular union dues) is includible in full in gross income when received. Similarly, unemployment benefits received from employee contributory plans are generally includible to the extent payments received exceed amounts contributed to the plan by the recipient.

Reasons for Change

The present exclusion for unemployment benefits paid pursuant to government programs is incorrect as a matter of proper income definition, tends to create artificial distortions in the labor marketplace, and promotes unjustified vertical and horizontal inequities in the incidence of the income tax.

Compensation paid to individuals during periods of unemployment is, in substance, a substitute for taxable wages. As recognized by the present law treatment of privately funded unemployment compensation plans, unemployment benefits are properly includible in the gross income of a recipient to the extent they exceed nondeductible contributions made by the recipient to acquire the benefits. Unemployment benefits paid pursuant to government programs are substantively equivalent to unemployment benefits paid pursuant to employer funded plans and, like privately funded unemployment benefits, should be includible in gross income.

The present exclusion tends to create a work disincentive and, in certain cases, influences decisions both as to the timing of entry into the labor market and the duration of employment thereafter. It has been estimated that under the present system, government unemployment

benefits on average replace more than 60 percent of lost after tax income. For women as a class, the replacement rate is close to 80 percent. Empirical studies confirm the fact that the existence of unemployment compensation adds to unemployment. The tax-free nature of unemployment compensation increases the incentive to remain unemployed. The exclusion therefore contributes, to some extent, to the period of unemployment and the consequent cost of maintaining unemployment coverage.

Finally, the present exclusion benefits taxpayers subject to tax at higher marginal tax rates more than those subject to tax at lower marginal rates and provides no tax benefits at all to those who would be nontaxable even if all such benefits were included in gross income. Those who derive the greatest benefit from the tax-free treatment afforded unemployment compensation by existing law are the unemployed with other sources of income, those who have spouses with substantial income, or those who earned large amounts of income during some portion of a year and were unemployed for the balance. Indeed, there are those who plan employment patterns to maximize the after-tax benefits available through the receipt of nontaxable unemployment compensation.

Table IIE-8

Distribution of Unemployment Compensation and
of Personal Income Tax Savings from Exclusion

Expanded Income	Number of Returns (000) 1/	Percent of All Returns With Unemployment Compensation	Percent of Total Unemployment Compensation	Tax Saving ($millions)	Percent of Tax Savings by Income Class
Under $ 5,000	4,700	41.2	27.3	190	11.0
$ 5,000 - $10,000	2,762	24.2	26.8	438	25.3
10,000 - 15,000	1,863	16.3	19.2	369	21.4
15,000 - 20,000	1,234	10.8	13.7	318	18.4
20,000 - 25,000	485	4.2	6.3	167	9.7
25,000 - 30,000	196	1.7	3.0	92	5.3
30,000 - 35,000	69	0.6	0.9	30	1.7
35,000 - 40,000	36	0.3	1.0	38	2.2
40,000 - 50,000	27	0.2	0.6	25	1.4
50,000 - 75,000	25	0.2	0.7	31	1.8
$75,000 and over	16	0.1	0.5	30	1.7
Total	11,413	100.0	100.0	1,728	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

January 26, 1978

1/ Number of Personal Income Tax Returns which would report Unemployment Compensation were all Unemployment Compensation includible in Adjusted Gross Income.

Nore: Details may not add to totals due to rounding.

As Table IIE-8 demonstrates, the distribution of tax savings attributable to the receipt of excluded unemployment compensation differs markedly from the distribution of such benefits by income class. Those with incomes above $20,000 received 13 percent of the total unemployment compensation paid. Yet 23.8 percent of the savings attributable to the unemployment compensation exclusion went to those individuals. Those with incomes from other sources of less than $10,000 received 54.1 percent of the unemployment compensation but only 36.3 percent of the savings.

General Explanation

In order to eliminate the horizontal and vertical inequity and labor market misallocations produced by the present exclusion for unemployment compensation and yet avoid taxation in hardship situations, benefits in the nature of unemployment compensation paid pursuant to government programs, including trade readjustment allowances, will be includible in the income of taxpayers with adjusted gross income from all sources (including unemployment compensation) in excess of $20,000 if the recipient is single or $25,000 if married.

Effective Date

The provision will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	212	207	204	204	214

Technical Explanation

Benefits in the nature of unemployment compensation paid pursuant to government programs will be includible in income to the extent of one-half of the excess of adjusted gross income (including the total amount of unemployment benefits and disability payments) over $20,000 in the case of single taxpayers and $25,000 in the case of married taxpayers. For example, if a single taxpayer received income from other sources of $22,000 and unemployment compensation of $3,000,

$2,500 (adjusted gross income of $25,000 less the applicable threshold limitation of $20,000, divided by two) of unemployment compensation will be included in income. To prevent abuse of the foregoing income limitations, married taxpayers who desire to exclude unemployment compensation will be required to file joint returns for the taxable period within which such compensation was received.

The proposal will apply to the following programs:

(1) Federal-State Regular Unemployment Insurance Program;

(2) Federal-State Extended Unemployment Insurance Program;

(3) Unemployment Compensation Program for Federal Civilian Employees and Ex-servicemen;

(4) Railroad Unemployment Insurance Program;

(5) Trade readjustment assistance pursuant to the Trade Act of 1974; and

(6) Payments in the nature of unemployment compensation pursuant to the Disaster Relief Act of 1974.

For purposes of determining the includible amount of unemployment compensation, adjusted gross income will include all disability payments received by a taxpayer despite the fact that all or a portion of such payments might be excluded from income under present law. Similarly, for purposes of determining the includible amounts of disability payments, adjusted gross income will include all unemployment compensation received by the taxpayer. For example, if a single taxpayer received income from other sources of $17,000, disability payments subject to exclusion of $3,000 and unemployment compensation of $1,000, the taxpayer's adjusted gross income for purposes of determining both the includible amount of unemployment compensation and the excludable amount of disability payments will be $21,000. Five hundred dollars of unemployment compensation will be includible (adjusted gross income of $21,000 less the applicable threshold limitation of $20,000, divided by two). The entire disability payment will be includible, because the disability payment exclusion phases out on a dollar-for-dollar basis to the extent adjusted gross income exceeds $15,000.

ENTERTAINMENT AND TRAVEL

INTRODUCTION

"Business related" entertainment which is deductible under present law provides personal benefits to the recipient. Sometimes the entertainment provides luxuries. Often it is merely personal entertainment in disguise. Some types of deductible business travel also provide personal benefits. These personal benefits generally are not taxed to the recipient, thereby encouraging this form of consumption over consumption which must be purchased with after-tax dollars.

Allowing entertainment and travel expenses to be deducted, without taxing the related personal benefits to the recipient, has the effect of providing these benefits partially at public expense. In effect, present law requires the many taxpayers who cannot or do not obtain these subsidized entertainment and travel benefits themselves to help pay for the benefits enjoyed by others. These benefits tend to be disproportionately distributed to upper-income taxpayers. Moreover, some types of entertainment and travel deductions are sources of abuse due to the vagueness of the standards applied to determine deductibility.

For these reasons, the President proposes to disallow deductions for some entertainment and travel expenses not taxed to the recipient. In general, the proposals will disallow deductions for:

- expenses of all entertainment activities and facilities, except 50 percent of expenses of entertainment meals;

- first class air fare, to the extent that it exceeds coach fare; and

- expenses of attending foreign conventions which are held outside the United States without good reason.

EXAMPLES OF PROBLEMS UNDER PRESENT LAW

The deductibility of expenses related to owning and operating a yacht is illustrated in the following excerpt from an article entitled "The Great Tax Write-off", which appeared in the February 1976 issue of Motor Boating and Sailing Magazine, at p.63:

> "An awful lot of rules for only a limited tax deduction? It isn't really all that complex. As an illustration of how these rules actually work, consider the situation of Robert Gaylor, a young lawyer who recently joined an established law firm. His success with the firm -- in fact, his continued employment -- depends on his contributing to the growth of the company. Robert joined the Lakeside Yacht Club expressly to meet the members, many of whom he considered potential clients. As a result of his participation in the club's activities, he made several valuable contacts which led to an increase in his -- and the law firm's -- practice.
>
> The situation of Dr. Roger Lawrence, an orthopedist, is not very different. Dr. Lawrence bought a 28-foot powerboat on which he entertained other doctors who referred patients to him. Since entertainment of this nature was generally expected of him, and since a substantial number of patients were referred to him as a result of his entertainment, the deduction was allowed.
>
> What specific expenses on your boat are deductible by you as the owner, chief stockholder, employee, or professional when the yacht is used primarily for business entertainment? Certainly all of the following will qualify:
>
> 1) Operating costs: gas, oil, tune-ups, phone calls;
>
> 2) Maintenance and repairs, and even storage fees;
>
> 3) Insurance;
>
> 4) Salaries paid to hired hands or workers;
>
> 5) Yacht depreciation: A portion of your boat's cost may be written off each year for wear and tear. Your deduction would be the percentage of that figure that represents the entertainment portion of its use;

6) Sales losses: If you sell your boat at a loss after several years of claiming a percentage of its expenses for business entertainment, a fraction of the loss would be deductible. The balance, of course, would be a non-deductable personal loss;

7) Cost of food and beverages during the boat's business use.

* * * * * * * * * * *

Families with children unfortunately find themselves faced with a problem when it comes to determining the business and personal use of a club's facilities. Use of the club by any member of the family constitutes personal use and makes it doubly difficult for the club to qualify as a business entertainment facility. For this reason many members will, as soon as possible under club rules, buy their children junior memberships. Since the junior memberships are not counted as personal use by the parent/taxpayer, the parent is in a better position to establish the more-than-50 percent use for tax purposes. The cost of a junior membership is usually modest when compared to the amount an individual would be permitted to deduct on his own membership for business use."

Advice on how to structure personal consumption expenditures in order to support deductions is readily available. Prentice-Hall, Inc., has published a pamphlet entitled "How to Get Top Trouble-Free Deductions for Travel, Entertainment, and Related Business Expenses Under the Latest Liberalizations and Crackdowns" containing the following headings:

-- Two cases show -- how to use a diary to win every deductible expense.

-- Mix your vacation with a business trip -- let the company foot most of the bill.

-- Bring your wife along and deduct the cost?

-- How to nail down deductions for home entertainment.

-- "On the town"

-- Club dues

-- Yachts, hunting lodges, and other facilities

-- "Quiet business meals" are "directly related."

Another Prentice-Hall, Inc. publication "Executives Tax Report" answers questions on how best to arrange entertainment so as to obtain the maximum tax benefits.

BIG T&E WRITEOFF:

How Club Members Get Top-Dollar Deductions —Year In and Year Out

Club memberships can mean big deductions. It makes no difference whether they're country clubs, athletic clubs, or fishing and hunting clubs. They are all good for business—either to have a customer to dinner, to golf with a group of execs, or for an outing sponsored by a local businessmen's organization.

Key question #1: If I use my club to entertain other business people—and I do it for business reasons—do I get a deduction?

Answer: Chances are you can deduct a good-sized chunk of your club costs—even though you and your family also use the club for your own enjoyment.

Key question #2: How much can I deduct?

The answer here depends on the kind of expense it is.

• *Meals and bar bills:* Suppose you take your top-level execs to dinner at your club—or you have a few drinks with them at the club bar. *Deductible?* Yes. You can write off every single penny. And you can deduct it whether or not you and your guests discuss business matters.

• *Greens fees and other club expenses:* Let's say you have a meeting with a customer in the morning and take him to your golf club for lunch and a round of golf in the afternoon. All your expenses for the day would be deductible. *Rule:* Goodwill expenses of this kind are deductible if they directly precede or follow a substantial discussion of business affairs.

How soon before or after is "directly?" Generally it means the same day—for example, golf in the afternoon following a morning meeting. But if the customer were from out of town, taking him to the club the day before or the day after your meeting is all right, too.

➠IMPORTANT→ The cost of the lunch is deductible even when other expenses aren't. It's a "quiet business meal"—thus deductible on its own.

Key question #3: How about my club dues? They're probably my biggest single expense.

Answer: Dues—in whole or in part—may be deductible. BUT—

You can't deduct one nickel of dues unless you use your club more than 50% of the time for business reasons. And even then, you can deduct only that percentage of dues that's "directly related" to your business dealings.

Example: Mr. Moller's country club dues run to $2,500 a year. During the summer, he uses the club an average of three days a week. On one of these days, Moller plays golf with other businessmen, but doesn't discuss anything connected with his company during the game. It's strictly for goodwill. On two days, he takes his customers or top sales people to lunch or dinner—at which there may or may not be actual business discussions. In addition to these days at the club, Mr. Moller or his family use it for pleasure an average of two days a week.

Is Mr. Moller entitled to a deduction? Yes! Since he uses the club for business three days out of five, he easily meets the "over 50%" test. So he can deduct whatever portion of the club's use was "directly related" to business. In his case, only the days when he's hosting "business meals" are considered directly related. Since these constitute two-fifths of the total use of the club, Moller can deduct two fifths ($1,000) of the total dues.

➠ADDED BONUS→ A day when you're using the club for business reasons counts as a business day even if the family's using it for pleasure at the same time. So you can get extra personal use out of the club without jeopardizing your entertainment deduction.

Key tax-saving move: Make a point of having a quiet business lunch (or breakfast for that matter) with your customers on the same day you play golf with them. If Mr. Moller had done that, all three days would have been directly

related. One business meal in the day is enough. *Another point:* A few drinks with your customers at the club bar can also transform a casual golf date into a full-fledged business day. One qualification: The bar must be quiet and have "no substantial distractions to discussion."

How does a meal at which business matters aren't discussed qualify as a "directly related" expense?

It's simply the big exception to otherwise strict entertainment rules. If you and a customer have a quiet lunch or dinner at the club, you get this—

TRIPLE BENEFIT→ (1) The cost of the meal is deductible in and of itself. It also helps nail down and *increase* your club dues deduction, counting as (2) a *business day* that helps bring your business use of the club over the 50% mark, and as (3) a *directly related expense* that adds to the amount of your dues deduction.

Deduction saver: The quiet business meal break is particularly important when you use the club partly for business reasons and partly for pleasure. As you get down to the end of the year, you may find your personal-use days running neck and neck with your business-related days. When this happens, here's—

WHAT TO DO→ Schedule some quiet business meals at the club. They can make the big difference that wins you the deduction.

Warning: Just one extra family outing at the club—a family dinner, for example, or a Sunday afternoon swim—can cost you your entire dues deduction.

IDEA IN ACTION→ If you belong to more than one club—and many do—you may want to use one club strictly for business entertaining, and the other for socializing.

Another warning: The tax rules specifically state that you must keep accurate records. If you don't, your use of the club is presumed to be primarily personal.

Result: You won't qualify for *any* deduction for *any* club expenses.

THE EXECUTIVES TAX REPORT brings you IDEAS for reducing taxes and increasing wealth. It is recommended that you consult your own professional advisors before acting on these ideas.

How do you deduct at-home entertainment expenses? Business Week of May 30, 1977, tells you:

Deducting at-home entertainment expenses

Tax deductions for nonreimbursed business entertaining at home can get sticky for anyone who glosses over the rules on recordkeeping. "Records, records—that's the key point," says a nationally known tax writer, Bernard Greisman.

Fewer court cases of late and less time spent on the subject in tax advisers' offices indicate that the Internal Revenue Service has recently taken some of the heat off such deduction-taking by executives. Wining and dining business associates at home has become an accepted routine, notes Greisman. "With credit cards, keeping track of what you've spent in home entertaining is easy, anyway," he adds. "So keep your guest lists straight."

There are two basic rules:

- For this year, beginning now, keep a diary of all business entertaining at home. Include all receipts, plus entries showing dates, guests, their business identity, the business purpose (noted briefly), and amounts spent. Even a smart CPA cannot win points with the IRS by "estimating" these costs.
- For past months, if you have failed to keep complete records, remember that it is possible—and permissible—to reconstruct needed tax records. This can save you tax dollars. It is not possible, of course, to create a tax diary, but you can recover misplaced receipts, bills, canceled checks, and such, and gather some that have never been collected. Often, an executive's spouse can help solve the problem by recalling guest lists, dates, items purchased, and such.

Remember, too, that if challenged by the IRS, a taxpayer must be able to show that his guests were, indeed, business associates who were in his home for business purposes. "Associates" has a broader meaning than you may realize. It covers customers, clients, suppliers, advisers such as management consultants and lawyers, and prospective associates such as a possible customer or supplier. The term also covers the wives of business contacts—or the husbands—and one's own spouse, as well.

The purpose counts. "Goodwill" entertaining counts, too, notwithstanding its pure informality and indirect connection to a particular business deal. It need not be shown, for instance, that after cocktails and dinner, the executives at the party departed to the den to talk business. The underlying business purpose is what counts.

Once the validity of taking the deduction is established, the question of what to deduct becomes a bookkeeping chore. It amounts to more than the cost of food and drink for business associates and their spouses. You also can write off expenses for a caterer, flowers—including a table or buffet centerpiece—tent or other equipment rental, music, car parkers, and invitations.

It is even possible to prorate some expenses—such as music—when some of the guests are business people and others purely social friends. But such mixed guest lists at home parties cause tax troubles. Here the records for tax deductions need to be given special attention, with the people and business purposes clearly shown. There also must be a very clear breakdown of expenses on a per-guest basis.

Greisman cautions: "You may have a hard time supporting the deduction if the business contacts are invited to a wedding reception or some similar affair that is purely social."

Foreign conventions and study programs are also popular means of writing off vacations at other taxpayers' expense. Reproduced below are excerpts from a brochure of the California Trial Lawyers Association for the year 1977.

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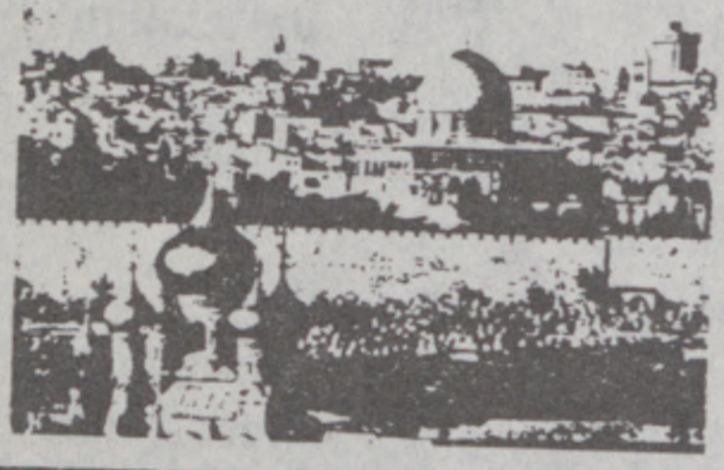


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DAY 2	Arrive Tel Aviv
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	2pm-4pm: SEMINAR – WORKSHOP
DAY 4	10am-12pm: SEMINAR – WORKSHOP
	2pm-6pm: SEMINAR – LECTURE
DAY 5	12pm-3pm: SEMINAR – WORKSHOP
DAY 6	8am-12pm: SEMINAR – WORKSHOP
	1pm-3pm: SEMINAR – WORKSHOP
DAY 7	At Leisure
DAY 8	At Leisure
DAY 9	Transfer to Jerusalem
DAY 10	8am-12pm: SEMINAR – LECTURE
	2pm-4pm: SEMINAR – WORKSHOP
DAY 11	2pm-4pm: SEMINAR – WORKSHOP
	6:30pm-10:30pm: SEMINAR – LECTURE
DAY 12	At Leisure
DAY 13	At Leisure
DAY 14	At Leisure
DAY 15	9am-12pm: SEMINAR – CONCLUSION
DAY 16	Depart Israel
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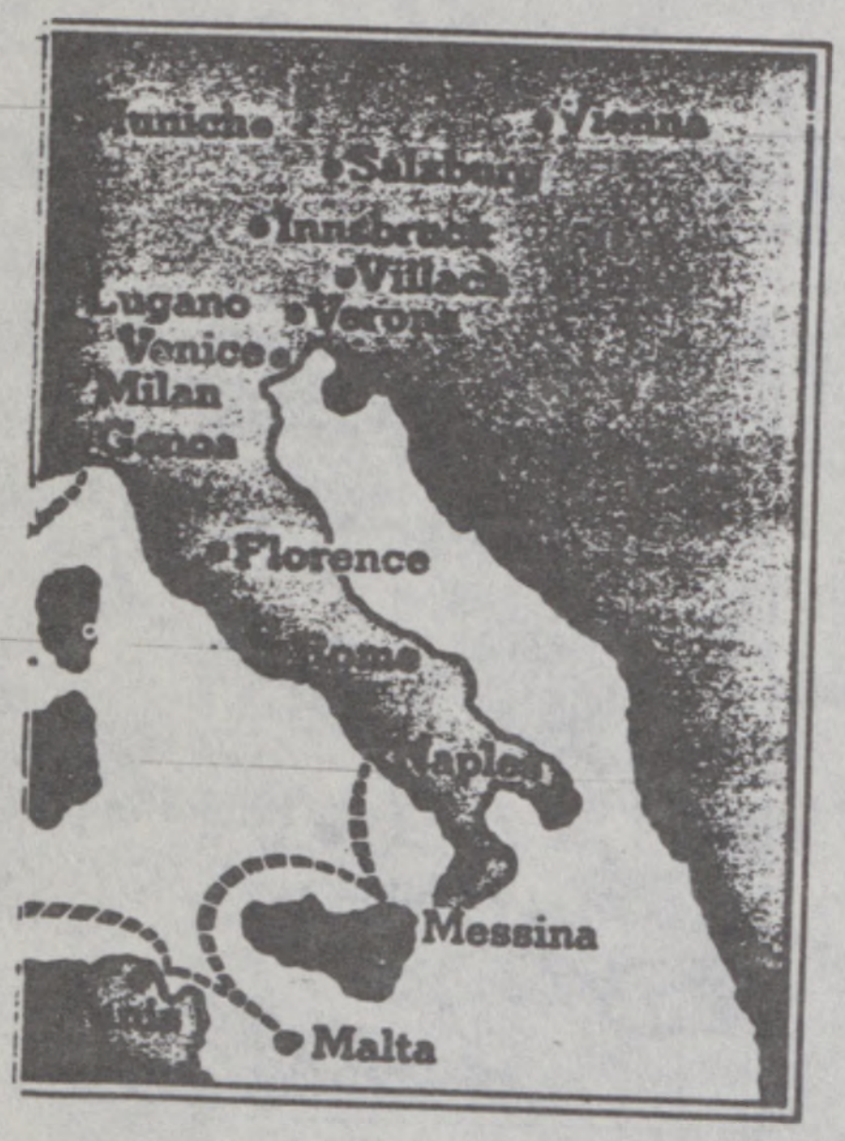
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DAY 2	Arrive Milan
DAY 3-DAY 8	LAND
DAY 9	Board Boat. 7pm-10pm: SEMINAR — INTRODUCTION
DAY 10	Cruise. 2pm-6pm: SEMINAR — LECTURE 8pm-10pm: SEMINAR — WORKSHOP
DAY 11	Cruise. 7am-9am: SEMINAR — WORKSHOP 3pm-7pm: SEMINAR — LECTURE
DAY 12	Cruise. 8am-12pm: SEMINAR — LECTURE 2pm-4pm: SEMINAR — WORKSHOP
DAY 13	Cruise. 8am-12pm: SEMINAR — LECTURE 2pm-4pm: SEMINAR — WORKSHOP
DAY 14	Cruise. 2:30pm-6:30pm: SEMINAR — WORKSHOP 7:30pm-9:30pm: SEMINAR — WORKSHOP
DAY 15	Cruise. 8am-11am: SEMINAR — CONCLUSION
DAY 16	Cruise. Afternoon, transfer to Milan Depart Milan Arrive USA

(For your information, the applicable Y-class economy air fare round trip from San Francisco and Los Angeles to Milan, including departure tax, is $1275.00.)

One wonders how the Holy places of Jerusalem will stimulate the trial lawyers of California in "Handling the Personal Injury Case"; or, how the ambiance of Italy, Switzerland, Austria, and France will promote "Trial Advocacy." The answer, of course, is that they won't and that the "study" portions of the trip are designed to disguise vacations subsidized by the majority of taxpayers. Nevertheless, such vacation programs are claimed to be tax deductible as ordinary and necessary business expenses.

Theater tickets and tickets to sports events are also popular forms of business entertainment. The following is an excerpt from an article in the March 20, 1977, issue of the Philadelphia Bulletin:

> "Many of Philadelphia's major companies occupy "superboxes" at Veterans Stadium. They include Atlantic Richfield, Girard Bank, First Pennsylvania Bank, McCloskey and Co., Fidelity Bank, Central Penn National Bank, C. Schmidt and Sons, Telesystems Corp., Industrial Valley Bank, Philadelphia National Bank and Brooks Armored Car Service, Inc.
>
> The annual rental of a 28-seat superbox is $18,000, allowing the occupant privileges both for Phillies and Eagles games. One Philadelphia businessman estimated that costs of food and maintenance of a superbox run upwards of $15,000 a year."

The Prentice - Hall, Inc., "Executives Tax Report" instructs executives on how to record ticket entertainment expense:

HERE ARE THE GROUND RULES:

How to Cover All T&E Bases When You Take a Customer to the Ballpark

Another baseball season is just around the corner. Since season tickets for gift and entertainment purposes are big items with many businesses, the question of deductibility is vital. The Tax Law is tough when it comes to these deductions—but it's not impossible. With this in mind, let's bat out some questions and answers on the do's and dont's for deducting the cost of season tickets.

Question: Suppose I buy a season ticket for business purposes. How do I handle it taxwise?

Answer: First of all, you must break down the cost of each individual ticket. The deductibility of each ticket depends on the use you put it to.

Example: A season ticket for four box seats at Yankee Stadium costs $1,400 ($1,300 for admission plus $25 each for Stadium Club membership). It covers some 81 home games played on 78 admission dates. (The rest—for those of you who don't follow the game—are double headers). Each seat costs $325 for the season and it breaks down to about $4.17 per date ($325 ÷ 78).

Question: What will be considered a deductible business use of a season ticket?

Answer: Business entertainment; business gifts; and recreation for rank-and-file employees.

➡IMPORTANT→ If it's entertainment, the game must precede or follow a substantial business discussion. If it's a gift, the deduction is limited to $25 per recipient per year.

Question: Many of my customers will be attending a convention in my area. Can I claim an unlimited entertainment deduction if I take them to night games while the convention is in town—even if we don't discuss business?

Answer: Yes. The T&E rules say a business convention can pinchhit for a "substantial business discussion."

Question: Suppose I have some very good customers. Can I give them tickets more than once?

Answer: Sure. You can give each one up to $25 worth of tickets a year and deduct the cost. Anything over that and you bear the extra cost—Uncle Sam won't help pick up the tab. On our facts, if you give a customer two tickets to 3 games, it's a $25.02 gift (6 × 4.17). *Result:* You can deduct $25.

Question: How about this—I give my customer $25 worth of tickets and give his wife the same. Will I be safe then?

Answer: No. A gift to the wife is considered part of the husband's gift. *Result:* Your deduction would still be limited to $25.

Question: Does it make any tax difference if I go to the game with the customer?

Answer: It certainly does. If you go along, it's considered entertainment. In other words, you get no deduction unless there was a substantial business discussion (or a convention). If you don't go, it's a gift (subject to the $25 limit) unless you choose to treat it as entertainment.

Question: Does the $25 limit on deductible gifts apply if I just send the tickets to a customer for *his* rank and file employees?

Answer: No. But make sure the gift isn't restricted to the top people.

But the ball game is far from over. To get your deduction, you'll have to—

➡KEEP RECORDS→ First of all, you'll have to designate whether it's a business gift or business entertainment. If it's entertainment, you'll have to show the cost of the tickets; date of the game; whom you entertained and the business relationship, the time, duration, place and nature of business discussion; plus identification of those who were at the business discussion.

ENTERTAINMENT EXPENSES

Present Law

Present law imposes relatively few restrictions on the deductibility of "business" entertainment. To be deductible, entertainment expenses must be "ordinary and necessary" in the taxpayer's business. Voluminous litigation attests to the difficulty of defining the "ordinary and necessary" standard. However, it is clear that "necessary" does not mean "essential." Rather, courts generally have construed the term "necessary" as imposing only the minimal requirement that an expense be appropriate and helpful for the development of the taxpayer's business.

The regulations require that entertainment expenses be reasonable in amount. Theoretically, an entertainment expense is not deductible to the extent that it is lavish or extravagant. However, since one man's "lavish" is another man's "moderate," this requirement is difficult to apply evenhandedly -- and hence difficult to apply at all.

Theoretically, entertainment is deductible only to the extent that it is allocable to the taxpayer's business. However, it is seldom possible to distinguish between personal and business motives in entertainment, let alone to prove that distinction. Further, even entertainment provided for business reasons must produce personal enjoyment in order to have its intended effect. Thus, the personal element in business related entertainment generally is not disallowed.

In short, some taxpayers are in a position to deduct many of the luxuries of life as business entertainment. Costs of country club memberships, cocktail parties, cruises, hunting lodges, lunches, dinners, nightclub shows, yachts, hotel suites, swimming pools, tennis courts, and vacation trips--all can be deductible under present law.

In response to President Kennedy's tax reform proposals, in 1962 Congress enacted several provisions intended to prevent abuse of entertainment deductions. However, <u>most</u> entertainment expenses deductible before 1962 still can be deducted today.

One provision enacted in 1962 requires substantiation of entertainment expenses that are deducted. The taxpayer must substantiate, "by adequate records or by sufficient evidence corroborating his own statement," the amount of expense, time and place of entertainment, business purpose of expense, and business relationship to the taxpayer of any persons

entertained. To the limited extent the IRS can enforce this requirement, it impedes those who previously created entertainment expenses out of whole cloth or simply guessed at what they had spent. However, the substantiation requirement is not a serious obstacle to those who actually incur expenses and keep careful records.

Another provision enacted in 1962 requires that expenses of entertainment activities be "directly related to" or "associated with" the taxpayer's business in order to be deductible. These tests are easy to meet.

While the "directly related" rules purport to require some expectation that business will be conducted at the entertainment event, entertainment is considered "directly related" without a showing that business benefit resulted from the entertainment, or that more time was devoted to business than entertainment, or even that business was discussed. Even the loose "directly related" standard does not apply if meals are furnished under circumstances "conducive to a business discussion." As described in a prominent publication which advises taxpayers how to obtain "trouble-free" deductions, this exception operates as follows:

> Say you take a customer or a client to dinner at . . . [a] restaurant. Or, perhaps you prefer to take him to a hotel bar or cocktail lounge for a few drinks. As long as he's a business associate, you can deduct the tab whether or not you discuss business, make a sales pitch, or even if it's only for goodwill. The only limitation is that the atmosphere must be conducive to a business discussion.

In short, the "directly related" requirement may have little more practical effect than to disallow deductions for entertainment which offers little or no opportunity for business discussion--such as entertainment at night clubs, entertainment at cocktail parties where non-business associates are present, or entertainment which the taxpayer does not attend.

Moreover, even entertainment which offers no opportunity for business discussion is deductible if it meets the "associated with" test. Thus, expenses of an entertainment activity which does not qualify as "directly related" still may be deducted if the activity has some proximity to a business discussion. Under the "associated with" rule, expenses for dinner and a night on the town for the taxpayer, a business contact, and their spouses, are deductible merely because that afternoon or the following morning some of the participants talked or will talk business.

Like expenses of entertainment activities, expenses of entertainment facilities such as yachts and swimming pools may be deductible. (Dues or fees paid to a social, athletic, or sporting club are also considered entertainment facility expenses.) To be deductible, such expenses must meet the "directly related" test, and more than half of the use of the facility must be for business entertainment.

Reasons for Change

Present law on deductibility of entertainment expenses is an open invitation to charge personal expenses to the Treasury, and many taxpayers accept the invitation. Some who have done so in recent years are described below. The expenses described in these examples are deductible under present law.

A New York City taxpayer claimed deductible expenses of $9,665 for business lunches throughout the year. According to the taxpayer's records, he entertained a business client or associate each day for 338 days of the year. The taxpayer skipped his business lunch on Thanksgiving Day, but not on the Friday, Saturday, or Sunday of Thanksgiving weekend. He entertained at top restaurants on an average of 6-1/2 days a week all year, at a cost of well over $20 each lunch time.

In a recent year, an electrical fixture salesman structured his business calls so that he ate breakfast, lunch, and dinner, five days a week, with a customer or purchasing agent either before or after a business discussion. The deductible amount for the year was $8,000, of which $3,000 was spent on the salesman's meals.

A university professor received $30,000 in annual salary and, in addition, many of his expenses were reimbursed. His department did not reimburse him for $1,300 spent to entertain visiting professors, but these expenses were deductible on the basis of his department chairman's statement that entertaining visiting professors was required as part of the professor's job.

A surgeon deducted $14,000 a year for expenses of entertaining doctors who referred patients to him. He entertained the doctors on a yacht, where they discussed patients recently referred. The surgeon claimed that he took care to begin each medical discussion early in the cruise in case a doctor later became seasick.

The corporation of an incorporated dental surgeon had gross income of $500,000, a deduction of $160,000 for the surgeon's salary, and taxable income of only

$26,000. An amount close to $17,000 was deducted for the surgeon's expenses of entertaining dentists who referred patients to him during the year. The surgeon entertained the dentists (and sometimes their wives) at home, at a country club, at sporting events, at restaurants, and at a rental cottage. He entertained the same few dentists the preceding year, and they are his personal friends.

A small corporate manufacturer with few competitors owned a yacht. Before and after business discussions, the corporation entertained customers and potential customers on cruises and fishing trips. Yacht expenses of $67,000 were deductible for the year.

A corporation which operated an iron foundry and machine shop in Virginia owned several hunting and fishing lodges on an island off the coast of North Carolina. The corporation used these lodges to entertain employees of its major customers. Deductible costs of lodge operation and depreciation, plus airplane expenses, were over $100,000 a year.

These taxpayers are not isolated examples. As President Kennedy said 16 years ago:

> ... Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well.

Even when entertainment promotes business and hence can be argued to have a business purpose, the entertainment provides substantial personal benefits to the recipient. It is this personal consumption which distinguishes entertainment from other business purchases, such as advertising.

Reading an advertisement is not comparable to dining at an elegant restaurant, sailing on a yacht, or attending a Sunday football game. Entertainment is more closely analogous to wages; they both provide personal benefits. However, the tax collector withholds a portion of wages before they can be spent for personal consumption while entertainment benefits are now received tax-free.

The benefits associated with business related entertainment tend to be disproportionately distributed to upper-income taxpayers. For example, lunches are deductible

by a lawyer who eats with clients at a club, but not by a carpenter who eats with other workers at a construction site. Costs of giving a party for friends are deductible by a businessman whose friends are his business associates, but not by a secretary or nurse, for whom entertaining cannot be said to have a business purpose. In light of the personal benefits associated with entertainment, the disproportionate availability of entertainment deductions to upper-income taxpayers makes the allowance of such deductions particularly unfair.

And entertainment expenses intended primarily to promote business are not the whole problem. Frequently "business related" entertainment is personal entertainment in disguise. A taxpayer in the 50 percent tax bracket can purchase two tickets to a football game for the price of one if he deducts their cost. Therefore, he has nothing to lose by inviting a friend who is also a business associate to join him for the game. If the expense account fan happens to pick up a little business as a result of this entertainment or to receive a return invitation from the friend, this is all gravy paid for by Uncle Sam. Since it is extremely difficult to distinguish between personal and business intent in entertainment, entertainment which is intended to provide tax-free personal benefits often cannot be disallowed.

In addition to entertainment expenses which are deductible under present law, some nondeductible expenses are in fact deducted. The subjectivity of present law encourages taxpayers to deduct entertainment expenses which, though not clearly deductible, are "arguably" so.

For example:

A life insurance salesman recently deducted his tennis club dues on the theory that tennis games enabled him to judge the physical fitness of prospective customers.

A large casino operation in Nevada deducted as promotion expenses the costs of using and maintaining a lake property and a hunting lodge. The annual deduction was $110,000 for the lake property and $350,000 for the hunting lodge.

A practicing attorney with gross income of $150,000 entertained clients throughout the year on his yacht. He claimed deductions of $22,000 for operating the yacht, $19,000 for depreciation of the yacht, and $6,000 for operating an airplane to fly clients to the yacht.

A physician deducted $13,000 a year for expenses of entertaining other physicians at parties, dinners, and a hunting cabin -- all on the theory that any physician is a potential source of referrals.

The sole shareholder-officer of a small corporation deducted the costs of entertaining employees of another corporation from which he bought scrap on a "highest bidder" basis.

The owner of an insurance agency deducted $31,000 one year and $32,000 the next on a claim that every single meal during the two years (except for the meals on one day) was motivated by business.

A medium-size corporation which supplies parts to auto manufacturers deducted $35,000 in each of two consecutive years for lunch expenses of the corporation's three owners and three salesmen. According to their oral testimony, supported only by invoices, the owners and salesmen entertained purchasing agents and other representatives of customers under circumstances conducive to business discussion.

The controlling shareholder of a small retail sales corporation received a salary of $19,000. From this, he deducted $26,000 for the expenses of entertaining at a cottage on a Caribbean island.

Taxpayers may claim "arguably deductible" entertainment expenses in the belief that they are properly deductible, or in the hope or expectation that they will not be audited, or in an attempt to obtain bargaining power for use if they are audited. Whatever the reason, many nondeductible entertainment expenses are in fact deducted. IRS data suggest that about 20 percent of all entertainment expenses deducted on individual returns should not be deducted. Overreporting of this magnitude breeds disrespect for the law and impairs the integrity of the tax system.

Stricter enforcement of present law cannot solve the overreporting problem. Present law on the deductibility of entertainment expenses is so generous, and its application so subjective, that it invites taxpayers to test the boundaries. Determinations of "necessary," "reasonable," "directly related," and "associated with," as well as the allowance of substantiation by means other than adequate records, necessarily leave much to the judgment of the individual IRS agent. They make administration extremely difficult, and uniform administration unattainable.

General Explanation

To reduce the unfairness and abuse associated with present law, the Administration proposes to disallow deductions for expenses of entertainment which is not taxed to the recipient as compensation. In general, deductions for

expenses of all entertainment activities and facilities will be disallowed. However, 50 percent of currently deductible entertainment expenses for food and beverages will remain deductible.

Regardless of the existence of a business purpose, the high level of personal value associated with entertainment justifies the proposed disallowance of deductions. Disallowance is required to achieve the equivalent of including in the tax base the personal value of the benefit to the recipient. Since entertainment meals often involve business conversations, they may be less likely than other forms of entertainment to have personal value to the recipient equal to cost. Fifty percent disallowance is roughly equivalent to allowing a full deduction to the payor and including half of the cost of the meal in the income of the recipients.

This proposal will affect entertainment expenses only. Costs of business travel away from home will continue to be deductible, subject to the limitations proposed with respect to foreign conventions and first class air fare. Travel is less likely to have personal value to the businessman than entertainment, and travel deductions are less subject to abuse. Therefore, it is appropriate to continue to allow them to be deducted.

However, since entertainment is entertainment, no matter where it takes place, entertainment expenses incurred in connection with business travel will be subject to the Administration proposal. For example, if an employee traveling away from home on business entertains associates by taking them to the theater, the cost of the theater tickets will not be deductible. Also, if the only purpose of a trip is to entertain the traveler, no deduction will be allowed. For example, no deductions will be allowed for costs of a cross country trip by business associates to attend the Masters Golf Tournament or the Superbowl.

Certain employer-provided meals will be excepted from the proposal. Present law excludes from an employee's income the value of meals which are furnished to him by his employer on the employer's business premises and for the employer's convenience. In applying this exclusion, meals are considered to be furnished for the employer's convenience only upon a clear and strong showing of business necessity. The proposals do not modify the statutory exclusion, and costs of providing such meals will continue to be fully deductible under the proposals.

Analysis of Impact

The Administration proposal will not hurt American business. If the increased revenue from the proposal is used to lower tax rates, as recommended, the proposal will simply

make it relatively more expensive for businesses to provide entertainment to employees and business associates, and relatively less expensive to lower prices or to increase salaries.

In terms of economic efficiency, the proposed changes will be beneficial. The government will no longer be subsidizing consumption in such forms as yachts, theater tickets, and country club memberships connected with an ostensible business purpose. The government subsidy for entertainment meals will also be reduced. Persons will continue to engage in such entertainment, either on their own or in the company of business associates, if they feel that the benefit derived from the entertainment is worth its cost. Because entertainment expenses will have to be purchased with after-tax dollars, there will no longer be a bias in favor of entertainment over other forms of consumption.

It is true that many forms of business entertainment have become accepted as social custom and are viewed by some businessmen as necessary to attract and keep customers. However, one reason that business entertainment has become accepted as social custom is because the tax system lowers its price. In the long run, social customs related to business entertainment might change if the tax subsidies that encourage it change. Even in the very short run, changes in deductibility of entertainment expenses will affect all business firms engaging in entertainment alike.

The Administration proposal will not have a substantial effect on those industries benefiting from tax incentives for entertainment. Expensive restaurants catering to individuals eating tax deductible meals might suffer some decline in the demand for their services. However, the Administration proposal will cause relatively little, if any, loss of jobs. It is estimated that the total employment reduction in the restaurant industry will be no more than 2 percent, at most, of all such jobs. The rapid employment turnover in that industry will absorb much of any such employment reduction. Hotels and other travel related industries generally will not lose business as a result of the proposal since most costs of business travel and domestic convention attendance will continue to be fully deductible.

It should be emphasized that output and employment in the economy as a whole will NOT decline as a result of the Administration proposal. Any reduced spending on entertainment will be balanced by increased spending on other goods and services by individuals benefiting from the reduced tax rates.

Effective Date

The proposed changes in the deductibility of entertainment expenses will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	1,195	1,322	1,434	1,564	1,706

Technical Explanation

For purposes of the proposal, as under present law, entertainment activities include any activity of a type generally considered to constitute entertainment, amusement, or recreation. Thus, expenses of activities such as theater parties, attendance at sports events, and fishing trips will be fully disallowed.

For purposes of the proposal, as under present law, entertainment facilities include any facility used in connection with an entertainment activity. Thus, expenses of facilities such as hunting lodges and swimming pools will be fully disallowed. As under present law, dues or fees paid to any social, athletic, or sporting club or organization will be considered expenses of entertainment facilities. Such dues or fees will not be deductible unless the club or organization operates solely to provide lunches under circumstances conducive to business discussion. Dues or fees paid to such business lunch clubs will be treated the same as meal expenses and hence will be disallowed only by half. Similarly, expenses of employer facilities used primarily to provide meals to employees will be treated the same as the expenses of the meals provided.

Costs of business travel away from home will continue to be deductible, subject to the limitations proposed with respect to foreign conventions and first class air fare. Deductible business travel costs include costs of transportation, lodging, and meals. However, they do not include expenses of a trip undertaken purely to provide entertainment to those traveling.

Whether a meal is considered a travel meal or an entertainment meal will depend on the travel status of the person who eats the meal, not the person who pays for it. For example, assume Mr. A lives in New York City, Mr. B is in New York City away from home on business, and they eat a business meal together. Regardless of whether Mr. A or Mr. B picks up the check, Mr. A's meal is 50 percent deductible and Mr. B's meal is fully deductible. For reasons of administrative convenience, all meals consumed at the same time will be presumed to have the same cost. In the example, 75 percent of the total check will be deductible. As a consequence of this rule, meals purchased for those attending a bona fide business convention generally will be deductible.

Where entertainment is furnished to an employee by his employer, the Administration proposal will limit or disallow a deduction to either the employer or the employee, but not both. Rules for preventing double disallowance are as follows: (1) The proposal will not apply to an employer to the extent that he treats entertainment expenses as compensation to the recipient employee. For this purpose, treatment as compensation means treatment as compensation to the employee on the employer's income tax return as originally filed and treatment as wages to the employee for purposes of withholding. Entertainment expenses treated as compensation will remain fully deductible by the employer as wages or salary; at the same time, such expenses will be subject to the proposed disallowance rules for purposes of determining deductibility by the employee. Expenses incurred by an employee and not reimbursed by or charged to his employer also will be subject to the proposed disallowance rules. Of course, the Administration proposal will not operate to allow deductions, but simply to disallow them. (2) Entertainment expenses paid or reimbursed, or entertainment provided, by an employer to an employee and not treated by the employer as compensation will be subject to the proposed disallowance rules for purposes of determining deductibility by the employer, but not for determining deductibility by the employee. Similar rules to prevent double disallowance will apply to independent contractors.

FIRST CLASS AIR FARE

Present Law

Transportation expenses may be deductible if incurred in connection with the taxpayer's travel away from home on business. The deductibility of such expenses depends on the primary purpose of the trip. If the trip is related primarily to the taxpayer's business, expenses of transportation to and from the destination are deductible. These expenses are not deductible if the trip is primarily personal in nature. The primary purpose of the trip is determined on the basis of the facts and circumstances in the individual case.

First class air fare generally is deductible under the above rules. However, first class air fare incurred in connection with travel to attend a foreign convention, is not deductible to the extent that it exceeds coach fare.

Reasons for Change

For most people, first class air fare is a luxury. The primary difference between a first class seat and a coach seat on an airplane is personal indulgence.

The speed of air travel may be a business necessity, but the luxury of first class seating is not. Both ends of the plane arrive at the same time. Coach seating adequately serves the business purpose.

Allowing the full amount of first class fare to be deducted, without taxing the first class portion to the recipient, provides a tax subsidy for first class travel. Thus, present law requires the many taxpayers who either cannot afford first class fare for themselves, or choose to forego it, to subsidize the personal benefits enjoyed by others.

General Explanation

To remove this tax subsidy, the President proposes to disallow deductions for the portion of air fare attributable to first class. The portion of first class fare which is equal to coach fare will remain deductible.

Specifically, the President proposes to disallow deductions for costs of regularly scheduled, commercial air transportation to the extent that they exceed the amount of

22-302 O - 78 - 17

the lowest priced, generally available fare for regularly scheduled flights between the same points at the same time of day. A fare will not be considered "generally available" if it is available only to those who fly on stand-by status, purchase tickets a specified period of time in advance, or stay at their destination a specified period of time. The deductibility of costs of air transportation which is noncommercial or not regularly scheduled will not be affected.

This proposal will apply to all currently deductible costs of regularly scheduled, commercial air transportation incurred in connection with the taxpayer's own travel on business (including, as under present law, travel to attend foreign conventions). Under the Administration's separate proposal on deductibility of entertainment expenses, the full amount of any transportation expenses incurred in connection with a trip whose sole purpose is to entertain the traveler will be disallowed.

Where first class air fare is furnished to an employee by his employer, a deduction for the portion of the fare attributable to first class will be disallowed to either the employer or the employee, but not both. For rules to prevent double disallowance, see the Technical Explanation of the Entertainment Expenses proposal.

Analysis of Impact

The major effect of this proposal will be to cause a shift in demand among business travellers using commercial airlines from first class to coach seats. However, some business travellers currently using first class travel may reduce their use of commercial airlines and shift to corporate aircraft.

Since first class seats sell for a higher price than coach seats, these expected shifts will cause some loss of revenue to the commercial airlines. At the same time, a change in airline seating configurations to increase the proportion of space devoted to coach travel would increase airline seating capacity. If these additional available seats are filled, the net loss of revenue to the airlines from the switch will be very small.

The proposal is expected to have little or no effect on overall use of air transportation or on employment in the air transportation industry. Employment will not decline because the existing air fleet will still be used to service roughly the same number of passengers.

Effective Date

The proposed change in the deductibility of first class air fare will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978 :	1979 :	1980 :	1981 :	1982 :	1983
--	281	311	337	368	401

FOREIGN CONVENTIONS

Present Law

Expenses of business travel away from home, including costs of transportation, meals, and lodging, may be deductible. If a trip is related primarily to the taxpayer's business, all travel expenses to and from the destination are deductible; none are deductible if the trip is primarily personal in nature. Even if expenses of traveling to and from the destination are not deductible, subsistence expenses incurred at the destination are deductible if allocable to the taxpayer's business.

Foreign travel is subject to a special allocation rule. If a trip outside the United States lasts longer than a week and 25 percent or more of the taxpayer's time on the trip is devoted to personal pursuits, all travel costs must be allocated between personal and business activities, generally in proportion to the number of days spent on each. Otherwise, the "primary purpose" test applicable to domestic travel applies.

Convention expenses are considered allocable to the taxpayer's business if the relationship between the taxpayer's trade or business and his attendance at the convention is such that by his attendance he is benefiting or advancing the interests of his trade or business. Whether such a relationship exists depends on the facts and circumstances of each case.

In 1976 Congress recognized the growing practice among professional, business and trade organizations to sponsor cruises, trips and conventions during which only a small portion of time was devoted to business activity. Committee reports noted that promotional material often highlighted the deductibility of expenses incurred in attending a foreign convention and, in some cases, described the meeting in such terms as a "tax-paid vacation" in a "glorious" location. Committee reports also noted that some organizations advertised that they would find a convention for the taxpayer to attend in any part of the world at any given time of the year.

In short, many taxpayers were attending foreign conventions primarily to take advantage of opportunities for sightseeing and recreation. However, since it was extremely difficult to distinguish between personal and business motives in taking such trips, often the personal element was

not disallowed. As a result, deductions for attending foreign conventions had become a source of tax abuse.

In an effort to prevent this abuse, the 1976 Tax Reform Act imposed special limitations on such deductions. Those limitations provide that when a person attends more than two foreign conventions in one tax year, no more than the costs of two conventions may be deducted.

With respect to foreign conventions for which a deduction is allowable, the 1976 Act limits the deductible amount. The amount deductible for transportation outside the United States, to and from a convention, generally may not exceed the lowest coach or economy rate charged by any commercial airline for such transportation during the month of the convention. This amount may be deducted in full only if at least half of the days of the trip, excluding transportation days, are devoted to business-related activities; otherwise, only a proportionate amount may be deducted.

The 1976 Act also limits the amount deductible for subsistence expenses. If at least six hours of business activities are scheduled during each day of the convention and an individual attends at least two-thirds of these activities, his subsistence expenses for each convention day may be deducted. If at least three hours of business activities are scheduled each day and the individual attends at least two-thirds, half of his subsistence expenses may be deducted. However, in no event may the amount of subsistence expenses deducted exceed the Federal per diem for the convention site.

Reasons for Change

The present limitations on deductions for attending foreign conventions are inadequate to prevent abuse. These rules allow taxpayers to take two foreign vacations a year at public expense, and opportunities for such vacations are not hard to find. For example, the California Trial Lawyers Association sponsored seminars all over the world for its members in 1977. The promotional booklet advertises as follows:

> Decide where you would like to go this year: Rome. The Alps. The Holy Land. Paris and London. The Orient. Cruise the Rhine River or the Mediterranean. Visit the islands in the Caribbean. Delight in the art treasures of Florence.

The booklet also notes that these trips have been "designed to qualify under the 1976 Tax Reform Act as deductible foreign seminars." This type of advertising breeds disrespect for the tax system.

Another group, the Association of Trial Lawyers of America, is holding its mid-winter convention in Monte Carlo this year. The word "convention" is the closest that a recent 4-page advertisement for the convention comes to mentioning business -- except to note that expenses of attending continuing legal education programs have been held deductible for Federal income tax purposes. The advertisement is devoted to describing the vacation aspects of Monte Carlo, "the jewel of the Riviera" and the "most exciting square mile on earth."

The 1976 tax provisions on foreign conventions not only fail to prevent abuse, but also increase tax complexity. They require close scrutiny of conference agendas and individual attendance records. In claiming deductions, it is particularly difficult for employers to be sure that the required number of hours of business activities were scheduled for each day of each convention and that each employee for whom expenses are deducted actually attended two-thirds of the scheduled activities.

General Explanation

To prevent abuse and simplify the law, the President proposes that expenses of attending a foreign convention be deductible only if it is as reasonable to hold the convention outside the United States and possessions as within. For purposes of this proposal, as under present law, conventions include seminars and similar meetings. The factors to be considered in determining reasonableness of the convention site are the purpose and activities of the convention; the purpose and activities of the sponsoring organization; the residence of active members of the sponsoring organization; the places at which other meetings of the sponsoring organization have been held; and the particular reason(s) why the convention is being held abroad rather than in the United States or possessions.

For example, if a significant portion of an organization's members resided in Canada, it could be considered as reasonable for the organization to hold a convention in Canada as in the United States. Similarly, if the members of an organization composed of individuals engaged in a certain type of business regularly conducted a portion of their business in Mexico, it could be considered as reasonable for the organization to hold a convention in Mexico as in the United States.

With respect to foreign conventions for which deductions are allowable, the limitations on deductible amount which were enacted in 1976 (including the detailed attendance rules) will not be continued. However, subsistence expenses will be nondeductible to the extent that they exceed 125

percent of the Federal per diem for the convention site. Thus, if it is as reasonable to hold a convention outside the United States as within and if the expenses of attending the convention are ordinary and necessary business expenses, then (subject to the allocation rules of pre-1976 law and any disallowance of the first class portion of air fare) the full cost of transportation to and from the convention will be deductible, and subsistence expenses will be deductible up to 125 percent of the Federal per diem.

Where an employee's expenses of attending a foreign convention are paid or reimbursed by his employer, a deduction for such expenses may be disallowed to either the employer or the employee, but not both. For rules to prevent double disallowance, see the Technical Explanation of the Entertainment Expenses proposal.

Analysis of Impact

The proposal will not decrease the number of conventions held outside the United States and possessions for non-vacation reasons. However, as compared to both pre-1976 and present law, the proposal can be expected to reduce the number of conventions held outside the United States and possessions which are essentially vacations at public expense.

Presumably most conventions not held outside the United States as a result of the proposal, will be held inside the United States. Thus, the proposal can be expected to increase the number of conventions held in this country and hence increase employment in some hotels and restaurants in the United States and possessions.

While the proposal can be expected to reduce the overall number of conventions held outside the United States and possessions by American organizations, as compared to present law the proposal probably will increase the number held in neighboring countries such as Canada because business reasons for holding conventions there are likely to exist.

Effective Date

The proposed change in the deductibility of expenses of travel to foreign conventions will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

III

★★★

Tax Exempt Financing

III-A

STATE AND LOCAL TAXABLE BOND OPTION

Present Law

Since the adoption of the Federal income tax in 1913, interest on State and local government obligations generally has been exempt from Federal income tax. This exemption represents a recognition of the independent sovereignty of States and their instrumentalities under our federal system as well as the desire to enhance the strength of State and local governments, as entities closest to the people, in solving local problems.

The exemption applies to all State and local government obligations, except for most industrial development bonds and arbitrage bonds. Industrial development bonds are obligations issued nominally by a State or local government to raise funds for private development. (See discussion in TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS.)

Arbitrage bonds are obligations issued to provide funds for financial investment, generally in taxable Federal securities. Since Federal credit underlies the arbitrage bonds, the issuer of such bonds is guaranteed a market and a profit at no risk to itself. Therefore, since 1969 the Code has provided that arbitrage bonds do not qualify for the exemption.

Reasons for Change

The tax exemption of interest on State and local bonds should not be interferred with in any way. Any recommendation for change in current financing mechanisms is intended only to complement rather than to replace tax exemption as a means of aiding State and local governments and to reduce the inequities and inefficiencies that arise when tax exemption provides the sole form of State and local financing.

The tax-exempt market for financing capital outlays of State and local governments is characterized by three interrelated problems. First, from the viewpoint of structural tax policy, tax exemption is an inequitable way of providing a subsidy to the State and local sector. Secondly, the subsidy provided by tax exemption is an inefficient one in that only a portion of the revenue loss to the Federal treasury results in benefits to State and local governments. Thirdly, the municipal bond market, while performing reasonably well over the long term, has, as a result of its tax-exempt character, exhibited periods of considerable instability which have been disruptive of the financial

planning of States and localities. Related to this last consideration, is the longer term concern that the sources of funds for State and local borrowing may not expand sufficientl'y to accommodate the capital financing requirements of the sector. Each of these problems of the municipal market will be considered in some detail. Each can be mitigated by the taxable bond option which will provide State and local governments with access to the market for taxable bonds in addition to the market for conventional tax-exempt securities.

Tax exemption and tax equity. A tax-exempt source of income, such as the interest on State and local bonds, violates the principles of both horizontal and vertical equity; that is, tax-exempt income reduces the progressivity of the tax structure and fails to tax all income alike. Vertical equity is violated since taxpayers in different income classes and, therefore, in different marginal tax brackets receive varying benefits from tax exemption. Thus, $100 of tax-exempt income is equivalent to $333 in before-tax income to an investor in the 70 percent marginal tax bracket but to only $143 to an investor in the 30 percent marginal tax bracket. Also, for reasons explained below, tax-exempt bonds are generally not economic investments for those in tax brackets below 30 percent. As a significant source of tax-exempt income, interest on municipal bonds, therefore, tends to undermine the progressivity of the tax structure.

Tax-exempt income also is a violation of horizontal equity since all sources of income are not taxed equally. Two taxpayers may have the exact same before-tax income -- in one case derived from wages and salaries and in the other from tax-exempt interest -- but will pay quite different amounts of tax. It has been claimed that holders of tax-exempt bonds do, in fact, pay a tax on their interest income since they receive a lower before tax yield than may be earned on comparable taxable debt. While this is true, this implicit tax on municipal bond interest generally amounts to only 30 percent, far less than the tax high-income investors would pay on fully taxable income.

Tax Exemption as an Inefficient Subsidy. Tax exemption provides a subsidy to State and local governments by enabling them to issue bonds at interest rates below those prevailing on comparable taxable securities. However, as a device to reduce State and local borrowing costs, tax exemption is an inefficient use of Federal funds because the loss in revenue to the Treasury is greater than the reduction in interest costs to the borrower. The difference accrues in the form of windfall gains to high-income purchasers of tax-exempt bonds.

To demonstrate the inefficiency of tax exemption as a subsidy, it is first necessary to determine the actual subsidy which tax exemption provides to State and local

governments. As Table IIIA-1 indicates, tax-exempt borrowers over the years have benefited from interest rates on average equal to about 70 percent of taxable rates. Thus, the implicit subsidy of tax exemption is equivalent to a 30 percent interest rate reduction. The 30 percent implicit subsidy to tax-exempt securities is an average across the maturity spectrum of State and local bonds as well as over time. The current operation of the municipal bond market provides a larger subsidy for securities with maturities of five years or less--on the order of 40 percent below taxable rates--and a smaller subsidy on 20 to 30 year securities--on the order of 25 percent. Thus, as maturities lengthen, interest rates for State and local bonds rise more steeply than those for comparable taxable debt. The reason for this is the domination of the shorter term municipal market by commercial banks. However, to simplify the analysis, the discussion which follows generally considers the market as a whole with an average implicit subsidy of 30 percent.

Although the average subsidy provided by tax exemption is 30 percent, a reasonable estimate of the average marginal tax rate of all purchasers of tax-exempt bonds -- households or individual investors, commercial banks, and other financial institutions -- is about 42 percent. In other words, if municipal bond interest income were subject to tax, issuers of this debt would lose a subsidy of 30 percent of the taxable rate and the Treasury would gain revenues equal to about 42 percent of the taxable rate. This means that less than 75 percent of the Treasury revenue loss flows to State and local governments.

There is no inconsistency in the fact that tax-exempt interest rates average about 70 percent of taxable rates at the same time that the average investor is in the 42 percent marginal tax bracket. Clearly, not all holders of tax-exempt debt are in the 42 percent tax bracket. Some, such as banks and high-income individuals are in higher tax brackets and others with smaller amounts of taxable income are in lower tax brackets. High-income taxpayers generally have a strong incentive to invest heavily in tax-exempt debt, since their after-tax returns from such investments tend to greatly exceed their after-tax returns on comparable taxable securities. Indeed, high tax bracket individuals and institutions comprise the bulk of the purchasers of tax-exempt bonds.

If issuers of bonds, however, wish to borrow more funds than are generally supplied from high-tax bracket individuals and institutions, tax-exempt debt has to be made attractive to potential lenders with more moderate incomes. The only way this can occur is by increasing the tax-exempt interest rate relative to the taxable rate so that tax-exempt bonds yield a higher after-tax return even to those in less than the highest tax brackets. To be sure, the very rich may also

be induced to increase their lending at more favorable tax-exempt rates, but tax-exempt rates will continue to rise until lenders across all tax brackets are supplying the exact amount of funds that State and local governments wish to borrow.

Table III A-1

Tax-Exempt and Taxable Interest Rates

Year	Tax-Exempt Interest Rate (Bond Buyer 20)	Taxable Interest Rate (Moody's Newly (Issued Industrials)	Ratio
1960	3.54	4.67	75.8
1961	3.45	4.70	73.4
1962	3.17	4.53	70.0
1963	3.16	4.42	71.5
1964	3.22	4.51	71.4
1965	3.25	4.80	67.7
1966	3.81	5.52	69.0
1967	3.92	5.79	67.7
1968	4.42	6.64	66.6
1969	5.66	7.84	72.2
1970	6.36	8.86	71.8
1971	5.52	7.80	70.8
1972	5.25	7.51	69.9
1973	5.22	7.86	66.4
1974	6.09	8.87	68.7
1975	7.06	9.12	77.4
1976	6.70	8.61	77.8
1977	5.68	8.15	69.7

Office of the Secretary of the Treasury
Office of Tax Analysis

January 18, 1978

This analysis indicates why tax-exempt bonds, on the average, trade at interest rates equal to 70 percent of those on taxable securities. For current levels of borrowing, it is necessary for tax-exempt rates to rise to the point where the investor in the 30 percent marginal tax bracket can benefit from buying tax-exempt bonds. Thus, while it was earlier stated that the average lenders of funds are in the 42 percent tax bracket, the last, or the marginal, lenders of funds are in about the 30 percent tax bracket. The marginal tax rate of the marginal lender determines the interest rate advantage to the issuing governments, but the marginal tax rate of all borrowers together determines the losses to the Treasury. The reason why tax exemption as a subsidy is inefficient is that the marginal tax rate of the last lender is below the marginal tax rate of all lenders taken together.

Individual investors, of course, are not the only source of funds for State and local governments. As considered below, commercial banks play a major role in the municipal bond market as well. Nonetheless, to the extent that State and local governments wish to borrow more than commercial banks are willing to lend, individual investors have to be drawn into the market. To attract individuals in lower tax brackets to tax-exempt bonds, tax-exempt rates must increase relative to taxable rates.

Thus, tax exemption as a source of tax inequity and as an inefficient subsidy are two reflections of the same image. A higher tax-exempt rate relative to the taxable rate means both a lower subsidy to State and local governments and greater windfall gains to high bracket individuals. An investor in the 50 percent tax bracket, for example, would be willing to buy tax-exempt bonds as long as the return was just about one-half of that on taxable instruments. As municipal rates rise to 60 percent, 65 percent and 70 percent of the taxable rate, this investor finds that the after-tax return becomes increasingly above that required to induce him to invest. This extra return is purely a windfall gain for him. Thus, the higher the tax-exempt rate relative to the taxable rate, the smaller the advantage of tax-exempt financing to the borrower and the greater the windfall gains to the lenders.

The Cyclical Volatility of the Tax-Exempt Market. The tax-exempt bond market, largely as a consequence of the tax exemption itself, exhibits a high degree of volatility over the business cycle. While the long-term trend of issues of State and local government securities has been upward as shown in Table IIIA-2, there have been periods of tight money, such as the years 1966 and 1969, when the volume of new issues has either been stagnant or has declined. Moreover, as indicated by the ratio of tax-exempt to taxable interest rates in Table IIIA-1, there is a strong tendency for tax-exempt rates to increase relative to taxable rates in

Table III A-2

Volume of Gross New Issues of Long-Term Municipal Bonds by Year

Year	Gross Issues
1960	7,229
1961	8,359
1962	8,558
1963	10,107
1964	10,544
1965	11,084
1966	11,089
1967	14,288
1968	16,374
1969	11,460
1970	17,762
1971	24,370
1972	22,941
1973	22,953
1974	22,824
1975	29,326
1976	33,845
1977	44,915

Office of the Secretary of the Treasury
Office of Tax Analysis

January 18, 1978

Source: Bond Buyer.

such periods. These phenomena mean that when credit conditions tighten State and local governments experience relatively higher borrowing costs and are among the first borrowers to be crowded out of capital markets.

To understand why the tax-exempt market exhibits this volatility, it is necessary to examine the behavior of the major participants in the municipal bond market. The traditional sources of lending to State and local governments consist of individuals and institutions in sufficiently high marginal tax brackets to find tax-exempt securities attractive. Three groups comprise the major sources of demand for State and local bonds: commercial banks, casualty insurance companies, and household investors. Table IIIA-3 shows the ownership of outstanding municipal securities by these three investor groups and all others taken together by five year intervals from 1960 through 1975. Table IIIA-4 indicates the annual net purchases of State and local bonds by these same investors over the period 1960 to 1976.

Table III A-3

Ownership of Municipal Securities

Year-End Outstandings, Selected Years

(millions of dollars)

Year	Total	Households		Commercial Banking		Nonlife Insurance		All Other	
		Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent
1960	$ 70.8	$ 30.8	43.5%	$ 17.7	25.0%	$ 8.1	11.4%	$ 14.2	20.1%
1965	100.3	36.4	36.3	38.8	38.7	11.3	11.3	13.8	13.8
1970	144.4	46.0	31.9	70.2	48.6	17.0	11.8	11.2	7.8
1975	221.9	67.5	30.4	102.8	46.3	33.3	15.0	18.3	8.3
1977 1/	259.1	79.7	30.8	114.2	44.1	42.8	16.5	22.4	8.7

Office of the Secretary of the Treasury
Office of Tax Analysis

January 18, 1978

Source: Federal Reserve Board, flow of funds data.

1/ Estimated for end of third quarter.

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Table III A-4

Net Change in Ownership of Municipal Securities

Seasonally Adjusted Annual Rates

Year	Total		Individuals		Commercial Banks		Fire & Casualty Insurance Companies		All Other	
	Billions of Dollars	Percent	Billions of Dollars	Percent	Billions of Dollars	Percent	Billions of Dollars	Percent	Billions of Dollars	Percent
1960	5.3	100.0	3.6	67.9	.6	11.3	.8	15.1	.3	5.7
1961	5.1	100.0	1.2	23.5	2.8	54.9	1.0	19.6	.1	2.0
1962	5.4	100.0	-1.0	-18.5	5.7	105.6	.8	14.8	-.1	-1.9
1963	5.7	100.0	1.0	17.6	3.9	68.4	.7	12.3	.1	1.8
1964	6.0	100.0	2.6	43.3	3.6	60.0	.4	6.7	-.6	-10.0
1965	7.3	100.0	1.8	24.7	5.1	69.9	.4	5.5	.0	-
1966	5.6	100.0	4.0	71.4	2.4	42.9	0.7	12.5	-1.5	-26.8
1967	7.8	100.0	-2.3	-29.5	9.1	116.7	1.5	19.2	-.5	-6.4
1968	9.5	100.0	-.5	-5.3	8.6	90.5	0.9	9.5	0.5	5.3
1969	9.9	100.0	9.3	93.9	.6	6.1	1.1	11.1	-1.1	-11.1
1970	11.2	100.0	-.9	-8.0	10.7	95.5	1.5	13.4	-.1	-0.9
1971	17.4	100.0	0.1	0.6	12.6	72.4	3.5	20.1	1.2	6.9
1972	14.7	100.0	2.3	15.7	7.2	49.0	4.3	29.3	.9	6.1
1973	14.7	100.0	5.3	36.1	5.7	38.8	3.6	24.5	.1	0.7
1974	17.1	100.0	8.9	52.1	5.5	32.2	2.2	12.9	.5	2.9
1975	13.6	100.0	5.0	36.8	1.7	12.5	2.6	19.1	4.3	31.6
1976	15.1	100.0	4.2	27.8	3.0	19.9	4.2	27.8	3.7	24.5
1977 1/	29.0	100.0	9.3	32.1	11.9	41.0	7.2	24.8	0.6	2.1

Office of the Secretary of the Treasury
Office of Tax Analysis

January 18, 1978

1/ First three quarters of year expresse at annual rates.

Source: Federal Reserve Board, flow of funds data.

These tables illustrate the important impact of commercial bank behavior on the municipal bond market. When money is tight, commercial banks first look to meet the demand for loans by their customary business clients, and only as their resources permit do they purchase municipal bonds. Thus, the most difficult periods of financing for States and localities are generally when commercial banks are able to absorb only a small portion of the net issues of municipal debt, such as occured in the years 1966 and 1969 and more recently in 1975 and 1976. During these periods, increased purchases of municipal debt by households only partially offset the decline in commercial bank participation. Borrowing costs to State and local governments rise, and the dollar volume of new issues falls. The reason tax-exempt rates must rise when banks leave the market is to provide a sufficient incentive for households to absorb a larger share of municipal debt. In periods of credit stringency, then, the loss of bank demand for municipal bonds is only partially compensated by increased household purchases. At the same time, the rise in the tax-exempt rate relative to the taxable rate reduces the value of the subsidy provided by tax exemption.

Tables IIIA-3 and IIIA-4 also indicate that the overall participation of commercial banks in the municipal bond market has declined in recent years. Throughout the 1960's, commercial banks absorbed 63 percent of the total supply of State and local debt. In the 1970's commercial banks have absorbed only 40 percent. Table IIIA-5 presents even more sharply the declining role of commercial banks in the municipal bond market. This table shows net changes in holdings of credit market instruments other than U.S. securities by commercial banks since 1965. Through 1971, municipal bonds generally amounted to 50 percent of commercial bank acquisitions of credit market securities. Since 1972, however, partly as a result of the availability of other sources of tax-favored income, the share of such security purchases accounted for by State and local bonds has declined to the range of 20 to 30 percent. Thus, in addition to the cyclical volatility of the market, there is some concern that traditional purchasers of tax-exempt debt will fail to provide funds for State and local capital financing over the longer term. In 1975 and 1976, other investors took up the slack of a reduced volume of purchases by commercial banks. In part these other investors were State and local pension funds whose purchases reflect the unusual circumstances in New York City and State. Since pension funds derive no advantage from tax exemption, they cannot be expected to continue as a permanent source of State and local financing.

Table III A-5

Net Changes in Holdings of Credit Market

Instruments Other Than U.S. Securities by Commercial Banks

Year	State & Local Bonds	Corporate Bonds	Commercial Mortgages	Other Mortgages	Total	State & Local Bonds as Percentage of Total
	(.....billions of dollars.....)					(.....%.....)
1965	5.1	-.1	2.0	3.7	10.7	47.7
1966	2.4	*	2.0	2.7	7.1	33.8
1967	9.1	0.8	1.6	3.0	14.4	63.2
1968	8.6	0.3	2.6	4.0	15.4	55.8
1969	0.6	-.1	1.8	3.7	6.0	10.0
1970	10.7	0.8	1.2	1.0	13.6	78.7
1971	12.6	1.2	3.0	6.7	23.6	53.4
1972	7.2	1.7	5.4	11.4	25.6	28.1
1973	5.7	0.4	6.9	12.8	25.9	22.0
1974	5.5	1.1	5.0	7.9	19.4	28.4
1975	1.7	1.8	3.2	1.1	7.8	21.8
1976	2.9	-0.6	2.6	11.0	15.9	18.2
1977 1/	11.9	-0.4	8.0	18.1	37.6	31.7

Office of the Secretary of the Treasury
Office of Tax Analysis

January 18, 1978

1/ First three quarters expressed at annual rates.

* Less than $0.05 billion.

General Explanation

The Administration proposal will establish an election in the Internal Revenue Code for State and local governments to issue taxable bonds and other debt obligations with the Federal Government paying a fixed portion of the actual dollar amount of the issuer's interest cost. For obligations issued during 1979 and 1980, the Federal Government will pay 35 percent of the interest cost. For obligations issued thereafter, the Federal Government pay 40 percent. All tax-exempt State and local obligations will be eligible for this taxable bond alternative. These include general obligation and revenue bonds issued by a State and local government as well as industrial development bonds, the interest on which is tax exempt. There would be no Federal control over the purposes for which the taxable obligations could be issued. However, obligations held by related entities (such as related pension funds) would be eligible for the election only if the obligations were issued through a competitive public offering. The Federal interest subsidy would be paid to the issuer (or its paying agent) which would act as paying agent for the Federal Government. The Federal Government would not be liable for its portion of the interest until the issuer pays the remaining interest. The proposal would establish an entitlement for State and local governments to assure that funds necessary to pay the Federal Government's portion of the interest would be appropriated annually.

Analysis of Impact

The taxable bond option, under which State and local governments will have the choice of issuing either conventional tax-exempt bonds or subsidized taxable bonds, will deal simultaneously with all of the major problems in the tax exempt bond market. To determine the extent to which the taxable bond option will contribute to tax equity, the efficiency of the subsidy now provided to State and local governments, and the stability of the municipal bond market, it is first necessary to analyze how the option will operate.

Under the taxable bond option, State and local governments which choose to issue taxable bond in place of tax-exempt bonds will receive a Federal subsidy equal to a fixed percentage of the interest costs on the taxable securities. It is important to emphasize the voluntary nature of this plan. State and local governments on their own volition will decide whether they wish to issue subsidized taxable or conventional tax-exempt debt. Since this decision will presumably be made on the basis of which type of security affords the lower net interest cost, State and local governments can only benefit from the plan. If the subsidized taxable bond fails to yield lower net interest costs, States and localities simply will not avail themselves

of it. Furthermore, the higher the subsidy the greater the benefits to the issuing governments.

Nonetheless, some representatives of State and local governments have expressed a concern that the subsidy rate could be too high. The basis of this concern is that if taxable bonds were made too attractive, the tax-exempt market would virtually disappear and issuers would no longer have available a tax-exempt market in the event that the subsidy to taxable bonds were discontinued. On these grounds, the subsidy should never be so high as to completely eliminate the tax-exempt market.

On the other hand, too low a rate of subsidy would clearly undermine the objectives of the plan. A low subsidy would in the first instance accomplish little in solving the basic problems of the tax-exempt market. In addition, the subsidy must be large enough to elicit a sufficiently large volume of issues of the new taxable security to generate market acceptance. If only a slight volume of taxable municipal debt were issued, such debt could very well be regarded as a mere market curiosity with little secondary trading, poor liquidity characteristics, and an attendant loss of interest on the part of potential lenders. Thus, the subsidy under the taxable bond option must be provided at a level which will maintain both the taxable and the tax-exempt alternatives for State and local financing. It must neither be so high as to eliminate the tax-exempt market nor so low as to preclude the development of a taxable municipal market. A permanent subsidy of 40 percent (after a two year transitional subsidy of 35 percent) would maintain markets for both taxable and tax-exempt municipal debt.

The permanent 40 percent subsidy on taxable bonds will operate as follows. For each of their bond issues, State and local governments presumably will accept bids on both a tax-exempt and a taxable basis. Then, after accounting for the Federal subsidy on taxable bonds, they will decide which form of security will yield the lower interest costs. Initially, with market yields unchanged, it may be expected that subsidized taxable bonds would provide the lower interest costs. In fact, to forestall too large an initial shift of financing out of the tax-exempt market which could have a disruptive impact on that market, the subsidy for the first two years of operation of the plan is set at 35 percent rather than 40 percent. As the volume of tax-exempt debt declines in response to the taxable subsidy, interest rates on tax-exempt debt also will decline, since the reduced volume will no longer require higher interest rates to attract marginal lenders.

This decline in tax-exempt rates will itself keep tax-exempt financing attractive, and the flexibility of financial markets will soon effect an equivalence of interest

costs between subsidized taxable and tax-exempt debt. The issuing governments themselves, along with the underwriters of their debt, will be instrumental in bringing this equivalence about since States and localities will tend to issue debt in that sector of the market providing the most advantageous financing terms. Thus, State and local governments will generally face a situation where the interest costs of taxable borrowing (net of the Federal subsidy) will equal the costs of tax-exempt borrowing. At this point, the issuing governments will be indifferent to the particular type of debt they issue, and the form of debt will merely reflect the market preferences of lenders for tax-exempt as opposed to taxable securities.

The voluntary nature of the plan assures that States and localities will gain significant benefits in terms of reduced borrowing costs. They will only choose the taxable option if it offers cost advantages. As long as taxable bonds are issued, however, tax-exempt interest costs will also decline. Thus, a saving in interest costs will occur on the total volume of debt issued and will be independent of the form in which it is issued. The equilibrium outcome, then, will be that under the 40 percent subsidy, tax-exempt interest rates will be 40 percent below taxable rates and States and localities will be indifferent between issuing subsidized taxable or tax-exempt debt.

The benefits of the taxable bond option will accrue to all issuers of tax-exempt debt regardless of their relative credit standings. The Federal Government's agreement to pay a portion of the interest cost on taxable bonds will not in any way constitute a guarantee of the issuer's obligation to pay principal or its portion of the interest cost. Consequently, the taxable bond option will not enable issuers with a poor credit standing to gain any greater access to financial markets than that available to more creditworthy issuers. The taxable bond option will establish a tax-exempt rate for all grades of issuers at approximately 60 percent of the taxable rate for comparable credits. All issuers, therefore--both those with good and poor credit standings--will benefit from a reduction in their borrowing costs.

The new volume of issues of taxable and tax-exempt debt under a 40 percent subsidy is not easy to estimate. It depends not only on what lenders will wish to hold in their portfolios at the new structure of interest rates but also on how quickly they will be able to adjust their portfolios from their current pattern of holdings. A reasonable calculation, based on informed market opinion as well as on estimates derived from econometric models, is that after an adjustment period of possibly five years, about 25 percent of State and local bond issues will be in taxable form and 75 percent in tax-exempt form. This is the likely response to tax-exempt

rates 40 percent below taxable rates rather than 30 percent as under current law. In the short run, however, in order to bring about this large a portfolio shift in long-run asset holdings, perhaps 50 percent of the market will be taxable until final equilibrium is achieved. The revenue estimates provided below reflect these assumptions.

Effects on Equity. On equity grounds, a 40 percent subsidy will mean a higher implicit tax rate on those holding municipal bonds -- 40 percent rather than the current implicit tax rate of about 30 percent. Very high-bracket taxpayers will continue to find tax-exempt bonds to be an advantageous investment since even the increased implicit tax of 40 percent will remain below the explicit taxes they will pay on taxable debt. Nonetheless, the after-tax income distribution in general will exhibit greater equity as a result of the reduced opportunity for tax avoidance by those in high-income tax brackets.

The improvement in tax equity will be brought about in two ways. First, there will be a smaller volume of tax-exempt debt available as some State and local governments choose to issue subsidized taxable rather than tax-exempt debt. Secondly, the tax-exempt debt which continues to be issued will command lower interest rates on the market. For both of these reasons, the dollar volume of interest income avoiding tax would be reduced by about 35 percent under the taxable bond option. At current levels, this will amount to a reduction of tax-exempt interest income of about $4.0 billion.

Effects on Tax Exemption as a Subsidy. The taxable bond option also will increase the efficiency of the current subsidy which tax exemption provides to State and local governments. Under current law, these governments receive less than 75 cents in reduced interest costs for each dollar of tax revenue foregone by the Federal Treasury. The incremental benefit to cost ratio under the taxable bond option is much more favorable. In the first five years of the plan, each dollar of Federal subsidy net of revenue gain will provide between $2 and $2.50 of interest savings. In the long run, this number will rise to over $4 per dollar of net Federal cost.

The high leverage of the taxable bond option as measured by State and local interest saving per dollar of net Federal cost results from two sources. The first, as already noted, is that the subsidy is only paid on issues of taxable bonds, whereas States and localities also benefit from the lower interest rates which will prevail on tax-exempt bonds. The second source of the high leverage of this plan is the fact that a portion of the cost of subsidizing taxable municipal bonds will be recouped as increased tax revenues on the new taxable securities. The result is that the net cost of the

taxable bond option is considerably lower than the gross outlays for the subsidy. Under the assumption that the option is made available on January 1, 1979, the saving in interest costs for States and localities beyond that currently provided by tax exemption is as follows:

Calendar Year
($ billions)

1979	1980	1981	1982	1983
0.1	0.3	0.5	0.9	1.3

Effects on Cyclical Volatility. The taxable bond option will also help to solve the problem of the cyclical volatility of the municipal market. The main source of this short-run volatility, as well as a possible troublesome development in the long run, is the tendency of commercial banks to abandon the tax-exempt market causing tax-exempt interest rates to rise. Under the taxable bond option, the tax-exempt rate will be linked necessarily to the taxable rate by the subsidy percentage. With a 40 percent subsidy, borrowers trying to minimize interest costs will maintain the tax-exempt rate at 60 percent of the taxable rate. If the tax-exempt rate were to temporarily rise to more than 60 percent of the taxable rate, State and local governments would switch their new issues from the tax-exempt to the subsidized taxable market until the tax-exempt rate again declined to 60 percent of the taxable rate. Since the taxable bond option will assure that the tax-exempt rate is effectively tied to 60 percent of the taxable rate, the withdrawal of commercial banks from the tax-exempt market will not cause a rise in State and local borrowing costs. Instead, a decline in commercial bank participation will be reflected in an increased volume of taxable issues as State and local governments compensate for the lost bank demand by turning to other sources of lending such as tax-exempt institutions, life insurance companies and individual investors who are not interested in tax exemption. The taxable bond option will allow these governments to retain the benefit of a constant borrowing cost differential below taxable rates because they will be able to tap new sources of funds and new investors beyond those who now derive advantages from tax-exempt interest income.

Effective Date

The taxable bond option will apply to obligations issued after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years				
1978 :	1979 :	1980 :	1981 :	1982 : 1983
—	156	465	863	1355 1808

Outlay Estimate

Change in Outlays
($ millions)

Calendar Years				
1978 :	1979 :	1980 :	1981 :	1982 : 1983
--	199	592	1115	1770 2374

Technical Explanation

The Internal Revenue Code will provide an election for State and local governments, possessions or territories of the United States and the District of Columbia, to issue taxable obligations. The Federal Government will provide an interest subsidy of 35 percent of the interest cost on taxable obligations issued during 1979 and 1980, and 40 percent for obligations issued thereafter.

Form of Election. The election will be made in the form of a notice to the Secretary of the Treasury (or another official designated by the Secretary).

A separate election will be made by the issuer for each taxable issue. It is intended that the election be made at any time before the obligations are, in fact, issued (i.e., before there is a physical delivery of the evidences of indebtedness in exchange for the issue price). Thus, the issuer will be able to request dual bids (separate bids for tax-exempt bonds and for taxable bonds) and make the election based upon the bids received for both types of bonds.1/

An election with respect to any issue will be irrevocable once the obligations are issued. Thus, any notification to the Federal Government relating to an

election could be withdrawn at any time before obligations are issued. No advance ruling or any other form of advance approval by the Secretary or any other Federal official will be required before the election can be made.2/

Eligibility. In general, all obligations the interest on which is exempt from tax under the Internal Revenue Code will be eligible for the taxable bond election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. Also, industrial development bonds, the interest on which is exempt from tax under the Internal Revenue Code, and obligations the interest on which is presently tax-exempt under the Housing Act of 1937 will be eligible for the election. The election will not apply to arbitrage bonds, which are denied tax exemption under the Code, non-exempt industrial development bonds and obligations whose exemption derives from provisions other than the Internal Revenue Code or the Housing Act of 1937.

Obligations on which the United States guarantees all or part of the principal or interest or is liable to pay any part of the principal or interest will not be eligible for the subsidy. Further, obligations which the United States is committed to purchase as a means of providing financial assistance will not be eligible for the subsidy. For example, the United States may purchase or promise to purchase obligations at a price higher than the market price as a means of guaranteeing the bonds or subsidizing their interest payments.

Obligations will be eligible for this subsidy, however, even though the United States indirectly provides funds for the payment of part of the principal or interest. For example, obligations issued under Section 8 of the Housing Act of 1937 will be eligible for the subsidy.

Related Entities. The election to issue taxable bonds will not apply to any obligation which is held by an entity related to the issuer if the obligation is not issued pursuant to a public underwriting. This requirement is intended to prevent issuance of taxable bonds at an inflated rate to take advantage of the Federal subsidy. Since a State or local government may be making payments to related entities in any event, its share of an inflated interest rate may not be a real cost. Where these obligations are distributed through a public underwriting, the Federal Government can be assured that the interest rate on any obligation held by related entities is not overstated. In limited circumstances where a State or local government needs immediate funding and there is no public market for the obligations, the Secretary may waive the requirement of a public underwriting if he is satisfied that the interest rate is not artificially inflated.

An issue of obligations will be considered to have been issued pursuant to a public underwriting if the obligations are purchased by independent underwriters for resale to the general public. An issue will not be considered to have been purchased for resale to the general public unless at least 40 percent of the face amount of the issue is acquired for investment by persons which are not related entities. Further, in any case in which an issue is composed of obligations bearing different rates of interest, at least 40 percent of the face amount of the obligations issued at each separate interest rate must be acquired for investment purposes by persons who are not related entities.

Related entities include, in the case of a State, any political subdivision of the State, and, in the case of a political subdivision of a State, the State itself and any other political subdivision of the same State. Thus, unless issued in a public underwriting, bonds of one municipality purchased by another municipality within the same State will not be eligible for the taxable bond election. Furthermore, the State cannot, except through a public underwriting, buy eligible obligations of any of its municipalities nor can municipalities buy eligible obligations of their State. Any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) will be treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of the municipality, of all other municipalities of the State, and of the State. However, a municipal bond bank, whose function is to assist the marketing of obligations of small governmental issuers, will not be treated as a related party. Finally, in the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States will be considered related entities to the instrumentality.

Arbitrage. The arbitrage bond provisions of the Code currently applicable to tax-exempt bonds will be applicable to taxable bonds issued under the election. Thus, bonds denied the tax exemption under the arbitrage rules of the Code will not be eligible for the subsidy. In determining whether or not an obligation is an arbitrage bond (i.e., whether its proceeds are reasonably expected to be used to acquire securities which will produce a yield materially higher than the yield on the obligations issued), the yield on the issue will be determined with reference only to that portion of the yield which is to be paid by the issuing State or local government. In this way municipalities will have no incentive to issue taxable obligations in order to reinvest the proceeds in other taxable securities.

Payment of Subsidy. The Federal Government will make a payment of 35 or 40 percent (depending on the date on which the obligation was issued) of the interest liability of the issuer on each obligation to which a taxable bond election applies. The Treasury Department will pay its portion of the interest to the issuer (or to a paying agent appointed by the issuer). However, the Federal Government will not be liable for its payment on the obligation until the issuer has paid its portion of the interest on the obligation. Thus, if a State or local government defaults on its interest payment, the Federal Government will not be required to pay its portion of the interest on the obligation. Of course, the Federal Government will pay its portion at any time that the issuer cures its default by making its payment to the holders of the obligation.

The interest subsidy payment will be made without any condition or requirement by the Secretary of the Treasury. Thus, unless the bond or other obligation is determined to be ineligible for the election under the Code, the payment will be made automatically. In addition, the purposes for which the obligation is issued will not be reviewed by the Secretary as long as the obligation qualifies for the election under the Code.

The availability of funds necessary to finance the Federal interest subsidy will be assured by establishing an entitlement for State and local governments to the amount of appropriations necessary to pay the full accrued cost of the interest subsidy. Annual appropriations of the necessary funds will be automatic since, if no funds are appropriated, State and local government issuers will be able to sue the United States in the Court of Claims for payment of the funds. Such legal action will not be necessary since the Congress has not once failed to appropriate funds under entitlement programs.

Footnotes

1/ It is anticipated that bids on issues of serial bonds (i.e., where the bonds in the issue have varying maturities) will often indicate that a State or local government should split its issue, with the longer term bonds being taxable and the shorter term bonds tax-exempt. Nothing in this proposal will prevent a State or local government from splitting such an issue. For purposes of these provisions, however, the taxable bonds and the tax-exempt bonds will be considered to be separate issues.

2/ Of course, if a tax ruling is requested by the issuer prior to making the election, the Treasury Department will require that appropriate documents, as is the case today for tax-exempt bond rulings, be submitted or be made available to show that the obligations included in the issue qualify for the election under the Internal Revenue Code.

IIIB

TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS

Present Law

Industrial development bonds (IDBs) are obligations which raise capital for private business enterprise but are nominally issued by State or local governments. Most frequently, the proceeds of an issue of IDBs are used to acquire or to construct a facility; the facility is then "leased" to a private user for a rental exactly sufficient to pay debt service on the bonds. The lease generally provides that the private user may purchase the facility for a nominal amount at the end of the lease term. Payment of debt service on the bonds is secured by the rental payments and the facility itself. Generally the nominal issuer is not liable for payment of debt service on the bonds and the holders must look solely to the credit of the private user.

In issuing IDBs a State or local government essentially lends its tax exemption to a private business to enable it to finance facilities at the lower interest rates prevailing in the tax exempt market. In addition, the "lease" agreement between the issuer and the private user is generally treated as a conditional sale contract for Federal income tax purposes; the user is, therefore, able to obtain the tax benefits associated with ownership of the property, including investment tax credits and accelerated depreciation or amortization. State and local governments use IDB financing to assist local industrial development. Since these governments incur no liability on the bonds, which are universally recognized as a debt of the private user, the issuance of IDBs has no direct consequence to the nominal issuer.

Interest on State and local government obligations is generally exempt from tax under the Internal Revenue Code. However, the Revenue and Expenditure Control Act of 1968 denied tax exemption to IDBs, with certain exceptions. In general, a bond is an IDB under the Code if (1) the proceeds of the issue are to be used in any trade or business not carried on by a government or tax-exempt organization and if (2) repayment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in a trade or business. Obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax exempt.

The exceptions to the general rule allow tax exemption for IDBs issued to finance certain enumerated facilities and for certain "small issues". The enumerated facilities for which tax-exempt IDBs may be issued without any dollar amount limitation, include:

(1) Residential real property for family units,

(2) Sports facilities,

(3) Convention or trade show facilities,

(4) Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to these facilities,

(5) Public utility facilities used to provide sewage treatment or solid waste disposal and facilities designed for the local furnishing of electric energy or gas,

(6) Air or water pollution control facilities,

(7) Facilities for the furnishing of water, if available on reasonable demand to members of the general public, and

(8) Industrial parks.

There is also an exemption for "small issues" of IDBs in amounts of $1 million or less if the proceeds are used for the acquisition or construction of land or depreciable property. The $1 million limitation applies to all bonds issued to provide facilities in one municipality or county for the same person or group of related persons. At the election of the issuer, the $1 million limitation may be increased to $5 million; if elected, however, the higher $5 million limitation is restricted to projects where the total capital expenditures over a 6-year period will not exceed $5 million.

Reasons for Change

Prior to 1968, interest on industrial development bonds (IDBs) issued by State and local governments had been exempt from Federal income taxation. The use of such IDBs had been growing in importance as a mechanism by which State and local governments sought to attract plants to their communities. Through the use of IDBs, these governments had been able to extend the tax exemption afforded to interest on their securities issued for public investment to interest on bonds issued for essentially private purposes. Of course, as many

States and localities came to utilize this method, the competitive advantage was lost and the increased volume of tax-exempt financing affected the interest cost of public issues. These factors, and fear of increasing revenue losses to Treasury as use of this method of financing long-term private debt expanded, led to the limits on tax-exempt IDBs included in the Revenue and Expenditure Control Act of 1968.

In this Act, Congress did not remove the exemption for all industrial development bonds. In terms of the dollar volume of obligations, the most important of the exceptions that remain is for financing pollution control expenditures. As Table IIIB-1 shows, pollution control IDBs for the years 1973 - 1977 accounted for over 80 percent of private tax-exempt borrowing, and for 6 to 7 percent of all tax-exempt borrowing.

Table IIIB-1

Tax-Exempt Borrowing: 1971-1977

Year	Gross Long-Term Tax-Exempt Borrowing ($millions)	Private IDBs 1/		Pollution Control as Percent of:	
		Pollution Control ($millions)	Others ($millions)	All Tax-Exempt	Private IDB's
1971	24,370	77	220	0.9	25.9
1972	22,941	563	471	2.5	54.5
1973	22,953	1771	270	7.7	86.8
1974	22,824	1673	340	7.3	83.1
1975	29,326	2134	518	7.3	80.5
1976	33,845	2064	357	6.1	85.3
1977	44,915	2982	476	6.6	86.2

Source: Weekly Bond Buyer

1/ Includes pollution control, small issues and industrial park IDBs. Does not include IDBs of a quasi-governmental character, such as airports, docks, wharves, and residential real property for family units.

As recently as 1971, in contrast, tax-exempt financing of pollution control facilities accounted for less than one percent of all tax-exempt borrowing. In fact, the annual volume of tax-exempt pollution control financing today is more than double the total annual volume of all industrial development bond financing in 1967 ($1.4 billion) which had motivated legislation to limit the use of tax-exempt IDBs. 1/

Table IIIB-2 shows how dramatically tax-exempt borrowing has increased as a source of funds for pollution control expenditures. Using estimates on air and water pollution control expenditures supplied by McGraw-Hill, the table shows that tax-exempt borrowing financed only 2.4 percent of pollution control expenditures in 1971. In contrast, tax-exempt borrowing has accounted for between one-fourth and one-third of all pollution control expenditures for the years 1973 through 1976.

Table IIIB-2

Importance of Tax-Exempt Borrowing for Pollution Control Expenditures

Year	Industrial Pollution Control Borrowing ($millions)	Air and Water Pollution Control Expenditures BEA ($millions)	Air and Water Pollution Control Expenditures McGraw-Hill ($millions)	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing BEA	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing McGraw-Hill
1971	77	n.a.	3245	n.a.	2.4
1972	563	3913	4501	14.4	12.5
1973	1771	4938	5687	35.9	31.1
1974	1673	5219	6922	32.1	24.2
1975	2134	6152	6702	34.7	31.8
1976	2064	6336	7713	32.6	26.8

Source: Weekly Bond Buyer, various issues, U.S. Department of Commerce, Bureau of Economic Analysis (BEA) Survey of Current Business, July issues, McGraw Hill, Pollution Control Expenditures; Annual Surveys

In permitting the pollution control exception in 1968, Congress could not have contemplated this large a volume of tax-exempt financing. It was argued at that time that private investments for pollution control could justify some type of Federal subsidy since these investments produced

22-302 O - 78 - 19

benefits to the public in terms of environmental improvement for which firms might not be compensated in private markets. Moreover, it was argued that the low level of spending on such investments assured that the revenue loss from exempting the interest on IDBs used to finance them would be small.

Furthermore, whatever their merit in the past, the reasons for allowing tax free interest on IDBs for pollution control no longer apply. In recent years, many pollution control investments have been effectively mandated by the requirements of Federal law and by EPA regulations that firms meet specified emissions standards.2/ Because these regulations compel firms to undertake the desired investments, tax exemption no longer functions as an effective incentive.

Moreover, continuing to allow tax-free IDBs to finance pollution control facilities has three undesirable effects:

1) It lessens tax equity by increasing the amount of interest income which is tax-exempt.

2) It creates economic inefficiencies by encouraging the wrong types of investments in pollution control equipment and by subsidizing some industries relative to others.

3) It raises the cost to State and local governments of borrowing in the tax-exempt market for public sector investments.

Thus, as discussed in detail below, the elimination of tax-exempt financing for pollution control equipment would promote tax equity and economic efficiency and would lower the cost of borrowing to State and local governments.

The two other types of tax-exempt IDBs that relate to borrowing for essentially private purposes are small issue IDBs and IDBs for industrial parks. Repealing the tax-exempt treatment of these bonds would also improve tax equity, increase economic efficiency, and reduce borrowing costs to State and local governments. However, an exception should be made for small issue IDBs in some economically distressed areas to promote economic development where it is most needed.

Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Limits on such financing are complementary to other proposals included in the Administration's Hospital Cost Containment Act designed to prevent excess expansion of hospital facilities.

General Explanation

The Administration proposal will revise the tax law relating to IDBs in three respects. First, it will repeal the tax exemption for IDBs issued to finance pollution control facilities and industrial parks. These facilities will be placed on the same footing as other purely private facilities. The proposal will thus restrict access to the tax-exempt market to bonds issued to finance activities and facilities which are generally governmental in nature, thereby improving the access of those bonds to the market.

Second, the Administration proposal will revise the small issue exemption by doubling the $5 million small issue limitation to $10 million. The proposal will also limit this exemption to IDBs issued to finance the acquisition or construction of land or depreciable property in economically distressed areas. The utility of the small issue exemption will thus be enhanced, while at the same time the subsidy afforded by tax exemption will be targeted towards those areas in which it is most needed.

Third, as part of the Administration's Hospital Cost Containment program, the proposal will revise the definition of industrial development bonds to deny tax exemption to obligations issued to finance certain hospitals for which a certification of need has not been issued. Under present law, obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax-exempt. Under the Administration proposal, the definition of a taxable IDB will be expanded to include obligations issued to finance hospital facilities that are operated by such organizations, unless a need for the facilities has been established under the relevant provisions of the Public Health Services Act or the Social Security Act. If a need for the facility has been established, interest on the bond will remain tax-exempt.

Any industrial development bonds which can be issued on a tax-exempt basis may, at the election of the issuer, qualify for the Federal interest subsidy provided for State and local government issues under the Administration's taxable bond option proposal. (See TAXABLE BOND OPTION.)

Analysis of Impact

Pollution Control Bonds

It is undesirable to continue financing of pollution control investment with tax-exempt bonds because they decrease tax equity, reduce economic efficiency, and increase State and local borrowing costs.

Tax Equity. The existence of an opportunity to earn tax free income from any type of investment reduces the effective progressivity of the tax system by enabling high-income individuals to earn greater after-tax returns on capital than they otherwise would obtain. This windfall to high bracket lenders occurs because individuals in high tax brackets have more to gain from owning a tax free asset than individuals in low tax brackets. As the relative volume of tax-exempt borrowing increases, the interest rates on such bonds as compared to the rate on taxable bonds must rise to make them attractive to investors in lower tax brackets. As a result, the interest rate differential, in equilibrium, between tax-free and taxable bonds will be determined by the relative supplies of the two types of securities and by the statutory schedule of marginal tax rates. In the equilibrium thus determined, the lowest bracket buyer is indifferent between holding tax-exempt and taxable assets, while the higher bracket buyer receives a higher rate than needed to attract him to the tax-exempt asset.

In recent years, the interest rate differential between equivalent quality tax-exempt and taxable bonds has been equal to approximately 30 percent of the taxable interest rate. This means that any taxpayer with a marginal tax rate of above 30 percent would obtain a higher after-tax yield from tax-exempt bonds than from taxable bonds. In effect, the high income investor will pay an implicit tax, reflected in a lower gross interest rate, of 30 percent on tax-exempt securities rather than the rate that would otherwise be determined by his marginal tax bracket.

If the relative supply of tax-exempt bonds continues to increase by the issuance of more pollution control IDBs, the interest rate differential between taxable and tax-exempt bonds will fall, lowering the implicit tax on owners of tax-exempt bonds and increasing their windfall gain. The effective progressivity of the tax system will decrease, moving another step away from the nominal progressivity reflected in the statutory schedule of tax rates.

Eliminating the use of tax-exempt IDBs to finance pollution control investments will increase the amount of interest income subject to tax. The windfall gains to high income lenders from tax-exempt interest would fall, making the tax system more progressive relative to current law.

Economic Efficiency. It may be generally viewed as improper to allow private borrowers to avail themselves of the tax-exempt market. While this view is based on a common notion of fairness, allowing some firms to borrow at privileged rates also can have very harmful effects on economic efficiency by encouraging misallocation of scarce capital resources. More specifically, any special incentive

for investment in pollution control equipment has undesirable efficiency effects in the context of legislated environmental standards.

The efficiency losses from such subsidies are of two kinds. First, because any definition of pollution control investment is necessarily arbitrary, only a limited number of the alternative ways of reducing pollution are subsidized. For example, a firm may reduce pollution by changing production processes or inputs used. However, under current law, only the installation of specifically designated "pollution control" equipment would be eligible for subsidized financing through IDBs.

Secondly, even if firms were to choose to purchase the same type of equipment without the subsidy, the subsidy still causes an efficiency loss through a misallocation of economic resources. The efficiency loss in this case occurs because the subsidy lowers the total cost of production in industries where significant outlays for environmental controls are required, thereby leading to relatively lower prices and relatively higher output in those industries as compared to what market forces would determine. The resource misallocation results from a failure to transmit to the consumer the appropriate economic signals which would induce him to purchase relatively less of those products involving high pollution control costs.

The proposed elimination of tax-exempt pollution control financing will provide firms with an incentive to select the lowest cost alternative among methods of pollution control consistent with existing Federal regulations. It will end the bias towards the defined eligible investments such as "end of the line" types of pollution control equipment fostered by present law tax incentives, and move in the direction of requiring consumers to pay the full cost of pollution control.

Furthermore, efficiency losses from providing a tax subsidy for pollution control facilities are much greater for new plants than for existing plants. Frequently, with existing plants, addition of pollution control equipment eligible for a tax subsidy is either the only feasible way of achieving environmental standards or the lowest cost method even in the absence of a subsidy.

It may also be argued that mandated pollution control investments for plants already in existence should not be fully borne by the firm and the consumers of its products. At the time the plant was initially built the firm may not have anticipated these extra capital requirements. The original investment was presumably made on the assumption that society did not place a high cost on emissions and would not compel firms to reduce pollution.

Current tax law does provide such subsidies for old plants. In addition to tax-exempt IDB financing, pollution control equipment installed in plants in use before January 1, 1976 is eligible for 5-year amortization and a 5 percent investment credit.

To provide continued assistance for existing plants, it is proposed elsewhere in the Administration's tax program to raise the investment credit from 5 percent to 10 percent for pollution control facilities amortized over five years (see REVISIONS TO THE INVESTMENT CREDIT.) Such investments may also be eligible for tax-exempt IDB status under present law. The proposed increase in the investment credit to 10 percent will typically more than compensate the investor for the loss of the interest savings realized by borrowing in the tax-exempt market.

Another proposal in the Administration's tax program is to provide States and localities with the option of issuing taxable bonds with a Federal subsidy in all cases where tax-exempt borrowing is currently allowed. (See TAXABLE BOND OPTION.) The efficiency losses from continuing to allow tax-exempt borrowing for pollution control equipment would be even greater under this plan for a taxable bond option (TBO) than under current law. TBO will lower the interest rate on tax-exempt borrowing from about 70 percent to 60 percent of the taxable rate. Because the subsidy rate to tax-exempt borrowers is thereby increased, the efficiency losses resulting from providing tax exemption for pollution control IDBs are also increased. Thus, while it is desirable to remove pollution control bonds from the tax-exempt market under current law, it is even more important under TBO.

State and Local Borrowing Costs. Allowing private firms to use tax-exempt IDBs for pollution control equipment raises the cost of borrowing to State and local governments. As the supply of tax-exempt bonds increases, their price must fall to attract additional investors in lower marginal tax brackets. Thus, the expansion of the use of IDBs in recent years has had the effect of raising the interest rate paid by State and local borrowers. It is for this reason that the National League of Cities and the Municipal Finance Officers Association have consistently opposed the financing of pollution control investment through the tax-exempt market. 3/

Recent studies have estimated that for each extra billion dollars of tax-exempt borrowing, interest rates on tax-exempt issues rise by 5 to 20 basis points. (A basis point equals .01 percent.) 4/ In 1977, tax-exempt borrowing for pollution control IDBs was equal to almost $3 billion (See Table IIIB-1). Thus, the research findings imply that tax-exempt interest rates in 1977 were from 15 to 60 basis

points higher than they would have been if there were no pollution control IDBs. Using a conservative estimate of 25 basis points or 1/4 of 1 percent, the additional annual interest cost on the $41.5 billion of non-IDB State and local obligations issued in 1977 can be estimated to be in excess of $100 million. This additional cost will occur for each of the 20 or more years these bonds will be outstanding. Savings of this magnitude will occur upon removal of these bonds from the tax-exempt market.

Another way of viewing this saving is to note that at prevailing levels of tax-exempt interest rates, 25 basis points is equal to a reduction in interest costs of slightly over 4 percent. At current levels of debt service (about $9 billion annually), this amounts to an annual interest savings of $360 million when all outstanding obligations have been issued under the new rules.

Elimination of tax-exempt IDBs for pollution control equipment would, therefore, lower the cost of financing State and local public services. The potential loss to State and local governments from continuing this tax-exemption is likely to become greater in future years, because borrowing for pollution control equipment is likely to increase.

The above analysis of the interest savings to State and local governments does not take into account the effects of the proposal to provide State and local governments with the option of issuing subsidized taxable bonds (See Taxable Bond Option). Under the taxable bond option, the tax-exempt interest rate will be a fixed proportion of the taxable rate. In this case, the increase in IDB tax-exempt financing would increase the volume of municipal bonds shifted from the tax-exempt into the subsidized taxable market, but the ratio of tax-exempt interest rates to taxable rates would remain unchanged.

The cost to the Treasury, however, of providing the subsidy to taxable municipal bonds would be increased by allowing pollution control IDBs to remain in the tax-exempt market. Since a relatively larger supply of municipals or tax-exempt IDBs implies a larger volume of subsidized taxable issues, greater subsidy payments are required of the Treasury. Removing pollution control bonds from the tax-exempt market will, therefore, reduce the Federal costs of maintaining the taxable bond option.

Other Industrial Development Bond Provisions

Small Issue IDBs. The $1 million and $5 million small issue IDBs are frequently used by States and localities to promote economic development by attracting new plants. If their use is available to everyone, however, then any potential benefit to one locality in attracting plants is

cancelled by the use of IDBs by other localities. For this reason, it is proposed here to retain the use of small issue IDBs only for those areas most in need of relief. In those areas of economic distress, it is proposed to extend the dollar limit on the amount of capital expenditures eligible for tax-exempt financing from $5 million to $10 million. For areas which do not qualify as economically distressed, the use of tax-exempt small issue IDBs will be disallowed entirely.

This proposal will reduce the losses in tax equity associated with tax-exempt financing, while at the same time channeling the tax subsidy to areas currently experiencing economic distress (for example, urban areas with very high unemployment rates) and requiring special assistance.

Industrial Parks. The tax-exempt financing of industrial parks allowed under current law also represents an unwarranted extension of the privilege of tax-exempt borrowing for purely private purposes. It raises the same issues of tax equity and economic efficiency already discussed. It also contributes to higher costs of State and local borrowing for public facilities.

Hospital Bonds. Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Under present law, the definition of a taxable industrial development bond generally does not include an obligation issued to finance a trade or business carried on by a private, non-profit charitable organization. Thus, many bonds issued by State and local governments to finance facilities for private non-profit hospitals are not considered to be taxable IDBs and are eligible for tax exemption on the grounds that they have been issued directly or indirectly by States and localities.

The Administration is concerned that excess expansion of hospital facilities is increasing costs of medical care and has, therefore, proposed, in its Hospital Cost Containment Act, that the number of certificates of need for hospital construction be drastically reduced. In order further to reduce incentives for construction of excess hospital facilities, the Administration proposal will not allow tax-exempt IDB financing for hospitals operated by charitable organizations for which a certificate of need has not been issued.

Effective Date

In general, the proposed changes will apply to obligations issued after the date of enactment. The proposed changes will also apply to obligations issued after February 1, 1978 unless it is reasonably expected on the date of issuance of the obligations that at least 85 percent of the

"spendable proceeds" (as defined in Proposed Treasury Regulation 1.103-14(b)(iii)) will have been expended within three years of the date of issuance of the obligations.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years				
1979 :	1980 :	1981 :	1982 :	1983
26	80	138	198	260

Technical Explanation

The tax exemption for small issues of IDBs provided by section 103(b)(6) of the Code will be amended to provide exemption only for issues the proceeds of which are used for the acquisition or construction of land or depreciable property located in an economically distressed area. For this purpose economically distressed areas will be defined by reference to such factors as (1) an average annual unemployment rate in excess of the national average rate and (2) an average annual growth in employment below the corresponding national rate. These criteria identify those areas with chronic unemployment problems which are attributable to an inability to absorb employable resident workers.

In addition, the proposals will be implemented by amending section 103(b)(6)(D) of the Code to substitute $10,000,000 for all references to $5,000,000, and by deleting sections 103(b)(4)(F) (relating to pollution control facilities) and 103(b)(5) (relating to industrial parks). Finally, section 103(b)(3)(B), which generally provides an exemption from industrial development bond treatment for obligations issued to raise funds for non-profit, charitable organizations, will be amended to deny the exemption to (and thus treat as taxable) obligations issued to finance hospital facilities for such organizations, unless a certificate of

need for the facilities has been issued under section 1523 of the Public Health Services Act or construction of the facilities has been approved under section 1122 of the Social Security Act.

Footnotes

1/ Congressional Record, Volume 114, Part 7, March 28, 1968, p. 8148.

2/ Federal and State regulation issued under authority in Clean Air Act 42 U.S.C. 1857 et. seq. (1970) (prior to 1977 amendments), and Federal Water Pollution Control Act Amendments of 1972, 33 U.S.C. 1341 - 1345 (1972)

3/ See, for example, Municipal Finance Officers Association Policy Resolution adopted April 30, 1975 in Montreal, Canada; and National Municipal Policy, official policy positions of the National League of Cities, most recently adopted in San Francisco, in December, 1977.

4/ John E. Peterson, The Tax-Exempt Pollution Control Bond, Municipal Finance Officers Association, March 10, 1975; Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations With a Large Econometric Model," Federal Reserve Bank of Boston, 1974; John E. Peterson, "Changing Conditions in the Market for State and Local Government Debt," Joint Economic Committee Study, April 16, 1976; and George E. Peterson and Harvey Galper, "Tax Exempt Financing of Private Industry's Pollution Control Investment," Public Policy, Volume XXIII, Winter 1975, Number 1.

IV

★★★

tax credit to structures. Reduction of the corporate tax rate will enable all corporations to realize some benefits from the business tax cuts.

3) In the context of the entire proposal, the corporate tax rate reductions are required to prevent a shift of capital away from corporate investments. Given the reduction in the personal income tax rates included in the package, maintenance of a rough balance between taxes on corporate equity income and taxes on other forms of capital income (including debt) requires an accompanying cut in the corporate tax rates.

For these reasons, it is desirable to reduce the rates of tax on corporate income for both small and large corporations.

General Explanation

Effective October 1, 1978, the corporate income tax rates will be reduced to 18 percent of the first $25,000 of corporate taxable income, 20 percent of the next $25,000 of taxable income and 45 percent of all taxable income in excess of $50,000. Effective January 1, 1980, the tax rate on taxable income in excess of $50,000 will be 44 percent. The reductions will be permanent.

Revenue Estimate

Change in tax liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-1,349	-5,965	-8,516	-9,228	-10,010	-10,764

Note: These estimates are based on permanent extension of the present rates.

Technical Explanation

Effective October 1, 1978 the normal tax imposed by section 11(b) of the Code, which currently is 20 percent of the first $25,000 of taxable income plus 22 percent of taxable income in excess of $25,000, will become 18 percent of the first $25,000 of taxable income plus 20 percent of taxable income in excess of $25,000.

The surtax imposed by section 11(c) of the Code, which currently is 26 percent, will be reduced to 25 percent effective October 1, 1978. A further reduction to 24 percent will become effective January 1, 1980. The surtax exemption, which currently is $50,000, will remain at $50,000.

Thus, effective October 1, 1978, the corporate rate will be 18 percent of the first $25,000 of taxable income, 20 percent of the next $25,000 and 45 percent of taxable income in excess of $50,000. Effective January 1, 1980, the top rate will decline to 44 percent.

In the case of a corporate taxpayer whose fiscal year does not begin with the effective date of a rate reduction (in this case, October 1, 1978 and January 1, 1980), existing law provides for the taxpayer to determine its tax liability for the taxable year of transition by computing tentative taxes based on the application to its full year's taxable income of the rates in effect before and after the date of the change, and paying a tax that consists of a portion of each tentative tax determined by reference to the number of days during the taxable year to which the old and new rates applied. In other words, the tax rate for the entire year is a weighted average of the tax rates applicable to the periods before and after the rate change with the weights being the number of days in the year before and after the change.

For example, suppose a calendar year corporation has taxable income of $100,000 in 1978. Under present law, its tax liability for the full year would be 20 percent of the first $25,000 of income ($5,000), 22 percent on the next $25,000 of income ($5,500) and 48 percent on all taxable income over $50,000 ($24,000) for a total tax of $34,500. Under the proposal, the full year's tax liability for the corporation will be 18 percent of the first $25,000 of taxable income ($4,500), 20 percent of the next $25,000 of taxable income ($5,000) and 45 percent of taxable income over $50,000 ($22,500) for a total tax liability of $32,000. There are 273 days in the transition year before the effective date of October 1, 1978, and 92 days on or after that date. Therefore the tax on the corporation for the transition year will be equal to 273/365 of $34,500 (or $25,804) plus 92/365 of $32,000 (or $8,066). Thus, the calendar year corporation's tax liability on $100,000 of taxable income in 1978 is $33,870.

INVESTMENT CREDIT

Present Law

Taxpayers are presently entitled to a credit against their tax liability equal, in general, to 10 percent of their investment in certain qualified productive assets. The rate of this investment credit was temporarily increased to 10 percent from 7 percent as of January 25, 1975, and is scheduled to revert to 7 percent on January 1, 1981. (In the case of investments in certain public utility property, the credit is scheduled to revert, in effect, to 4 percent on January 1, 1981.)

In general, property eligible for the investment credit consists of depreciable property having an estimated useful life of three or more years which is either tangible personal property or other tangible property (such as fixtures and heavy machinery) that is used as an integral part of the productive process. Buildings and their structural components, however, do not qualify for the credit.

To reduce the cost of pollution control equipment required to be installed in plants in use before January 1, 1976, a taxpayer may elect to amortize the cost of such equipment over a 5-year period in lieu of depreciating the equipment over its useful life. However, if pollution control equipment is amortized under this special rule, the investment credit is limited to 5 percent of the cost of such equipment.

The amount of investment credits for any year may be used, dollar-for-dollar, to offset completely tax liability of up to $25,000. Credits in excess of $25,000 may, in general, be used to offset up to 50 percent of tax liability in excess of $25,000. Special provisions, scheduled to be phased out over time, permit public utilities, railroads and airlines to offset more than 50 percent of their tax liability in excess of $25,000 with investment credits. In any year in which the amount of a taxpayer's investment credits exceeds the applicable limits, the excess may be carried back to the three taxable years before, and forward to the seven taxable years after, the year in which the asset was placed in service.

Reasons for Change

The investment credit, originally proposed in 1961 to stimulate the lagging modernization of the country's productive facilities, has proven to be an effective

incentive to capital investment. However, the unavailability of the credit for investments in industrial buildings has impaired somewhat its utility in promoting investment in long-lived manufacturing facilities.

As first proposed by the Treasury in 1961, the investment credit would have been available for investments in industrial buildings. However, while the Congress was examining the Treasury's 1961 proposal, it became apparent that investment in equipment, by historical standards, was lagging behind investment in non-residential structures. By the end of 1961, equipment investment had still not regained the peak level (in real terms) achieved in the third quarter of 1957, while investment in non-residential buildings had surpassed its earlier peak during 1960. Thus, the Committee on Ways and Means concluded that buildings and their structural components should not be eligible for the credit:

> "The credit is available for investments in most tangible personal property. It is also available for limited types of real property, other than buildings. The greater emphasis is placed on equipment and machinery because it is believed the need for such investment is the major requirement of the economy."1/

The decision in 1961, while appropriate at that time, has had a distorting effect on the composition of business fixed investment in the United States. While annual expenditures (in current dollars) for total fixed investment have increased by some 295 percent since 1961, expenditures for industrial structures have increased by only 145 percent. Moreover, during the recent cyclical recovery phase, annual expenditures for industrial structures have actually declined, while other investment expenditures have mildly increased. These developments are reflected in Table IVB-1.

Table IVB-1

Comparison, in Current Dollars, of Outlays for Total Business Fixed Investment and for Industrial Structures

	Business Fixed Investment	Expenditures for Industrial Structures
	1960 - 61 = 100	
1960	100.6	101.3
1961	99.4	98.7
1962	108.1	100.9
1963	113.1	103.2
1964	125.9	126.6
1965	150.3	201.3
1966	171.8	259.2
1967	173.2	235.4
1968	188.3	213.9
1969	208.8	240.9
1970	211.9	232.2
1971	219.5	192.6
1972	246.5	166.1
1973	286.9	221.7
1974	317.8	280.7
1975	314.6	284.8
1976	341.7	255.1
1977	395.6*	245.6*

Office of the Secretary of the Treasury
Office of Tax Analysis — January 19, 1978

* Based on first three quarters only.

Source: Survey of Current Business.

The decision in 1962 to deny the investment credit to buildings was also based, in part, on the favorable depreciation for Federal income tax purposes afforded buildings at that time. In contrast with the situation in 1962, there has been a substantial tightening in the tax treatment of depreciation of structures. Depreciation recapture rules have been extended to real property and it is proposed elsewhere in the President's tax program that the rules governing depreciation of buildings be changed to conform more closely to economic reality. See REAL ESTATE DEPRECIATION. Thus, industrial buildings will no longer enjoy the exceedingly favorable depreciation treatment available in 1962.

Accordingly, it is now appropriate to extend the stimulus provided by the investment credit to investments in industrial structures. This change will eliminate the bias of current tax law against balanced programs of industrial expansion, and will promote increased investment in long-lived productive facilities. Expansion of private investment in manufacturing facilities is essential to avoiding capacity shortages, with resulting inflationary pressures, as the economy continues to move ahead. Modernization of the stock of productive capital is likewise essential to further gains in labor productivity. Finally, this change will eliminate the many disputes occasioned under present law by the need to distinguish between equipment, for which the credit is available, and buildings and their structural components, for which it is not.

The investment incentive provided by the credit can be strengthened further by modifying the provisions of present law that limit current availability of investment credits to 50 percent of a taxpayer's tax liability in excess of $25,000. This limitation both dampens the investment incentive provided by the credit by delaying actual use of credits, and adds to the complexity of the tax laws by compelling some taxpayers either to resort to the use of carryovers, or to engage in complex and costly leasing transactions, to obtain the benefits of the investment credit. Furthermore, in years in which an excess credit can be fully utilized by carrybacks, the procedure for effecting a refund entails cumbersome recomputations of prior years' tax accounts with no compensating gain to either the taxpayer or the Treasury. Relaxing this limitation would thus simplify the tax laws, stimulate capital investment by accelerating the actual availability of investment credits, and promote economic efficiency by reducing the disparity, caused solely by variations in current tax liabilities, in the use of credits by enterprises that have made similar amounts of eligible investment.

22-302 O - 78 - 20

It would, however, be incompatible with the goals of the President's tax program to permit investment credits to eliminate completely a person's tax liability. See TAX SHELTERS -- INTRODUCTION. Under present law a taxpayer whose tax liability is $25,000 or less may use investment credits to eliminate that liability in its entirety. Permitting investment credits to offset up to 90 percent of a taxpayer's tax liability for any year would strike an appropriate balance between strengthening the investment incentive provided by the credit, on the one hand, and not permitting the credit to eliminate 100 percent of tax liability for any year, on the other.

The temporary increase in the credit to 10 percent, scheduled to expire in 1981, has had some beneficial effect on the rate of capital investment. However, the temporary nature of the 10 percent rate is an additional variable that must be taken into account by businesses in making long-range investment decisions. This uncertainty diminishes the incentive effect of the credit and is undesirable, particularly when the rate of capital investment is inadequate. For that reason, and because capital formation remains a long-term economic policy objective, the present 10 percent rate of the investment credit should be made permanent.

To reduce further the rising cost of compliance with environmental standards, pollution control equipment added to pre-1976 plants should, in addition to its eligibility for 5-year amortization, be eligible for the full 10 percent investment credit. It is proposed elsewhere in the tax program to eliminate the availability of tax-exempt financing to provide pollution control facilities. However, it is expected that, for eligible taxpayers, the benefit of the additional 5 percent investment credit for pollution control investment in pre-1976 plant generally will offset the loss of tax-exempt financing. See INDUSTRIAL DEVELOPMENT BONDS.

General Explanation

As an incentive to business to expand and modernize its investment in long-lived industrial facilities, thereby reducing the likelihood of future capacity shortages, the investment credit will be extended to industrial structures. This change will extend to otherwise eligible investments made in new industrial buildings as well as investments made to rehabilitate existing buildings.

An industrial structure will include a building and its structural components, but only if the building is used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or if the

building constitutes a research facility used in connection with any of these activities. Thus, for example, buildings used for residential purposes (e.g., apartment buildings, hotels and motels), commercial buildings (e.g., office buildings and retail stores), and buildings used for storage or distributional purposes (e.g., warehouses) will not be industrial structures eligible for the credit. Bulk storage facilities (e.g., grain storage bins and oil storage tanks) will continue to be eligible for the credit. This change in general will be accomplished by deleting the provision of present law that specifically excludes a building and its structural components from the definition of property eligible for the investment credit.

Because property eligible for the credit is generally subject to the depreciation recapture rules applicable to equipment rather than the less stringent rules applicable to real property, buildings for which an investment credit will now be allowed will also be subject to the depreciation recapture rules (section 1245) for equipment.

The provision of present law that limits the current availability of investment credits for any year to $25,000 plus 50 percent of tax liability in excess of $25,000 will be changed to provide that investment credits may offset up to 90 percent of tax liability in any year. Until this change becomes effective (See Effective Dates), airlines, railroads and public utilities will remain subject to the special limitations of current law. Permitting the credit to offset 90 percent of tax liability will both strengthen the incentive provided by the credit and simplify its administration. In addition, a uniform percentage limitation on the use of the credit will eliminate the inequity of present law that allows a complete offset of tax liability through the use of investment credits; the investment credit will no longer be permitted to offset completely the first $25,000 of tax. 2/

To assist business enterprises in making long-range capital investment decisions and to encourage long-term capital formation, the 10 percent rate of the investment credit will be made permanent. Investments in public utility property will remain eligible for the permanent, 10 percent credit.

Investments in pollution control equipment will be eligible for the full 10 percent investment credit, even if an election is made to amortize the cost of such equipment over the special 5-year period.

Effective Dates

Industrial structures placed in service after December 31, 1977 will qualify for the investment credit, but only to the extent of the portion of the adjusted basis of

such structures properly attributable to construction after that date. Otherwise eligible expenditures to rehabilitate existing industrial structures will also qualify for the credit, but only to the extent of the adjusted basis of such structures properly attributable to rehabilitation after December 31, 1977.

For taxable years beginning after December 31, 1978, the investment credit (and investment credit carryovers to such years) will be usable to offset up to 90 percent of a taxpayer's liability for tax. For taxable years beginning after December 31, 1978, investment credits will no longer be available to offset completely the first $25,000 of tax. These changes will apply to all taxpayers, including public utilities, railroads and airlines.

The 10 percent rate of the investment credit will not revert to 7 percent on January 1, 1981, but will be made permanent.

Certified pollution control facilities eligible for the special 5-year amortization period will be eligible for the full 10 percent investment credit, provided that as of December 31, 1977 no election has been made to amortize such equipment over the 5-year period.

Revenue Estimate

Change In Tax Liability
($ Millions)

	Calendar Years					
	1978	1979	1980	1981	1982	1983
Extend 10 percent investment credit to structures	-1147	-1443	-1714	-1942	-2153	-2354
Full Investment credit for pollution abatement facilities	- 142	- 93	- 107	- 127	- 115	- 144
Change investment credit limit to 90 percent for corporations	- 882	- 576	- 114	- 194	- 205	
Change investment credit limit to 90 percent for individuals	52	58	64	71	79	

Note: These estimates are based on permanent extension of the 10 percent investment credit.

Footnotes

1/ House Report No. 1447, 87th Cong. 2d Sess. (1962), at 9.

2/ The same rule -- that credits may offset 90 percent of tax liability -- will apply to the work incentive credit (section 40 of the Code) which, under present law, may be used to offset the first $50,000 of tax liability plus 50 percent of tax liability in excess of $50,000.

SMALL BUSINESS

INTRODUCTION

The corporate tax cuts described elsewhere in the Administration's tax proposals will particularly benefit small corporations with incomes of $50,000 or less; for these corporations the tax reduction will be nearly 10 percent. The Administration is also making three proposals specifically to assist small businesses. The first proposal will simplify and liberalize the rules (Subchapter S) that treat certain small corporations like partnerships. The second proposal will simplify methods of depreciation for small businesses. And, if an investor loses money on stock in a small business, the third proposal will make it easier for him to deduct his losses. The revenue effect of these changes is estimated to be $400 million in 1979, virtually all of which is accounted for by the reduction in corporate rates.

IVC-2

LIBERALIZATION OF SUBCHAPTER S

Present Law

In general, present law treats a corporation as an entity separate and apart from its shareholders. Income earned by a corporation is taxed to the corporation and distributions are taxed to the shareholders. Losses affect the tax liability of the corporation but not that of the shareholders. Under Subchapter S, however, a qualifying domestic coporation may elect not to pay the regular corporate income tax. Instead, the income of the corporation is taxed to the shareholders whether it is distributed as a dividend or retained by the corporation. In addition, the shareholders are allowed to deduct losses sustained by the corporation. This results, in a general way, in a pattern of taxation similar to that of partnerships. Subchapter S is available only to small corporations with simple structures that are essentially similar to partnerships.

Reasons for Change

Subchapter S reflects concern regarding the tax-induced distortions of business behavior that result from double taxation of corporate income. Such distortions include favoring debt over equity financing, unnecessary retention of earnings in corporate solution, and widespread resort to partnerships for certain types of business activities. Therefore, it is appropriate to revise Subchapter S to eliminate unnecessary barriers to its use. Such barriers arise from the fact that the Subchapter S rules, although revised since enactment, remain complex and are frequently misunderstood in ways that lead to unintended hardships. Complexity in this area is particularly undesirable because Subchapter S generally is limited to, and is best suited for, small businesses. Accordingly, the proposal simplifies and liberalizes Subchapter S.

General Explanation

The proposal will liberalize three sets of rules governing treatment of a small business corporation under Subchapter S. First, it will increase the permitted number of shareholders and relax certain other restrictions on the shareholders of a Subchapter S corporation. Second, it will liberalize the rules governing election and termination of election under Subchapter S. And third, it will liberalize treatment of losses sustained by a Subchapter S corporation. Under present law, a shareholder's deduction for losses cannot exceed his investment in the corporation. The proposal will permit the shareholder to carry excess losses over to subsequent taxable years.

Effective Date

In general, the proposed changes will apply to taxable years of corporations beginning after December 31, 1978. The change permitting carryovers will apply to losses sustained in taxable years beginning after December 31, 1978.

Revenue Estimate

This proposal will have no significant revenue effect.

Technical Explanation

(a) Eligibility for Subchapter S Election

The proposal will make it easier for a corporation to qualify under Subchapter S.

Number of Shareholders. Under present law, a corporation (with certain exceptions) must have ten or fewer shareholders to qualify as a small business corporation (section 1371 of the Code). Under the proposal, a corporation can qualify if it has fifteen or fewer shareholders.

Certain Trusts Permitted as Shareholders. In general, present law requires the shareholders of a qualifying small business corporation to be individuals. Exceptions are provided for grantor trusts and voting trusts, and for transitory ownership (for a period of not more than sixty days) by trusts established under the will of a deceased shareholder (section 1371(f) of the Code). The inability to transfer stock to a testamentary trust except on a transitory basis may cause shareholders difficulty in planning their estates. To alleviate this problem, the proposal will permit the transfer of shares to a testamentary trust established under the will of a deceased shareholder for the term of the trust. Similarly, an inter vivos grantor trust that now qualifies as a shareholder will continue to qualify after the grantor's death. A qualifying trust will be required to distribute all income currently to its beneficiaries in shares fixed by the governing instrument of the trust. For purposes of determining the number of shareholders in the electing small business corporation, each beneficiary having a present interest in the trust income will be treated as a shareholder. Because of the general increase to 15 shareholders, special rules that permit the corporation to have more than 10 shareholders in certain limited circumstances (section 1371(e) of the Code) will be repealed.

Husband and Wife as One Shareholder. The rules treating a husband and wife as one shareholder will be simplified and liberalized. In particular, the proposal will eliminate the

requirement that the stock be community property or be held as joint tenants, tenants by the entirety, or tenants in common.

(b) Election to be Taxed Under Subchapter S

The rules governing elections to be taxed under Subchapter S and terminations of such elections (including inadvertent terminations) are unduly complicated and restrictive. These rules will be simplified and liberalized.

Time for Election. Under present law, an election under Subchapter S may be made for a taxable year at any time during the first month of the year or at any time during the preceding month (section 1372(c) of the Code). For a new corporation, the first month of the taxable year does not begin until the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. Unless an election is terminated, it continues in effect and does not have to be renewed annually.

The requirement that an election may not be made more than 30 days before the beginning of a year is an unnecessary trap. For example, a corporation that has decided to make an election six months before the first day of the year may inadvertently fail to make the election in a timely fashion. This possibility will be eliminated by permitting the corporation to make the election at any time before the beginning of the taxable year. Thus, if a corporation decides in June of 1979 to elect Subchapter S for calendar year 1980, it will be able to do so immediately. In addition, an election will be permitted for 60 (instead of 30) days after the beginning of a taxable year.

Termination of an Election. Under present law, termination of an election is generally retroactive to the first day of the taxable year, even if it is caused by an event occurring at the end of the year (section 1372(e) of the Code). This had led to hardship in some cases and opportunity for manipulation in others. Therefore, under the proposal, a termination will generally take effect on the day of the triggering event. However, this rule could enable taxpayers to cut short an electing year -- particularly an initial electing year -- prior to the realization of income while permitting losses to be passed through to shareholders. Therefore, a termination during the first year of an election will take effect retroactively.

Election following Termination. If an election is terminated, present law precludes the corporation (or its successor) from making a new election until the fifth taxable year after the termination (unless the Treasury consents to a new election). This rule has caused difficulty in cases of

inadvertent termination. In many such cases, the termination is not discovered until it is too late for a new election. Moreover, the corporation has acted in reliance on the old election. Therefore, under the proposal, if an election is terminated because a corporation ceases to be a small business corporation (e.g., it has 16 shareholders or it owns 100 percent of the stock of another corporation) and if the corporation qualifies for a later year, filing a timely return as a Subchapter S corporation for the later year will be treated as a binding request for consent to a new election. In determining whether to grant such a consent, the fact that termination was inadvertent will be taken into account.

(c) Net operating loss carryover

Under present law, a shareholder may deduct losses sustained by a Subchapter S corporation to the extent of his adjusted basis in stock and debt of the corporation. The shareholder is not permitted to carry excess losses over to subsequent taxable years. Therefore, if a shareholder's pro rata share of the corporation's losses exceeds his adjusted basis in stock and debt, the excess is not deductible. Under the proposal, these excess losses will become deductible by the shareholder in subsequent years to the extent of subsequent increases in the shareholder's basis in stock and debt. This change is consistent with the present treatment of partnerships. The excess loss will not be transferable and will be deductible only by the same shareholder in a subsequent year.

While the Subchapter S election remains in effect, the carryover will be allowed as a deduction at the end of each subsequent taxable year of the corporation. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt of the corporation at the end of the year (giving effect to all adjustments made during the year). Any unused portion of the carryover will be allowed as a deduction twelve calendar months after the Subchapter S election is terminated. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt at the end of the twelfth month. Whenever the carryover is allowed as a deduction, there will be a corresponding reduction in basis.

Depreciation for Small Business

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

As discussed more fully in connection with the President's proposal for simplifying ADR depreciation, the use of ADR depreciation permits a taxpayer to depreciate assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service and offers substantial other benefits. See SIMPLIFICATION OF ADR DEPRECIATION. On the other hand, the ADR system imposes a number of formal accounting and reporting requirements which may differ from a taxpayer's past depreciation practices.

Reasons for Change

The ADR system provides many advantages for those who adopt it. However, while nearly 92% of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36% of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. The proposal for simplifying the ADR system should encourage more smaller businesses to adopt ADR. However, it is also appropriate to allow the smallest taxpayers to obtain the major benefits which the ADR system allows without requiring them to learn a system which, while simpler in its ultimate operation than depreciation based on facts and circumstances, may seem strange and complex to small businessmen and their bookkeepers.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue special regulations governing depreciation by small businesses. Under these regulations,

qualifying small businesses will be permitted to depreciate their assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service. The electing small business will be able to adopt a useful life within the same 20 percent range above and below the prescribed life as is permitted under the ADR system. For example, if the prescribed useful life for furniture is 10 years, a taxpayer will be permitted to compute depreciation on the basis of any period between 8 and 12 years.

A simple table will be published to help taxpayers determine the range of useful lives over which they can depreciate their assets.

Small businesses electing to depreciate assets on the basis of the prescribed useful lives will be able to ignore salvage value in claiming their depreciation deductions (as will taxpayers who elect the new simplified ADR system).

Small businesses will be permitted -- but not required -- to adopt a convention (the "half-year convention") that will enable them to begin computing depreciation for all assets placed in service during a taxable year from the first day of the second half of the taxable year (July 1 for calendar year taxpayers). If a small business does not elect the half-year convention, it may claim depreciation for each asset from the date that asset was placed in service during the taxable year.

Unlike taxpayers who elect the ADR system, qualifying businesses generally will not be required to participate in any special information gathering surveys. When they are required to furnish information, it is expected that the surveys will be conducted in a manner consistent with the limited professional resources normally available to small businesses.

In all other respects, taxpayers will be able to continue to depreciate their assets as they have done in the past.

A qualifying business will be any business whose depreciable assets have an aggregate initial cost of $500,000 or less. For this purpose, only assets for which prescribed lives are in effect will be taken into account. The $500,000 test will be applied at the level of the business (for example, at the partnership level rather than at the level of each partner). Special rules (similar to those now applicable for purposes of the Jobs Credit) will be applied to prevent the division of a large entity into a number of smaller ones in order to take advantage of this provision.

The opportunity to take advantage of this special depreciation system will be available to more than 90% of all corporations, partnerships and sole proprietorships.

Effective Date

The special depreciation system for small businesses provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on December 31, 1979, will have sufficient time to determine whether to elect the new special depreciation system for small businesses on their returns.

Revenue Estimate

The proposal will have no significant revenue effect.

SMALL BUSINESS STOCK

Present Law

Generally, the full amount of an ordinary loss is allowed as a deduction under present law. On the other hand, an individual may deduct capital losses only to the extent of capital gains plus $3,000 of ordinary income. Moreover, $2,000 of net long-term capital loss is required to offset $1,000 of ordinary income. Thus, at most $6,000 long-term capital loss can be used to offset $3,000 of ordinary income in any taxable year. Unused capital losses can be carried over indefinitely to future taxable years.

Under present law, unless an individual is a dealer, a loss on stock is generally treated as a capital loss. However, an exception is provided for "section 1244 stock." A loss sustained by an individual on section 1244 stock is treated as an ordinary loss, up to a maximum of $25,000 in any one year ($50,000 in the case of a husband and wife filing a joint return). This exception is designed to encourage investment in small business by decreasing the risk of such investment.

The exception applies only if the stockholder is an individual (and not a corporation, estate, or trust). The stockholder may purchase section 1244 stock in his individual capacity or in partnership with others. However, the exception applies only to losses sustained by the original purchaser of section 1244 stock, and not to losses sustained by any subsequent purchaser.

Section 1244 stock must be common stock in a domestic corporation. Furthermore, section 1244 stock must be issued pursuant to a plan adopted by the issuing corporation, and must be issued for money or other property (not including stock or securities).

Two additional requirements are imposed in order to limit the benefits of section 1244 to small business. First, a corporation may not issue more than $500,000 worth of section 1244 stock. Second, the total stock offering plus the equity capital of the corporation may not exceed $1,000,000. Thus, a corporation whose equity capital exceeds $1,000,000 cannot issue section 1244 stock.

A further requirement limits the benefits of section 1244 to operating companies. Under this requirement, in the five years before the taxpayer sustains a loss on his stock, the corporation must derive more than 50 percent of its gross income from sources other than royalties, rents, dividends,

interest, annuities, and sales or exchanges of stock or securities.

Reasons for Change

Small businesses need capital to modernize and to maintain a rate of expansion that will permit them to contribute fully to the well-being of the economy. To assist small business in raising the capital it needs, additional steps should be taken to decrease the risk of investment in small business stock.

General Explanation

The proposal will liberalize the rules relating to section 1244 stock. A small business corporation will be permitted to issue up to $1,000,000 of section 1244 stock, which is double the amount permitted by present law. The maximum amount allowed as an ordinary loss in any one year will be increased to $50,000 ($100,000 in the case of a husband and wife filing a joint return), which is also double the amount allowed under present law. The proposal will also eliminate the requirement of a plan and other technical requirements that needlessly restrict the ability of small business corporations to issue section 1244 stock.

Effective Date

The proposed changes will apply to stock issued by corporations in taxable years of the corporation beginning after December 31, 1978.

Revenue Estimate

The proposal will have no significant revenue effect.

Technical Explanation

Generally, the rules relating to section 1244 stock will be liberalized. The size limits on the issuing corporation will be relaxed. A corporation will be permitted to issue up to $1,000,000 of section 1244 stock, instead of the $500,000 permitted by present law. Moreover, the existing $1,000,000 limit on the corporation's equity capital will be completely eliminated.

In addition, the requirement of a plan will be eliminated. All stock issued during a taxable year of the corporation will be section 1244 stock if the aggregate worth of all stock ever issued by the corporation is $1,000,000 or less. (For this purpose, the worth of stock will be the value of the consideration paid for the stock at the time it was issued.) It the aggregate worth of all stock exceeds $1,000,000 at the end of the taxable year, but was less than $1,000,000 at the beginning of the year, then an allocable portion of the stock issued during the year will be treated as section 1244 stock. For example, assume that the aggregate worth of all stock issued by a corporation is

$400,000 on the first day of its taxable year, January 1, 1979. If the corporation issues $900,000 of common stock at $9 per share during 1979, then two out of every six shares issued during 1979 will be section 1244 stock. The corporation will be able to designate certain shares specially as section 1244 stock at the time they are issued. In the absence of such a special designation, each shareholder who purchases stock during 1979 will treat two out of every three of his shares as section 1244 stock. (Fractional shares will not, however, be treated as section 1244 stock. Thus, if a shareholder purchases ten shares of stock during 1979, only six shares will be treated as section 1244 stock.)

Further, a loss sustained by an individual on section 1244 stock will be treated as an ordinary loss up to a maximum of $50,000 in any one year ($100,000 in the case of a husband and wife filing a joint return). These are twice the maximum amounts allowed under present law.

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CORPORATE PREFERENCES

REPEAL OF DISC

Present Law

A Domestic International Sales Corporation (DISC) is a special corporation established to shelter export income from taxation. Often it is only a paper corporation with no employees or real business activity. The profits of a DISC are not taxed to the DISC, but are taxed to the DISC shareholders when such profits are distributed or deemed to be distributed.

The shareholders of a DISC (typically a parent corporation which is an operating company) are deemed to receive an annual dividend equal to a portion of the DISC's profits. This deemed dividend is fully taxable to the shareholders. Federal income taxation is deferred on the remainder of the DISC's profits. Because the tax is deferred indefinitely and because the parent can use the DISC's retained profits to finance its own export activity, the deferral of taxation is in effect equivalent to exemption.

Prior to 1976 the deemed dividend was fixed at one-half of a DISC's total profits. However, the Tax Reform Act of 1976 reduced DISC benefits. The incremental provision adopted in that legislation limits DISC deferral to one-half of export profits in excess of 67 percent of average export profits over a four-year base period. For taxable years beginning in 1976 through 1979, the base period years are 1972 through 1975. In 1980 and thereafter, the base period will move forward on a year-by-year basis.

A DISC usually acquires goods from its parent corporation or an affiliated corporation (a "related supplier") and sells them abroad. Alternatively, a DISC may act simply as a commission agent on export sales. Even if the DISC does nothing, paper profits are allocated to it.

The method used for allocating profi s between a DISC and its related suppliers is an important part of the DISC statute. The allocation is achieved through special intercompany pricing rules permitting the DISC to realize profits which do not exceed the greater of:

(a) 4 percent of the qualified export receipts attributable to the sale of export property plus 10 percent of related "export promotion expenses," defined as ordinary

and necessary expenses incurred to obtain export profits;

(b) 50 percent of the combined profits of the DISC and its related suppliers attributable to exports, plus 10 percent of related export promotion expenses;

(c) profits based on an arm's-length price.

Neither the 4 percent method nor the 50 percent method may be applied in such a way as to produce a loss to the related supplier while the DISC is earning a profit. These special rules serve, however, to allow U. S. exporters to allocate more income to a DISC, and thus to defer a larger portion of their total tax burden, than they could under the normal arm's-length rule.

Reasons for Change

The principal objectives of the Revenue Act of 1971 were "to increase our exports and improve our balance of payments." 1/ To help accomplish these objectives, the Act added the DISC provisions to the Internal Revenue Code.

The contribution of the DISC legislation to the promotion of exports has, however, been minimal. A 1977 Treasury Department report to Congress estimates the net effect of the DISC program on 1975 U.S. exports to have been between $1 billion and $2.5 billion, less than 3 percent of total U.S. exports of $98 billion for 1975. This estimated increase in exports attributable to the DISC program was achieved at a cost of $1.2 billion in tax revenue. Although U.S. exports have increased dramatically since the enactment of the DISC legislation, this expansion is largely attributable to other factors, including major dollar devaluations, inflation of export prices, and a sharp increase in the real volume of world trade associated with a rapid rate of real economic growth, especially in the Mideast.

The balance of payments arguments originally advanced in support of the DISC legislation are substantially weakened under a system of flexible exchange rates. To the extent that DISC promotes exports, it lessens the depreciation of the dollar in foreign currency markets. Although sudden and abrupt depreciation may be undesirable, a slower and more orderly depreciation encourages U.S. companies to export more and import less. The balance of payments adjustment process may take time, but it does take place. Between 1971 and 1977, the U.S. merchandise trade balance has swung from deficit to surplus to deficit to surplus and now back to deficit again. DISC is thus an anachronism in a world of flexible exchange rates, and a costly and wasteful anachronism at that.

If the United States wishes to assist the balance of payments adjustment process, other programs, such as the contemplated $2.2 billion increase in direct loans and $1.8 billion increase in loan guarantees by the Ex-Im Bank, are clearly preferable to DISC. Not only can Ex-Im Bank loans be more effectively aimed at producing genuine increments in U.S. exports, but the program can be scaled down in periods of balance of payments surplus. DISC is not an appropriate or a particularly effective policy for coping with transitional problems of balance of payments adjustment.

Congress has consistently been more skeptical of the DISC program than previous Administrations. In 1971, Congress cut in half the Nixon Administration's request for a complete deferral of taxation of DISC income. And Congress required the Treasury to report annually on the operation of the DISC legislation in practice. As the revenue cost of the DISC program soared far above initial projections, Congress overrode the opposition of the Ford Administration and further pared the cost of the DISC program. Nevertheless, the revenue cost of the DISC program once again exceeds a billion dollars per year, with little evidence that this money is being wisely spent.

Like all tax reductions, DISC tends to make its beneficiaries more competitive. But the beneficiaries of the DISC legislation tend to be the largest and most profitable of U. S. companies; DISC helps little, and may actually harm, footwear, textile, and steel producers facing competition from imports. Moreover, the substantial domestic costs of the DISC program are out of all proportion to the dubious value of DISC as a "bargaining chip" in international trade negotiations. Thus, continuing skepticism of the value of DISC is well-founded. The DISC program should be repealed.

General Explanation

Tax benefits granted to DISCs and their shareholders are to be phased out over a three-year period beginning in 1979 and ending in 1981.

The phase-out of DISC benefits will be accomplished by increasing the deemed distribution from the present 50 percent of DISC profits attributable to "incremental" exports. For taxable years ending in 1979, DISCs will be deemed to distribute 66-2/3 percent of such profits, and for taxable years ending in 1980 the deemed distribution will rise to 83-1/3 percent. DISC is repealed for the first taxable year ending after 1980. Accumulated past earnings of a DISC will continue to be tax deferred as long as they remain invested in export-related assets.

Analysis of Impact

(1) Impact on Exports, the Balance of Trade, and U.S. Employment

Companies benefiting from the DISC program can cite impressive statistics on the growth of their exports since the DISC legislation was enacted in 1971, on the number of jobs in their company that are dependent on export sales, on the number of jobs in supplier industries indirectly dependent on export sales, etc. Naturally, workers will be alarmed if told that their jobs depend on the continuation of the DISC program. A close examination of company statements reveals, however, little information on the specific contribution of DISC either to export sales or to employment. Disinterested economic analyses of the rapid growth of U. S. exports since 1971 indicate that such growth is largely due to factors other than DISC. The primary contributors to this growth have been:

-- From 1971 to 1974 the dollar fell in value relative to foreign currencies by 13 percent.2/ This decline meant that foreign currency prices of U.S. exports fell relative to prices of goods from other countries, thus making U.S. goods more attractive to foreign purchasers.

-- About half of the increase in the value of U.S. exports from 1971 to 1974 was attributable to general increases in all prices, reflecting worldwide inflation. The price rise was especially rapid for certain agricultural products and industrial supplies.

-- A sharp increase in the real (price deflated) volume of world trade was associated with a rapid rate of real growth. According to United Nations estimates, the real volume of world trade was 30 percent higher in 1974 than in 1971. During this period U.S. exports grew more or less in proportion to world trade; as a consequence, the U.S. share in the exports of industrialized countries rose by only 0.6 of a percentage point, from 18.9 percent in 1971 to 19.5 percent in 1974.

The Treasury Department's most recent report to Congress on the DISC program concluded that, had exchange rates been fixed, DISCs would have contributed only $1 billion to $2.5 billion to net U.S. exports. Much of the growth in exports benefiting from the DISC legislation may have come at the expense of non-DISC exports. The Treasury report pointed out, moreover, that under the system of flexible exchange

rates adopted in 1973, an increase in U.S. exports will increase the demand for dollars in foreign countries. This will, in turn, stimulate U.S. imports by reducing import prices in terms of dollars. The increase in U.S. exports due to DISC is thus offset by an increase in U.S. imports, and the net impact of DISC on the balance of trade is much less than the impact on exports.

DISC supporters often argue that flexible exchange rates have not been successful in restoring the U.S. balance of payments, and that DISC is necessary to reduce the current balance of trade deficit. To support their argument, proponents of the DISC program note that many foreign governments intervene in foreign exchange markets to keep the dollar from depreciating, that foreign import quotas and other trade barriers prevent U.S. exports from expanding as the dollar depreciates, and that foreign demand for many of the goods which the U.S. exports (e.g., agricultural products) does not expand much as their price falls. Even if these assertions were factually correct, however, they would not support the retention of the DISC program.

If depreciation of the dollar does not promote U.S. exports, neither does DISC. Both must work through the same mechanism: making exporting more profitable. As the dollar depreciates, the foreign currency price for U.S. exports translates into a higher dollar value, which raises export profits before and after taxes. With a DISC the tax burden on export income is decreased, so that after-tax profits increase even if before-tax profits are unchanged. If U.S. manufacturers cannot expand their exports when depreciation of the dollar makes foreign sales more profitable, they should not be able to expand those exports because DISC makes those sales more profitable. Thus, the argument that flexible exchange rates do not work is also an argument that DISC does not work.

To assess the further argument of some persons that DISC promotes U.S. employment, it is necessary to translate the impact of DISC on the balance of trade into an impact on employment. This requires estimates of the labor intensity of exports versus imports. If imports indirectly induced by DISC are highly labor intensive, it is possible that the DISC program actually produces a decline in U.S. employment.

DISC represents only one of many ways of reducing taxes, and a tax reduction is only one of the available macroeconomic tools -- expenditure programs, monetary expansion, and debt policy are alternatives -- for stimulating the economy. Therefore, a complete evaluation of the employment impact of DISC would require an analysis of the costs and benefits of alternative programs. Concern about U.S. employment should be -- and is-- reflected in the President's overall budget proposals, rather than in any one part alone.

(2) Impact on the Competitive Position of U.S. Corporations

U.S. exporters often argue that repealing DISC will make them less competitive in world markets. It is true that any tax increase leaves a corporation with fewer funds available for new investment, research and development, and so forth. But it is also true that competitiveness is a fact of business life for all firms, not just the corporations benefiting from DISC. Because of the legal and accounting costs of complying with the complex DISC legislation, larger corporations necessarily make more use of the DISC legislation than smaller corporations do. According to the 1977 Treasury report on DISC, over 60 percent of total DISC tax benefits went to parent companies with more than $250 million in assets.

Moreover, the profit margin on DISC export sales was 14.7 percent, which was more than twice as large as the comparable 6.5 percent margin on sales to the domestic, U. S. market. Those U. S. industries standing most in need of assistance, and which benefit not at all from DISC, are those facing stiff import competition (e.g., footwear, textiles, steel); they often incur losses that they cannot sustain for any extended period of time. Thus, while the DISC program perversely tends to help those industries that need help least, it also helps least those industries that need help most. Clearly, if the ultimate goal is making U.S. corporations more competitive, other measures such as the Administration's proposed corporate tax rate reduction and changes in the investment tax credit are more equitable and effective than the DISC program.

(3) Revenue Cost of DISC

The revenue cost of DISC in calendar year 1975 was $1,390 million. The cost in 1976 was reduced to $870 million because of the "incremental" provisions of the Tax Reform Act. The costs in 1977 and 1978 are projected to be $1.0 billion and $1.2 billion, respectively. A rough estimate of the cost of each additional dollar of net exports due to DISC can be derived by dividing the estimated additional exports of between $1 billion and $2.5 billion by the revenue cost for fiscal year 1975 of $1.2 billion. Each dollar of additional exports thus cost between $1.20 and $.48 in tax revenue -- a very expensive cost-benefit ratio.

Because of its growing concern over the high cost and limited benefits of the DISC program, Congress sought in 1976 to limit DISC benefits to "incremental" exports. Although concern with the DISC program is easy to understand, the 1976 changes appear to have reduced the incentive to export at the same time that they reduced the revenue cost. This is because an increment to exports in 1976 and thereafter will

be reflected in a higher base against which "incremental" exports will be measured in future years. As a consequence, the greater the taxes that are deferred now, the less will be the taxes deferred in the future. The Treasury's most recent report on DISC concluded that the 1976 changes reduced by 40 percent the tax incentive to expand exports. Because the reduction in the revenue cost of the DISC program was also roughly 40 percent, there is no reason to believe that the DISC program is any more cost-effective now than it was prior to 1976. The incremental approach may have produced less waste in absolute terms but it is not a solution to the waste inherent in the DISC program.

(4) Impact on U.S. Trade Relations

The European Community lodged a formal complaint with the Contracting Parties of the General Agreement on Tariffs and Trade (GATT) in July 1972, asserting that DISC was incompatible with Article XVI:4 of the GATT because it constituted a tax subsidy on exports. The United States entered a counter-complaint against the export tax practices of France, Belgium, and the Netherlands.

Four panels of experts were appointed by GATT, one to consider the complaints of the European Community against DISC and three to consider the complaints brought by the United States against the tax practices of France, Belgium, and the Netherlands. Each panel, however, consisted of the same persons.

The panels reported their findings to the GATT Council on November 2, 1976. Each of the panels concluded that the tax practices subject to complaint "in some cases had effects which were not in accordance with [that country's] obligations under Article XVI:4." Therefore, each of the panels found that "there was a prima facie case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement (GATT)."

The GATT Council discussed the panel reports at meetings held in November 1976, March 1977, and, most recently, November 1977, but it could not reach agreement on their adoption. Upon adoption, the GATT Council would be in a position to make recommendations to the parties regarding appropriate settlement of the disputes. At the November 1977 GATT Council meeting, U. S. representatives proposed that the Council adopt the reports of all four panels. The U. S. representatives also stressed that the United States was not concerned about European tax systems per se, but only with the possible tax-haven abuse of those systems. The United States expressed the hope that the Europeans shared this concern and that this would form a basis for adoption of the four reports.

France, Belgium, and the Netherlands continued, however, to express reservations about the panel findings on their respective tax practices, particularly the definition of export activity, and refused to agree to the adoption of the panel reports by the GATT Council. Since these countries refused to agree on the simultaneous adoption of all the panels' reports, the United States refused to accept unilaterally the panel report on DISC.

Supporters of DISC assert that DISC has certain value as a "bargaining chip" in international trade negotiations. But this factor must be weighed against DISC's substantial and growing domestic cost. When DISC is repealed, the United States will still have every right to expect other countries to bring their tax practices into conformity with GATT. If other countries do not make conforming adjustments, the Treasury, using the very same reasoning as it did before GATT, could find that these foreign tax practices violate U.S. domestic law and, accordingly, are subject to countervailing duties. In repealing DISC unilaterally, the United States will thus not be defenseless in protecting itself against the tax practices of foreign countries.

Effective Date

The phased repeal of DISC will begin for the first taxable year of a DISC ending on or after January 1, 1979 and will be complete in taxable years of DISCs ending after December 31, 1980.

Revenue Estimates

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
193	664	1,228	1,513	1,613	1,751

Footnotes

1/ H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 1 (1971); S. Rep. No. 92-437, 92nd Cong., 1st Sess. 1 (1971).

2/ The 13 percent figure represents the decline in the effective trade-weighted value of the dollar against ten major currencies. Source: Board of Governors of the Federal Reserve System.

TERMINATING DEFERRAL

Present Law

Under present law U. S. citizens, residents, and corporations are subject to U. S. taxation on their worldwide income. Foreign corporations, including foreign corporations controlled by U. S. taxpayers, are generally subject to U. S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U. S. shareholder is usually consolidated with the income of the U. S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U. S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U. S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U. S.-controlled foreign corporation until that income is distributed to the controlling U. S. shareholders. The term "deferral" is employed because the net U. S. tax liability -- equal to the difference between the U. S. tax and the credit for foreign taxes -- is "deferred" until such income is distributed as a dividend.

Deferral does not apply when the nature of the controlled foreign corporation and its income exhibit "tax haven" characteristics. Tax haven income (so-called "subpart F income") is taxed currently to U. S. shareholders regardless of whether they actually receive the income in the form of a dividend. Likewise, U. S. shareholders are taxed on their pro rata share of the retained earnings of a foreign personal holding company, and on the earnings of any controlled foreign corporation which are in effect repatriated to the United States through the purchase of certain U. S. property.

Since the practice of deferral permits the income of controlled foreign corporations to escape current U. S. taxation until that income is repatriated as a dividend, it is important that transfer prices for transactions between U. S. shareholders and their controlled foreign corporations be properly determined. It is also necessary to ensure that reorganizations involving controlled foreign corporations are not undertaken for the purpose of tax avoidance. The tax law presently contains complex provisions designed to carry out these purposes.

Reasons for Change

The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U. S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U. S. taxpayers now have to locate new investment overseas rather than in the United States.

Terminating deferral will permit the rationalization and simplification of U. S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporations and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U. S. taxpayers to avoid U. S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.

(1) Terminating Deferral Will Preclude Substantial Tax Benefits From Turning on the Choice of Corporate Structure

When losses or large foreign tax credits are desired for U. S. tax purposes, a U. S. taxpayer may obtain these benefits currently by operating overseas through a branch. When foreign income does not generate sufficient foreign tax credits to offset U. S. tax, a current U. S. tax may be avoided by interposing a foreign corporate entity. A U. S. taxpayer is thus permitted to choose, through the form of its overseas operations, between two very different sets of substantive U. S. tax rules.

There is no good reason for this state of affairs. A choice of tax rules should not be accorded simply because business operations are situated abroad rather than in the United States. Such operations, in the case of a controlled foreign corporation, are an integral part of the overall activity of the U. S.-based firm, and the profits from such operations should, for this reason alone, be subject to current taxation in the United States.

In 1969 Congress dealt with a similar situation involving the availability of the $25,000 surtax exemption for each entity in a group of related domestic corporations. Congress took the view that a commonly owned business enterprise should be entitled to only one such exemption, whether it was operated under a single corporate charter or multiple charters and regardless of any genuine business reason for having multiple charters. The issue in the case of deferral is essentially the same: even if fully justified by business considerations, the interposition of foreign corporate charters should not affect the substance of U. S. taxation.

This point is, in fact, already recognized by some provisions of the Internal Revenue Code dealing with foreign income. U. S.

corporations are allowed a foreign tax credit (the so-called "deemed paid" credit) for taxes paid by their foreign subsidiaries. This allowance, which in 1975 amounted to more than $3 billion, reflects a recognition that the existence of a foreign corporate charter should not determine tax substance.

(2) Terminating Deferral Will End a Present Tax Incentive To Invest Overseas

Deferral gives U. S. taxpayers a substantial incentive to invest overseas for purely tax reasons. This incentive arises from a combination of the absence of current U. S. tax on the retained earnings of controlled foreign corporations, and the presence of tax inducements in many foreign countries. These foreign inducements take the form of low tax rates, rapid depreciation, tax holidays, and other special tax advantages not available in the United States.

U. S. investors need not look very far for tax holidays, for such benefits are heavily marketed in the United States. One foreign country, for example, publishes a brochure urging American business to "Get in on the . . . bonanza!" The bonanza includes "tax holidays, unlimited remittance of profits, repatriation of capital, protection against risks and the assistance offered by a friendly government from application to the start of production." Another recent advertisement in a business publication has a banner headline: "Exceptional Return on Investment Continues ...." As the advertisement explains, "export profits . . . . are completely free of tax until 1990. So a U. S. subsidiary . . . . grows faster, and at less cost to the U. S. parent. In spite of the fact that profits can be freely repatriated, U. S. companies ploughed back 65 percent of them and notched up an expansion of U. S. investment of 30 percent." With an exemption from foreign tax and a deferral of U. S. tax, it is easy to understand why profit margins in this country are abnormally high.

Tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U. S. capital where it will be most productive, whether in the United States or overseas. The elimination of deferral will advance this policy, since it will tend to ensure that foreign investment will be motivated by genuine economic factors.

(3) Ending Deferral Will Permit Simplification of the Rules Relating to Taxation of Foreign Income

The termination of deferral will permit the simplification of U. S. rules relating to the taxation of foreign income. Subpart F, the rules relating to foreign personal holding companies, the rules governing the foreign tax credit, and the rules regarding reorganizations of foreign corporations will all be affected.

The subpart F anti-tax haven provisions originated in a proposal submitted to Congress in 1961 by President Kennedy. The

purpose of that proposal, and of the provisions of subpart F, was to prevent U. S. businesses from exploiting the multiplicity of foreign tax systems and tax treaties so as to reduce or eliminate both U. S. and foreign tax liabilities.

Subpart F as drafted was not, however, structured to eliminate international tax avoidance by U. S. firms. It is focused exclusively upon a narrow class of so-called "tax haven" income. And its provisions are so complex that only a relative handful of persons are capable of understanding all of their implications. Although subpart F has doubtless discouraged many companies from undertaking blatant tax haven operations, highly sophisticated means of circumventing both the specific subpart F rules and their general objectives are available. Moreover, the Internal Revenue Service does not have the resources to mount an effective administrative effort to combat such schemes.

Terminating deferral for all controlled foreign corporations, as this proposal recommends, will permit the replacement of subpart F with a simpler, more comprehensible set of rules for U. S. taxation of foreign income. Terminating deferral will also permit repeal of the Internal Revenue Code provisions relating to taxation of foreign personal holding companies -- another series of provisions aimed at tax haven abuses.

Furthermore, terminating deferral will reduce the importance of the complicated rules relating to both the "deemed paid" foreign tax credit and multinational corporate reorganizations. The rules relating to the credit are not limited to controlled foreign corporations, and will have to remain in effect to cover foreign corporations owned in part, but not controlled, by U. S. persons. They will not, however, generally be required with respect to controlled foreign corporations if deferral is terminated, because a foreign tax credit will be available without regard to the "deemed paid" credit. The rules regarding corporate reorganizations will become less important because the potential for tax avoidance on the transfer of assets abroad will be diminished.

Eliminating deferral will thus have the highly desirable effect of making the U. S. system of taxing foreign income more comprehensible. The present system, complex and internally inconsistent, understood in all its detail by only a very few highly trained individuals, is simply not appropriate in the U. S. tax system. The rationalization of U. S. rules in this area will permit the Administration and Congress to see more clearly where real problems exist and to structure appropriate solutions having no unintended and unforeseen consequences for either taxpayers or the government.

(4) Terminating Deferral Will Help Equity and Competition

The present system of U. S. taxation of foreign income, with deferral as its centerpiece, has produced increasingly

sophisticated methods of tax planning by those involved in multinational transactions. As the Internal Revenue Service has issued new Regulations limiting opportunities for tax avoidance, and as Congress has tightened various rules in the system, taxpayers have become more and more ingenious in avoiding their impact. Offshore financial subsidiaries, holding companies, and captive insurance affiliates have proliferated. Computer programs to guide tax planning efforts have been developed. The major accounting and law firms have devised ever more refined planning techniques.

For example, the "rhythm method" of distributing dividends from foreign companies has become increasingly popular. Under this method foreign corporations only pay dividends to their U. S. parent companies in those years in which their effective foreign tax rate is high, rather than paying smaller dividends on an annual basis. Because of deferral and the "deemed paid" credit for foreign taxes paid by the foreign corporation, U. S. companies are able through this method to minimize U. S. tax on repatriated earnings. The technique illustrates how the existence of contradictory principles for taxing foreign income -- the "deemed paid" foreign tax credit which effectively treats parent and subsidiary as one enterprise, while deferral treats them as separate -- inevitably gives rise to opportunities for tax avoidance.

(5) Terminating Deferral Will Help Stop Practices Used To Avoid U. S. Tax

U. S. taxpayers have many opportunities today to avoid U. S. tax by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations, or imports the same from them. It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States.

In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. To determine whether the assigned transfer prices are appropriate for tax purposes, the United States and many other countries apply an arm's-length standard -- i.e., they require terms that would have been fixed in comparable transactions between an independent buyer and seller. The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling

income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.

Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.

Since the elimination of deferral will subject U. S. shareholders to current tax on the income of controlled foreign corporations, it may be expected to reduce if not eliminate the incentive to use techniques which serve to transfer excessive income to foreign corporations.

General Explanation

This proposal will phase out deferral over a three-year period. Beginning in 1981 the income of a controlled foreign corporation will be taxable as if it had been earned directly by the U. S. shareholder. This is the rule that has always obtained under the U. S. tax system where foreign operations are conducted by a U. S. taxpayer through a branch, rather than through a foreign corporation. Thus, U. S. tax liability under the proposal will closely approximate the amount that a U. S. shareholder would incur if it operated through a foreign branch. For 1979 and 1980 the above rule will apply to one-third and two-thirds, respectively, of the controlled foreign corporation's income.

The approach taken in this proposal will result in an accurate assessment of the U. S. shareholder's U. S. tax liability. Losses incurred by a controlled foreign corporation will be allowed to offset the U. S. source income of the shareholder. Similarly, foreign taxes imposed on the controlled foreign corporation will be treated as if they had been imposed on the U. S. shareholder and thus will be taken into account currently for purposes of the foreign tax credit rather than when the underlying income is actually repatriated.

The proposal allows the Treasury to consider the negotiation of tax treaties providing, in appropriate situations, that U. S. shareholders will not be taxed currently on certain income of their controlled foreign corporations operating in a treaty country.

Analysis of Impact

(1) Effect on Investment

Investment which is responding to real market forces will not be affected by the termination of deferral. Such investment represents a significant part -- but not all -- of U. S. overseas investment.

Most developed countries impose, in addition to corporate income taxes, withholding taxes on dividends, interest, and royalties paid to U. S. investors. Although the total tax burden in such countries is comparable to or higher than that in the United States, U. S. investment still flows to these countries because their markets are large and growing, consumer incomes are high, the demand for U. S. products is substantial, and a U. S. company can maintain its market position only by investing locally. Likewise, petroleum and other natural resource investments flow to countries with abundant natural resource deposits despite substantial tax and other payments to the governments in those countries. Finally, many less-developed countries attract labor-intensive production with low wage rates rather than tax incentives. These investments are far more typical of U. S. investment abroad than those motivated solely by tax considerations, and they will continue without the added benefits of deferral. Terminating deferral will thus operate to restrict only tax-induced investments.

The United States does not have any general interest in encouraging tax-induced investments. Foreign countries that offer tax incentives are not usually interested only in the type of investment that attracts exports from the United States and thus promotes domestic employment. To the contrary, foreign tax incentives are frequently aimed at the type of investment that promotes exports to the United States and thus displaces U. S. jobs. The United States has no reason to favor the latter category of investments.

There is good reason to believe that eliminating deferral will provide a moderate stimulus to total U. S. investment and employment. For some companies production in the United States is a direct and viable alternative to producing abroad. Some U. S. companies may have been induced by the combination of deferral and foreign tax incentives to stop exporting and start producing overseas. Alternatively, some companies may have stopped supplying the domestic U. S. market with goods made in the United States, electing instead to rely on imports from their own foreign affiliates. Moreover, even when domestic investment is not a direct substitute for foreign investment, domestic production can still benefit indirectly from the repeal of deferral. The capital that would have been used to finance a tax-induced foreign investment can be retained in the United States and used to finance an unrelated, but job-producing, domestic investment. The gains may be substantial in specific industries where foreign tax practices have hastened the export of jobs and capital.

(2) Competitiveness of U. S. Corporations Overseas

Some U. S. companies maintain that they cannot remain competitive in world markets without deferral. Any change which alters corporate tax burdens tends to alter the funds available for new investment, new research and development, and other programs aimed at expansion. But if this is true of deferral, it is equally true of other tax measures such as changes in the corporate tax rate or the investment tax credit.

These other methods of promoting competitiveness are better and fairer than deferral. In order to benefit from deferral, a corporation must invest abroad, not in the United States. As noted above, deferral may encourage companies to invest abroad for export back to the United States, thereby undermining the competitiveness of U. S. companies that choose to stay at home. Zenith Corporation, for example, was forced to go overseas not only by its Japanese competitors (Sony, Panasonic, etc.) but also by its American rivals (RCA, Motorola, etc.) that went abroad to carry out assembly operations. Finally, deferral promotes continued investment overseas; repatriation of profits, which would help domestic investment, is actually discouraged by deferral. None of these perverse side effects of deferral characterizes reduction of the corporate tax rate and expansion of the investment tax credit, measures which the Administration has proposed.

It should be noted, finally, that the competitiveness of a corporation depends on its overall tax burden, not on any single tax provision. Terminating deferral represents only a small offset to the benefits envisioned for companies in the Administration's tax package.

(3) Reactions of Foreign Governments

It is often argued that if the United States terminates deferral, foreign countries will retaliate by discriminating against U. S. investors so that U. S. companies will pay higher taxes to foreign governments rather than the United States. Foreign countries, it is said, may revoke the eligibility of U. S. subsidiaries for tax holidays or accelerated depreciation, or they may deem all earnings distributed and thereby subject to high withholding taxes.

Such developments are, however, unlikely in the case of developed countries. The tax rates in most of these countries match those of the United States. Furthermore, most developed countries have tax treaties with the United States that require nondiscriminatory treatment of U. S. investors. Since residents of developed countries often have substantial investments in the United States, it is doubtful that these countries would risk abrogation of their treaties with the United States.

22-302 O - 78 - 22

The United States has tax treaties with only a few less-developed countries, and the tax burden in some of these countries is lower than that in the United States. However, in many cases there will be no reason for these countries to retaliate against U. S. investment, because the termination of deferral will not produce higher U. S. taxes for many of the multinational companies operating within their borders.

Numerous U. S. companies already have an overall excess of foreign tax credits, and more will fall into this category if the U. S. corporate tax rate is reduced to 44 percent, as the Administration proposes. Under the "overall" foreign tax credit limitation -- the only limitation now in effect -- operations in low and high tax countries are combined. In the case of taxpayers with excess foreign tax credits, the United States will not, upon the elimination of deferral, impose any tax on profits from low-tax countries which are "sheltered" by excess credits from high-tax countries. Thus, many U. S. companies operating in foreign countries with a low rate of tax will not bear any more U. S. tax upon the elimination of deferral, and therefore those foreign countries will not have an incentive to raise taxes in retaliation to this proposal.

Furthermore, it is by no means clear that even a low-tax country believing that the end of deferral will subject U. S. investors to a higher U. S. tax burden will choose to retaliate. In the first place, it will be made clear that discriminatory taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States are not creditable under U. S. law. Low-tax countries desirous of promoting U. S. investments may not wish to take actions that could have the effect of actually penalizing such investments. More likely, such countries may wish to "validate" some of the tax incentives that they offer by seeking treaty provisions under which U. S. investors within their borders would continue to be entitled to deferral.

In some cases the United States may wish to validate the tax incentives that a developing country offers to U. S. investors. For example, investments that promote genuine economic development, have a minimal impact on U. S. employment, or increase U. S. access to critical raw materials may serve the national interest. But rather than giving a blanket incentive to foreign investment of all types and in all countries, the United States should focus the benefits of deferral through its tax treaty program. If deferral is terminated subject to exceptions by tax treaties, less-developed countries will be far more eager to conclude treaties with the United States than they have been in the past and developed countries that have treaties with the United States or are engaged in treaty discussions may be persuaded to offer favorable concessions.

(4) Administrative Impact Upon Taxpayers

It is sometimes argued that terminating deferral will involve serious administrative problems for U. S. companies. U. S. taxpayers, it is said, will not be able to maintain or obtain adequate records reflecting the income and deductions of controlled foreign corporations, particularly when there is no majority U. S. shareholder. It is also argued that the difficulty of translating books and records kept in foreign currency and under foreign standards into U. S. currency and standards justifies the retention of deferral.

The Administration is aware that there may be some administrative difficulties in some situations. However, U. S. companies with overseas branches, which have always been required to report foreign operations currently, have been able to solve these problems. U. S. parent corporations have long reported the earnings of controlled foreign corporations for SEC and general accounting purposes. And since 1962, controlled foreign corporations of U. S. shareholders have translated their books and records into U. S. standards for the purposes of subpart F. Finally, the provisions allowing for a "deemed paid" foreign tax credit, which have been in the law since 1918, require every U. S. corporation owning 10 percent of any foreign corporation (whether or not controlled by U. S. interests) to translate foreign books and records into U. S. standards in order to obtain the benefit of the indirect foreign tax credit. Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

Effective Date

The phase-out of deferral will apply to the first taxable year of each controlled foreign corporation ending in 1979 and to taxable years of U. S. shareholders with which or within which such taxable years of such foreign corporations end.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
0	88	280	768	830	897

These estimates do not take into account the effect of the proposed reductions in the corporate tax rate. The revenue gain from terminating deferral depends on the spread between the U.S. and average foreign tax rates. Therefore even a relatively small decrease in the U.S. tax rate can substantially reduce the revenue gain from terminating deferral.

Behavioral adjustments could also affect these estimates. Some investors may, for example, increase their actual dividends and thereby incur foreign dividend withholding taxes; this would reduce net taxes paid to the United States.

Other behavioral adjustments could, however, increase U. S. tax revenues beyond the above estimates. U. S. investors may invest more at home and less abroad than they would if deferral were maintained. The reduction of tax incentives to manipulate intrafirm transfer prices in order to shift taxable income away from the United States could produce substantial revenues not taken into account in the estimates. Although the potential revenue gains from these location-of-investment and transfer-pricing adjustments are impossible to estimate, they could easily outweigh any adverse revenue consequences of other behavioral adjustments attributable to the elimination of deferral.

Technical Explanation

(1) Current Inclusion of Income Earned by Controlled Foreign Corporations

The proposal will currently include in the income of U. S. shareholders their pro-rata share of the gross income and deductions of controlled foreign corporations. Income and deductions of each controlled foreign corporation will be treated as having been earned and incurred by the U. S. shareholder. The character of the income or deduction will be the same in the hands of the U. S. shareholder as it would have been if the activity had

been carried out abroad directly rather than through a foreign corporation. Controlled foreign corporations will, however, continue to be treated as corporations for the purposes of rules affecting transfer prices, corporate reorganizations, and other provisions of current law.

(2) Controlled Foreign Corporation

A controlled foreign corporation will be any foreign corporation of which either: (a) more than 50 percent of the total combined voting power of all classes of stock is owned, or is considered owned, by U. S. shareholders; or (b) more than 50 percent in the value of the outstanding stock is owned, or is considered owned, by U. S. shareholders. The use of a voting power test is consistent with present subpart F provisions. The use of a value test is consistent with the foreign personal holding company provisions.

(3) U. S. Shareholder

A U. S. shareholder is a U. S. person who owns, or is considered as owning, either: (a) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation; or (b) 10 percent or more in the value of the outstanding stock of a foreign corporation. For purposes of determining whether a company is a controlled foreign corporation and whether a person is a U. S. shareholder, the meaning of "U. S. person" as well as the constructive stock ownership rules will be substantially the same as those now contained in subpart F.

(4) Percentage Inclusion

The amount of a controlled foreign corporation's gross income and deductions attributable to a U. S. shareholder will be determined in proportion to that shareholder's rights to the net earnings of the corporation. This approach is substantially the same as that set forth in the current Regulations under section 1248.

(5) Treatment of Noncorporate Shareholders

Noncorporate shareholders required to include income and deductions currently will be treated as though such amounts were initially received by a domestic corporation. This rule, the mechanics of which have been developed under subpart F, will ensure equality of treatment between noncorporate and corporate shareholders.

(6) Losses

The excess of deductions over the gross income of a controlled foreign corporation will be treated as if realized directly by a U. S. shareholder, regardless of whether a corporate shareholder meets the stock ownership requirements for filing a consolidated return domestically.

If a U. S. shareholder has an overall foreign source loss attributable in whole or in part to the shareholder's pro-rata share of the losses of one or more controlled foreign corporations, the loss may offset his U. S. source income but will be subject to the recapture rules currently in section 904.

(7) U. S. Branch Rule

Gross income, deductions, and U. S. taxes of a U. S. branch of a controlled foreign corporation will be attributed to the U. S. shareholders of that corporation. This income will not, accordingly, be twice subjected to U. S. tax.

(8) Blocked Income

For the purpose of exchange control, certain foreign countries do not allow the expatriation of earnings derived within their borders. The proposal recognizes that it is inappropriate to tax currently all the earnings of a controlled foreign corporation in cases where distributions to U. S. shareholders have been "blocked" by currency or other restrictions imposed by a foreign country.

The Administration recognizes that the current rules with respect to blocked income may not be appropriate when deferral is terminated. It is anticipated that Regulations will be promulgated to describe those situations that prevailed prior to 1978 that will be treated as creating blocked income. However, any currency or other restrictions that are imposed solely against U. S. shareholders or imposed solely on a shareholder-by-shareholder basis will not be recognized as blocking income.

(9) Repatriation of Previously Taxed Income

Previously taxed income will be excluded from gross income of a U. S. shareholder when such income is distributed to the shareholder or any other U. S. person who acquires any portion of the U. S. shareholder's interest in the controlled foreign corporation.

(10) Basis Adjustments

As gross income and deductions of a controlled foreign corporation are recognized by the U. S. shareholder, an adjustment will be made to the basis of the shareholder's stock in the controlled foreign corporation. Actual distributions from the corporation that are excluded from gross income because they are attributable to previously taxed income will decrease such basis.

(11) Foreign Tax Credit

Since income and deductions will be treated as if realized directly by U. S. shareholders, foreign taxes paid by controlled

foreign corporations, regardless of tier, will be treated as if paid directly by U. S. shareholders. This rule simplifies the foreign tax credit by making unnecessary the "deemed paid" foreign tax credit calculation in the case of U. S. shareholders of controlled foreign corporations. Further, the rule removes an inequity in current law, under which a foreign tax credit is denied for any year in which a foreign corporation has a deficit calculated under U. S. principles, even though taxes were paid to a foreign country.

Eliminating deferral reduces both a corporation's ability to control the effective rate of foreign tax by controlling the source and rate of dividend distributions and the corporation's ability to minimize timing differences in deductions between the United States and foreign countries. To allow for such timing differences, it is proposed that the foreign tax credit carryback be lengthened from 2 to 3 years and that the foreign tax credit carryforward be lengthened from 5 to 7 years. It will be made clear that a foreign tax credit will not be allowed for withholding taxes applied only to U. S. investors, or on a shareholder-by-shareholder basis, or to deemed distributions.

(12) Exchange Gains and Losses

The proposal provides that unrealized exchange gains and losses will be taken into account by a U. S. shareholder. This is the rule for financial accounting purposes and it is similar to a tax rule available to U. S. branches overseas and to the rule used to determine earnings and profits under subpart F. The proposal provides, however, that a U. S. shareholder may elect, with respect to all of its foreign operations, not to take into account unrealized exchange gains and losses. This election is revocable, on a prospective basis, ten years after it has been made.

(13) Accounting, Record Keeping, and Reporting Requirements

Rules will be provided for making elections with respect to controlled foreign corporations, translating amounts from foreign currency, the computation of taxable income and earnings and profits, the keeping of records and accounts, and the reporting requirements of U. S. shareholders.

In general, taxable income and earnings and profits will be computed under U. S. standards. The Administration recognizes, however, that there are differences between U. S. and foreign standards, and will prescribe Regulations describing the extent to which deviations from U. S. standards will be allowed.

(14) Tax Treaties

The proposal allows the Treasury to consider the negotiation of income tax treaties allowing deferral to continue, in appropriate situations, in treaty countries.

(15) Corporations Organized in Puerto Rico and U. S. Possessions

A current provision of subpart F allows a controlled foreign corporation organized in Puerto Rico or a possession of the United States to be excluded from subpart F if it meets certain tests with regard to the source and nature of its income and business. This provision parallels slightly broader statutory protection from U. S. tax granted by way of a special "possessions" tax credit available to electing domestic corporations doing business in Puerto Rico and the possessions (except the Virgin Islands).

This proposal allows U. S. shareholders to continue deferral with respect to income of corporations organized under the laws of the Commonwealth of Puerto Rico or a possession of the United States (including the Virgin Islands). Income that would have been eligible for the possessions tax credit currently provided by the Internal Revenue Code if the controlled foreign corporation had been a domestic corporation will not be taxed currently to U. S. shareholders. Instead, such income will be treated in the same manner as "blocked income."

(16) Transition Provisions

In 1979 and 1980, U. S. shareholders will be required to take into income 1/3 and 2/3, respectively, of the gross income and deductions of controlled foreign corporations. The provisions of subpart F will also apply during these two years, although most of subpart F will be repealed for years after 1980. The 1/3 and 2/3 inclusion in 1979 and 1980 will apply to the income and deductions of a controlled foreign corporation after adjustment for amounts included in income by a U. S. shareholder under the subpart F provisions. Thus, if in 1979 a U. S. shareholder's controlled foreign corporation has $150 of taxable income of which $30 is foreign base company income under subpart F, the inclusion under this proposal for the U. S. shareholder will be $40 (1/3 x ($150 - $30) = $40) and the U. S. shareholder's total taxable income attributable to the controlled foreign corporation will be $70.

The rules of subpart F will apply for purposes of calculating the foreign tax credit attributable to income included under subpart F, and the rules under this proposal will apply for purposes of calculating the foreign tax credit attributable to the additional amounts included in the U. S. shareholder's income under the proposal.

(17) Other Provisions

Various provisions of the Internal Revenue Code are modified or repealed under this proposal. The foreign personal holding company provisions are repealed after 1980. Subpart F is repealed for future operations, although it will be necessary to maintain certain historical aspects. For example, the rules relating to taxation of investments in U. S. property will continue to apply to previously accumulated earnings. Also, it will be necessary to

determine whether actual distributions had been previously taxed under subpart F, and to determine the tax on certain amounts previously excluded from a U. S. shareholder's gross income under subpart F because they were reinvested in qualified shipping assets or in less-developed countries; any amounts thus excluded will be taxable when they are withdrawn from such investment. Section 1248 is also kept in force to handle accumulated earnings.

FINANCIAL INSTITUTIONS

Present Law

Depository financial institutions are not taxed in a manner comparable to other corporate taxpayers. Credit unions are completely exempt from tax; commercial banks, savings and loan associations, mutual savings banks and cooperative banks are allowed to take artificially large deductions for additions to bad debt reserves in computing taxable income. These deductions are allowed under liberal statutory formulas which apply only to these institutions, while other taxpayers must generally compute these deductions on the basis of experience.

Commercial banks are permitted until 1988 to accumulate bad debt reserves equal to a specified portion of their outstanding eligible loans, without regard to actual loss experience. The present statutory provision for commercial banks is a phase-out, enacted in the Tax Reform Act of 1969, of even more generous treatment under prior administrative practice. Until 1982, commercial banks are permitted to build up their reserves for tax purposes to 1.2 percent of eligible loans (in general, loans made in the course of normal customer loan activities). Beginning in 1982 and before 1988, the build-up is permitted to 0.6 percent of eligible loans. Once the tax reserve is built up to these maximum levels, or the higher levels permitted prior to 1969, a bank can in effect continue to deduct actual losses rather than charge losses against its reserve, so long as there is no decrease in outstanding eligible loans. To date, this rule has permitted banks to shelter from tax approximately $4 billion of income. Beginning in 1988, however, commercial banks will have to base further additions to their reserves on actual loss experience.

Mutual savings banks, savings and loan associations, and cooperative banks (commonly referred to as "thrift institutions") are allowed to deduct annual additions to their bad debt reserves equal to a specified percentage of net income. In contrast to the treatment of commercial banks, the preferential treatment accorded thrift institutions will continue indefinitely; the allowable addition is, however, being phased down from 60 percent of net income (allowed prior to the Tax Reform Act of 1969) to a permanent level of 40 percent in 1979. Eligibility for this special percentage method depends on compliance with a comprehensive set of investment standards, adopted by Congress to limit these tax benefits to institutions engaged primarily in home mortgage financing.

The full percentage deduction is allowed only if a specified portion (82% for savings and loan associations and 72% for mutual savings banks) of an institution's investments consist of qualifying assets, primarily home mortgages. The deduction is reduced if the institution has a smaller portion of qualifying assets. The basic standards, however, are easily met by most savings and loan associations because of other regulatory requirements.

Thrift institutions are allowed only half of the investment tax credit available to other taxpayers. The dividends-received deduction otherwise allowable to a thrift institution is also reduced by a percentage equal to the percentage of net income exempted from tax by virtue of the special bad debt deduction.

In addition, in the case of both commercial banks and thrift institutions, the excess of the bad debt reserve deduction, computed under the statutory percentage method, over the deduction which would have been allowed based on experience is an item of tax preference, subject to the minimum tax.

Reasons for Change

Commercial Banks. The allowable bad debt deduction for commercial banks greatly exceeds actual losses. In the period 1955-66, commercial bank bad debt deductions of $5.7 billion exceeded actual losses of $2.1 billion by more than 167 percent. From 1969 through 1975, under the present statutory provisions, deductions exceeded losses by over $400 million. (See Tables IVD-1 & IVD-2). If not corrected the revenue loss from excessive bad debt deductions by commercial banks for the period 1979 through 1982 is expected to exceed $710 million.

The preferential bad debt treatment for commercial banks was developed by administrative action. In 1947, the Treasury Department permitted a bank to accumulate a reserve to reflect a loss rate not exceeding three times its average losses during the previous 20 years; in 1955, banks were permitted to select as a base period any 20 consecutive years after 1927, thus permitting inclusion of the depression years. In 1965, in order to eliminate the disparity in allowable deductions among individual competing banks, the Treasury Department broadened the availability of this special tax treatment to all commercial banks by permitting bad debt reserves equal to 2.4 percent of outstanding loans not insured by the Federal government. This figure is roughly three times the average annual bad debt loss of commercial banks during the period 1928-47.

Table IV-D-1

Bad Debt Losses and the Bad Debt Deduction: 1969-1975

Insured Commercial Banks
($ millions)

	1969	1970	1971	1972	1973	1974	1975	1976
Bad debt losses	489	982	1087	887	1159	1957	3243	3503
as a percent of uninsured loans	0.18	0.36	0.37	0.26	0.28	0.42	0.68	0.72
Bad debt deductions	521	703	867	973	1265	2286	3612	3691
as a percent of uninsured loans	0.20	0.26	0.29	0.29	0.31	0.49	0.76	0.75

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-2

Income, Income Shares, Income Taxes and the Bad Debt Deduction: Insured Commercial Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$30,299	$34,456	$36,710	$40,439	$52,994	$68,018	$66,640	$81,004
Percentage distribution:								
Administrative and operating expenses	40.4%	42.6%	42.1%	41.4%	35.8%	32.3%	36.4%	43.6%
Interest paid depositors & creditors	37.7	35.8	36.6	38.1	45.7	51.2	44.9	39.3
Net losses on loans	1.3	2.9	3.0	2.2	2.2	2.9	4.9	4.3
Income attributable to equity	20.5	18.7	18.2	18.4	16.3	13.7	13.8	12.7
Federal income tax	4.3	4.7	3.7	3.2	2.5	2.0	1.8	1.7
Net income after tax	16.3	14.0	14.5	15.2	13.8	11.7	12.0	11.0
Federal income tax as a percent of income attributable to equity	20.7	25.1	20.4	17.3	15.5	14.6	13.3	13.3
Provisions for loan losses as a percent of gross income	1.7	2.0	2.4	2.4	2.4	3.4	5.4	4.6
Excess of provisions for loan losses over net losses	120	-279	-220	86	106	329	369	188
As a percent of gross income	0.4	-0.8	-0.6	0.2	0.2	0.5	0.6	0.2
Additional tax liability that would result from the taxation of loan loss provisions in excess of net losses at 48 percent	58	-134	-106	41	51	158	177	90
As a percent of gross income	0.2	-0.4	-0.3	0.1	0.1	0.2	0.3	0.1
Bad Debt Reserves as a percent of loans other than Federal Funds, Insured Loans, and Loans to other banks	2.2	2.2	2.1	2.0	1.8	1.8	1.8	1.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation.

This very generous treatment was justified as a measure to protect commercial banks from possible catastrophic losses. It was argued that a commercial bank should be allowed to allocate a large portion of its income to reserves to protect its solvency during periods of extreme economic distress. However, since banks are not required to set aside the resultant tax saving in the form of cash or other liquid assets, the tax provision does not assure commercial bank solvency. Indeed bank solvency in periods of cyclical financial crises can only be assured by actions of the Federal Reserve system, which is authorized by law to make loans to member banks secured by their business loans and to make purchases of government bonds in the open market. Similarly, security for depositors is provided through deposit insurance. These institutional safeguards, along with continual surveillance of the lending policies of individual banks by Federal and state bank regulatory agencies, protect the banking system and its depositors.

In the Tax Reform Act of 1969 Congress recognized that continuation of the preferential tax treatment of commercial banks was not justified and required the adoption by 1988 of the experience method used by other taxpayers. Further, since 1976 commercial banks and other financial institutions have enjoyed special protection from extraordinary losses in the form of a ten year carryback and five year carryforward of net operating losses. (In contrast, other taxpayers are generally allowed a three year carryback and seven year carryforward of net operating losses.) It is, therefore, appropriate to place commercial banks on the same footing as other taxpayers in determining their bad debt deductions.

Thrift Institutions. Thrift institutions were originally exempt from tax on the same theory that now justifies the exemption for social clubs: there is no income if one deals with oneself. This exemption for mutual savings banks and savings and loan associations was ostensibly ended in 1951. Congress recognized at that time that savings and loan institutions "are no longer self-contained cooperative institutions as they were when originally organized..." (S. Rep. No. 781, 82d Cong., 1st Sess. 28 (1951).) In the long run, "membership" in these institutions was not restricted so that a member's investments and debts were approximately equal, nor was it certain that any given member would receive a proportionate share of the accumulated earnings of the organization. More generally, both mutual savings banks and savings and loan associations offered a full range of depository and lending services to a broad group of persons on terms differing in no significant way from the terms on which the same services were offered by taxable financial institutions. The size and character of thrift institutions required parity between them and their competitors.

Nevertheless, the movement from tax-exempt to taxable

status has proceeded slowly. Notwithstanding the 1951 legislation, thrift institutions were virtually tax exempt until 1962 because of their special deduction for bad debt reserves. Even after a revision of the bad debt reserve deduction in 1962, and until the Tax Reform Act of 1969, mutual savings banks were able to avoid substantially all Federal income taxes, and savings and loan associations were subject to effective tax rates of approximately 15 to 18 percent, only 30 to 35 percent of the then prevailing corporate rate. The 1969 Act increased the effective tax rate for thrift institutions to approximately 50 to 60 percent of the regular corporate rate.

The preferred tax treatment accorded thrift institutions is frequently justified because of the role played by these institutions in the home mortgage market. The thrift institution statutory bad debt deduction, however, is an insignificant factor in encouraging the supply of home mortgages. The ability of thrift institutions to hold mortgages depends critically on the willingness of depositors to hold savings accounts in those institutions; this willingness to hold deposits depends on the pass-book interest rates which the thrift institutions can pay. In turn, the interest rate thrift institutions can pay their depositors depends primarily on mortgage interest yields and the deposit interest rate ceilings imposed by Federal authorities. Finally, mortgage interest yields are governed by the activity of such federally sponsored institutions as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and a long list of public and private mortgage insurance agencies.

Allowance of the artificially high statutory bad debt deduction for thrift institutions undermines the basic policy decision that these entities should be taxable. The bad debt deductions of thrift institutions are typically three to six times their actual losses. (See Tables IVD-3 through IVD-5). Allowance of these deductions at the present statutory levels will result in a revenue loss of $4 billion over the six-year period 1977-1982. Artificial bad debt deductions do not afford thrift institutions protection from insolvency; as in the case of commercial banks, there is no requirement that the institution's untaxed income be set aside to provide for losses. Federal and state regulation and examination, along with the maintenance of secondary mortgage markets by federally sponsored agencies, protect the solvency of thrift institutions The special provision allowing ten year carryback and five year carryforward of net operating losses adequately protects thrift institutions from the tax effects of extraordinary, unprecedented losses.

Table IV-D-3

Bad Debt Deductions and Actual Bad Debts

Savings and Loan Associations and Mutual Savings Banks

($ million)

	1972	1973	1974	1975	1976
Savings and Loan Associations					
Actual bad debts	34	58	86	149	140
Bad debt deduction	923	1042	865	806	1109
Ratio of bad debt deductions to actual bad debts	27.15	17.97	10.06	5.41	7.29
Mutual Savings Banks					
Actual bad debts	36	34	61	52	58
Bad debt deduction	173	204	193	205	218
Ratio of bad debt deductions to actual bad debts	4.81	6.00	3.16	3.94	3.76
Total					
Actual bad debts	70	92	147	201	198
Bad debt deductions	1096	1246	1058	1011	1327
Ratio of bad debt deductions to actual bad debts	15.66	13.54	7.20	5.03	6.70
Losses on bad debts as a percent of uninsured loans	0.03	0.04	0.06	0.07	

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

22-302 O - 78 - 23

Table IV-D-4

Income, Income Shares and the Bad Debt Deduction:
Insured Mutual Savings Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$3,523	$3,754	$4,471	$5,280	$5,973	$6,335	$7,116	$8,333
Percentage distribution								
Administrative and operating expenses	13.6%	14.7%	14.2%	14.0%	14.4%	14.9%	15.6%	15.7%
Interest paid depositors and creditors	80.0	80.1	76.6	74.8	75.5	78.7	78.0	76.0
Net losses on loans	0.05	0.05	0.1	0.1	0.2	0.2	0.3	0.9
Income attributable to equity	6.4	5.1	9.1	11.1	9.9	6.3	6.1	7.4
Federal income tax	0.4	0.7	1.4	2.1	1.9	1.3	0.9	1.3
Net income after tax	6.0	4.5	7.7	9.1	8.0	5.0	5.1	6.1
Federal income tax as a percent of income attributable to equity	6.3	13.0	15.7	18.6	19.2	20.4	15.5	17.6
Bad debts as a percent of income attributable to equity	0.4	0.5	0.7	0.7	1.5	2.5	5.1	12.8
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	94	68	131	173	171	110	140	187
As a percent of gross income	2.7	1.8	2.9	3.3	2.9	1.7	2.0	2.2

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-5

Income, Income Shares, and Income Taxes:
Insured Savings and Loan Associations, 1972-1975

	1972	1973	1974	1975
Gross Income: (millions)	$15,323	$18,392	$21,102	$23,905
Percentage distribution				
Administrative and operating expenses	17.2%	17.5%	17.5%	17.5%
Interest paid depositors and creditors	68.2	68.5	72.6	73.7
Net losses on loans	0.2	0.3	0.4	0.6
Income attributable to equity	14.4	13.7	9.5	8.1
Federal income tax	3.4	3.4	2.5	2.1
Net income after tax	11.0	10.3	7.0	6.1
Federal income tax as a percent of income attributable to equity	23.5	24.7	26.4	25.7
Bad debts as a percent of income attributable to equity	1.5	2.3	4.3	7.6
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	541	588	435	435
As a percent of gross income	3.5	3.2	2.1	1.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Combined Financial Statements, Federal Savings and Loan Insurance Corporation

Credit Unions. Credit unions were excluded from the decision to make other thrift institutions taxable in 1951. Equity now demands, however, that these entities be placed on a parity with thrift institutions, their competitors.

Many credit unions are no longer truly mutual institutions with limited "common bonds" required for membership. The legal concept of common bond has been expanded so that mere residence in a state may be sufficient for membership in a credit union, and even those persons who leave an area may continue to be members. A Federal appeals court even held recently that an institution may qualify as a credit union despite the absence of membership restrictions if most depositors in fact have similar characteristics, a "de facto" common bond. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

Many credit unions also are expanding beyond the factory and farm worker constituency that they represented when they were first regulated nationally in 1934 by the Farm Credit Administration. The residential common bond, although presently the least frequently used, is the fastest growing one among Federal credit unions. Furthermore, the size of individual accounts is growing. In Federal credit unions, accounts larger than $5,000 aggregated $2.1 billion at the end of 1970 and $11.1 billion at the end of 1976. This increase and the increase in the median income of depositors indicate that credit unions are appealing to other than low-income workers who have been excluded from access to banking services elsewhere.

The powers and services of credit unions have also expanded enormously, especially over the past seven years, so that they are becoming indistinguishable from other financial institutions. In 1970, Congress enacted Federal share insurance legislation, which insures the accounts of Federal credit unions and about half of the savings in state credit unions. In the Depository Institutions Amendments Act of 1977, Federal credit unions were granted the power to offer credit cards, to loan funds without specific dollar limits for up to 12 years, and to make real estate loans for up to 30 years. Many state-regulated credit unions have similar powers, including the authority to offer interest-bearing checking accounts. There is no correlation between an individual's credit union loans and deposits; persons who become members with a $5 share may borrow up to the institution's lending limit. The state regulated La Caisse Populaire Ste. Marie (St. Mary's Bank), a "credit union," invested more than 80 percent of its loan funds in real estate and had substantial demand deposits.

The sheer growth of these financial intermediaries in the decades since 1951 demonstrates that they should be treated equally with their competitors. In consumer

installment credit, credit unions hold 17 percent of the market and have been the largest factor in the increase in installment credit in the past few years. The assets of some of the largest credit unions exceed or rival large savings and loan associations in some states, and a few credit union groups have even purchased banks. Since the end of 1970, the total assets of Federal credit unions have nearly tripled and those of state credit unions have more than doubled to a total of $45.1 billion for their 33.6 million members. (See Tables IVD-6 and IVD-7.) The numbers are even more striking when compared to the 1951 figures when thrift institutions were made taxable. At that time credit unions had $1 billion in assets and 5.2 million members.

The blurring of the distinction between credit unions and other thrift institutions argues for the same tax treatment for these entities. In the absence of such treatment the tax system elevates form over substance by encouraging banks and other thrift institutions to be organized in the form of credit unions.

General Explanation

The Administration's proposal will require commercial banks to use only the experience method for computing additions to their bad debt reserves. They will thus be allowed to deduct additions to loss reserves based on the larger of their average loan loss experience over the current and five preceding years or actual losses. The present transition rules, which until 1988 allow a build-up in reserves to a percentage of outstanding loans, will be repealed.

The percentage of taxable income method of determining bad debt deductions for thrift institutions will be phased down from its current 41 percent level to 30 percent by 1983. Credit unions will be made subject to tax on the same basis as thrift institutions, and will be permitted to claim the thrift institution bad debt deduction; they will not, however, be subject to the investment restrictions which apply to thrift institutions. The bad debt deduction available to credit unions will be phased down ratably from, in effect, 100 percent of net income under present law to 30 percent over a period of five years.

As a result of these changes, the investment tax credit available to thrift institutions (and credit unions) will be increased to 70 percent of the credit available to other taxpayers. In addition, thrift institutions and credit unions will be made eligible for the full (generally, 85 percent) dividends-received deduction. Dividends received will be excluded, however, from income for purposes of determining the maximum bad debt deduction.

Table IV-D-6

Federal Credit Unions

	1972	1973	1974	1975	1976
Gross Income: (millions)	$1,046	$1,251	$1,504	$1,749	$2,124
Percentage distribution					
Administrative and operating expenses	32.2%	31.3%	29.5%	30.4%	31.9%
Interest refunds	3.5	3.1	2.5	2.2	2.0
Other interest payments	1.4	1.8	2.6	2.9	3.0
Net losses on loans	3.2	3.1	4.4	4.2	2.4
Dividends to shares	49.4	50.8	50.7	52.9	53.2
Income attributable to equity	10.4	9.9	10.4	7.4	7.5
Growth Rate	18.0%	19.7%	20.2%	16.3%	21.5%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the National Credit Union Administration

Table IV-D-7

Federally-Insured State-Chartered Credit Unions

	1971	1972	1973	1974	1975	1976
Gross Income (millions)	$163	$278	$382	$554	$757	$958
Percentage distribution:						
Administrative and operating expenses	35.1%	35.4%	34.6%	34.4%	32.7%	31.8%
Interest Refunds	3.2	3.1	2.6	2.7	2.2	2.2
Other interest payments	1.4	1.5	1.9	2.4	2.1	2.4
Dividends on shares	48.5	46.8	48.7	47.8	48.2	46.4
Income attributable to equity	11.9	13.2	12.3	12.7	14.7	17.2
Growth Rate	-	70.9%	37.4%	45.1%	36.7%	26.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the National Credit Union Administration

Analysis of Impact

Depository institutions may be organized as stock corporations (generally, commercial banks and some savings and loan associations) or as mutual associations (generally, mutual savings banks, credit unions, and non-stock savings and loan associations). Institutions organized as stock corporations derive most of the funds used to acquire income producing assets from depositors and a relatively small portion from equity investors. A correspondingly large portion of the stock institution's income must be allocated to the cost of deposits and a relatively minor portion to equity. Since the interest cost of deposits and capital debt is deductible in computing taxable income, the burden of federal income tax falls initially on that portion of the institution's income attributable to equity.

Stock financial institutions adjust to changes in the rate of tax on income attributable to corporate equity in the same manner as other corporations. Possible responses by stock institutions to the increased tax burden resulting from these proposals include one or both of the following:

(a) Adjustment of portfolios to increase gross income sufficiently to cover the higher corporate income tax. This could be accomplished by increasing lending rates to customers or switching investment to higher yielding assets.

(b) Reduction of either the nominal interest paid depositors or the battery of "free" services provided them.

Since the gross income and interest expense of these institutions is quite large in comparison to the increase in tax resulting from these proposals, it is anticipated that the proposals ultimately will result in approximately a .03 to .04 percent increase in lending rates by all affected institutions, or in a .02 to .04 percent reduction in rates paid depositors. However, in the case of credit unions, if the full adjustment were borne by shareholders, the reduction would be slightly more than one-half of one percent.

The equity interest in mutual institutions is held, in effect, by depositors. Since "share dividends" (i.e., interest on deposits) are deductible by the institution, the burden of the Federal income tax falls solely on the income of the corporation which is not paid to depositors. A mutual institution will respond to the proposed changes in a manner substantially the same as a stock institution if it desires to maintain the same level of retained earnings as under present law, i.e., it will seek to increase the spread between gross income and its cost of funds to compensate for the additional Federal tax. A mutual institution may, on the other hand, avoid the imposition of additional tax by decreasing that spread. It may reduce its lending rates or,

more probably, increase its "dividend" to depositors.

Effective Date

Repeal of the commercial bank percentage method of computing bad debt deductions will be effective for taxable years beginning after 1978. The phase-down of the percentage method for computing bad debt deductions for thrift institutions and the phase-in of the taxation of credit unions will commence in the first taxable year beginning after 1978. Thrift institutions and credit unions will be allowed the increased investment tax credit and the full dividends-received deduction for taxable years beginning after 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	286	367	460	367	487

Technical Explanation

The percentage of outstanding loans method of computing deductible additions to bad debt loss reserves for commercial banks under present law will be repealed.

In the case of thrift institutions, the change in the percentage of net income method (from 41 percent in 1978 to 30 percent in 1983) will be made gradually, with a phase down similar to that in current law. The taxation of credit unions will be introduced gradually by allowing a deduction for bad debts phased down ratably from, in effect, 100 percent of net income for 1978 to 30 percent in 1983. Thrift institutions and credit unions will be permitted a 30 percent bad debt deduction beginning in 1983.

Bad Debt Deduction for Savings and Loan Associations and Mutual Savings Banks Under the Percentage of Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	38%
1980	36%
1981	34%
1982	32%
1983 or thereafter	30%

Bad Debt Deduction for Credit Unions Under the Percentage of Taxable Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	86%
1980	72%
1981	58%
1982	44%
1983 or thereafter	30%

Under present law the bad debt deduction for thrift institutions is computed as a percentage of taxable income, with certain modifications. Since the dividends-received deduction is reduced for thrift institutions using the percentage bad debt deduction, these institutions are permitted to include the taxable portion of their dividends received in taxable income for purposes of computing their bad debt deduction. Since thrift institutions and credit unions will be allowed a full dividends-received deduction under the proposal, dividends received will be excluded from taxable income for purposes of computing the bad debt deduction.

ACCRUAL ACCOUNTING FOR AGRICULTURAL CORPORATIONS

Present Law

The Internal Revenue Code requires that the accounting method used in preparing a taxpayer's return "clearly reflect income." This restricts the taxpayer's flexibility in choosing among the cash receipts and disbursements method, the accrual method and other permissible accounting methods in computing taxable income. 1/ Most taxpayers who are in the business of selling products are required to use the accrual method of accounting under which the cost of the product must be accumulated in inventory and offset against sales receipts. Expenses are thus properly matched with the income they produce, and taxable income is "clearly reflected" within the meaning of the tax law.

By virture of administrative rulings issued more than 50 years ago, however, farmers have generally been exempted from the accrual accounting requirement. The reason for this exemption was the impression that farmers lack the financial resources and the expertise necessary to match farming expenditures with the particular farming income. As a result, the simpler cash receipts and disbursements method was permitted, even though it tended to misstate farmers' taxable income.

Limited exceptions from the cash method privilege for farming operations were introduced by the Tax Reform Act of 1976. That Act established the general rule that corporations (and partnerships with a corporate partner) engaged in farming must use the accrual method of accounting and capitalize preproductive period expenses. However, exemptions were provided for (1) nurseries and farms engaged in raising or harvesting of trees (other than fruit and nut trees); (2) corporations with annual gross receipts of $1 million or less; (3) Subchapter S corporations; and (4) corporations where 50 percent or more of voting stock and 50 percent or more of all classes of stock are owned by members of the same family. 2/

Accrual accounting requires that firms match the deductions for farming expenditures with the income related to those expenditures. For example, an accrual farmer cannot deduct currently the cost of feed for his beef cattle; rather, the feed cost is reflected in the opening and closing inventory values of the cattle. Similarly, a farmer on the accrual basis cannot deduct the cost of such items as seed and fertilizer until the resulting crops are sold. In the

case of multi-yield assets such as dairy cattle or apple orchards, the costs of developing the assets to maturity must be capitalized and deducted after maturity through depreciation or, in the case of livestock, through inclusion in inventory values. However, an exception is provided from the capitalization requirement for taxes and interest and any expenses incurred on account of casualties.

In addition to the accounting requirements for corporate farms, the 1976 Reform Act contains related, but less stringent, accounting rules for "farming syndicates." A farming syndicate cannot deduct amounts paid for feed, seed, fertilizer, or other farm supplies until those supplies are actually used or consumed. Moreover, the cost of poultry purchased for use in a syndicate's trade or business must be capitalized and deducted ratably over the lesser of 12 months or their useful life; the cost of poultry purchased by a syndicate for resale can be deducted only upon disposition. And the expenditures incurred to raise a grove, orchard or vineyard to maturity must also be charged to a capital account. For these purposes, a "farming syndicate" is a partnership, subchapter S corporation or other enterprise, such as an agency relationship, which has its participation interests registered or required to be registered with a State or Federal securities agency, or in which more than 35 percent of the entity's losses are attributable to limited partners or other persons not actively participating in the management of the farming enterprise (referred to in the Code as "limited entrepreneurs").

Accordingly, the accounting rules for farm corporations and farm syndicates are similar with respect to limited categories of farm assets. Specifically, both corporations and syndicates are required to capitalize the cost of poultry, whether used for egg-laying or sold for meat. Both are required to capitalize the preproductive period costs of groves, orchards or vineyards, even though there are variations in the respective rules relating to the time over which capitalized amounts can be recovered. With respect to all other farm products, however, the accounting requirements relating to corporations are substantially more restrictive than the syndicate rules. Current law does not require that the feed, seed or fertilizer expenses of syndicates be matched with the income produced from such assets as field crops and cattle. As long as a syndicate actually uses the farm supplies during the taxable year, a current deduction is permitted. Corporations, on the other hand, are subject to the general requirement that all preproductive period expenses be matched with related income through use of the accrual accounting method and the capitalization of expenses incurred before the realization of income.

Reasons for Change

In enacting the Tax Reform Act of 1976, Congress recognized instances where the rationale for farmers' cash accounting privilege is no longer applicable. Large farming corporations cannot fairly claim that they lack access to the sophisticated accounting and recordkeeping procedures involved in the accrual method of accounting. In fact, most large companies are already required to keep financial records on the accrual basis in order to obtain certification of financial statements by an accountant. As a result, the cash method of accounting serves not to relieve large corporations from recordkeeping burdens, but rather to misstate substantially the taxable income of those enterprises.

The 1976 Act did not go far enough in its application of the accrual requirement. During consideration of the Tax Reduction and Simplification Act of 1977, Congress was presented with claims that the "one-family corporation" exception to the accrual accounting requirement arbitrarily granted a substantial competitive advantage to several multimillion dollar farming operations at the expense of other large farm corporations that failed to fall within the definition of a family corporation. The approach taken by Congress in the 1977 Act was to extend for one year the family corporation exemption to cover at least two additional corporations that allegedly had been placed at a competitive disadvantage in spite of the fact that these corporations each had annual gross sales in excess of $50 million. The 1977 Act did not address the fundamental cause of the inequity; the fact that a distinction between family and non-family corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers who truly lack access to the necessary accounting and recordkeeping procedures involved in the accrual method of accounting.

By eliminating the family corporation exemption, the Administration's proposal will result in the application of the accrual method requirement to all large farming corporations (aside from subchapter S corporations, which are treated for tax purposes essentially like partnerships). Farming corporations with annual gross receipts of $1 million or less will still be exempted in order to preserve the availability of the cash method of accounting for those corporate farms that may lack access to accounting and recordkeeping expertise. Moreover, the Administration's proposal will extend the accrual accounting requirement to all farming syndicates, regardless of size. In those instances where interests in farming operations are required to be registered with Federal or State securities officials or where a substantial portion of the enterprise is owned by

passive investors, the rationale for cash accounting is also inapplicable. Persons who are involved in farming as outside investors, whether for tax shelter opportunities or for positive economic return, should not share in a cash accounting privilege designed for farmers unaccustomed to sophisticated financial transactions.

One additional change is desirable in order to remove an exception to the accrual accounting requirements that no longer seems warranted. The Administration has proposed that state and local taxes, aside from income taxes and real property taxes, not be deductible as taxes. Sales taxes, personal property taxes and other miscellaneous taxes will instead be expensed or capitalized by a taxpayer in accordance with the rules relating to other business expenditures. Following this general treatment of state and local taxes, the taxes of a farmer (aside from income taxes and real property taxes) will be treated like any other expenditures incurred in raising farm products.

General Explanation

The Administration proposal will delete the exception for family corporations from the requirement that corporations engaged in farming compute taxable income on an accrual method of accounting and with the capitalization of preproductive period expenses. The proposal will also extend those accounting requirements to "farming syndicates" as defined in the Tax Reform Act of 1976.

Therefore, under the Administration's proposal, the following farming operations will be required to use an accrual method of accounting and to capitalize preproductive period expenses:

(1) All farming syndicates (as defined under current law);

(2) All corporations (and partnerships with a corporate partner) engaged in farming, with the exception of (a) nurseries or other farming operations that raise or harvest trees (other than fruit and nut trees), (b) subchapter S corporations, and (c) corporations which do not have annual gross receipts exceeding $1 million.3/

As under present law, the "preproductive period expenses" required to be capitalized will not include interest or expenditures incurred on account of casualties. However, taxes, aside from income taxes and real property taxes, will no longer be excluded from the definition of "preproductive period expenses."

Analysis of Impact

Approximately 94 percent of all corporate farms have annual gross receipts under $1 million and will thereby remain eligible to use the cash receipts and disbursements method of accounting. In most instances, farming syndicates and the large corporations with receipts above $1 million already use accrual accounting for financial purposes. Therefore, it is unlikely that the Administration proposal will create any substantial recordkeeping problems for the large, family corporations and syndicates formerly exempted from the accrual method requirement.

Since the exemption for ordinary corporations will be based solely on the amount of gross receipts, equity among comparably situated taxpayers will be increased. The Administration proposal will eliminate the competitive disadvantage incurred by large farm corporations, using the accrual method, which must compete with other large corporations entitled to use the cash method because the latter happen to fall within the definition of "family corporation."

Effective Date

The proposed change will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability

($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-	40	25	10	5	7

Technical Explanation

For the purpose of the accrual rules, a "farming syndicate" will be defined as it is in the Tax Reform Act of 1976. Accordingly, a "farming syndicate" will include any enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if any offering of interests in the enterprise were required to be registered with any federal or state securities agency, or an enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or

other limited entrepreneurs not actively participating in the management of the enterprise. The statutory definition of "farming syndicate" will also preserve the provisions that treat interests meeting the following requirements as interests not held by a limited partner or limited entrepreneur: (a) where an individual has an interest attributable to his active participation in the management of any trade or business of farming for a period of not less than 5 years; (b) where an interest is held in an enterprise engaged in operating a farm which serves as the principal residence of the individual who owns that interest; (c) where an individual has a participating interest in the further processing of livestock raised in a farming operation covered by the above provisions or in whose management that individual actively participates; (d) where the interest is owned by an individual whose principal business activity involves active participation in the management of a trade or business of farming; and (e) where an individual is a member of the family of a grandparent of an individual who would be excepted under any of the four situations listed above, and his interest is attributable to the active participation of such individual.

With respect to both farming corporations and syndicates, "preproductive period expenses" will refer to expenditures attributable to crops, animals or other property having a crop or yield during the period of time (a) prior to the disposition of the first marketable crop or yield of property having a useful life of more than one year, or (b) before disposition of any property having a useful life of one year or less. 4/ Exceptions from the definition will be retained for interest and expenses incurred on account of casualties, disease or drought; but taxes, aside from income taxes and real property taxes, will not be excepted. Also, in applying the definition, the use of self-produced supplies of the farm will be considered a disposition of those supplies.

Finally, any taxpayer required by this provision to change its method of accounting will treat such a change as having been made with the consent of the Secretary of the Treasury, will consider the change as not having been initiated by the taxpayer, and will generally be given a ten year period to take into account the net amount of adjustments required in the computation of taxable income. The Secretary will prescribe regulations indicating those situations in which less than a ten year period is appropriate (e.g., the taxpayer was in existence for less than ten years).

Footnotes

1/ Under the cash receipts and disbursements method, gross income items are to be included for the taxable year in which actually or constructively received; and expenses are to be deducted for the taxable year in which actually paid. Under the accrual method, income is to be included for the taxable year in which all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy; deductions are permitted for the taxable year in which all the events have occurred which establish the fact of liability and the amount thereof can be determined with reasonable accuracy.

2/ Under the Tax Reduction and Simplification Act of 1977, another exemption until taxable years beginning after December 31, 1977 was granted where two families own at least 65 percent of the stock or where three families own at least 50 percent of the stock and substantially all of the remaining stock is owned by corporate employees, their families or exempt retirement trusts established for the benefit of the employees.

3/ These exceptions will not apply if the entity is a "farm syndicate."

4/ Under present law, a farming syndicate must capitalize those expenditures incurred in developing a grove, orchard or vineyard prior to the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. This special rule will be eliminated, and farming syndicates raising fruit or nuts will be subject to the general provision described above. However, all taxpayers will continue to be covered by a special Code provision for citrus and almond groves (section 278). That provision requires capitalization of the developmental expenditures of a citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. Accordingly, a farming corporation or syndicate will be required to capitalize expenditures during the first four years after planting a citrus or almond grove even though the dispostion of the first marketable crop or yield might have occurred prior to the expiration of that four-year period.

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SIMPLIFICATION OF ADR DEPRECIATION

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

In 1971 Congress authorized the Secretary of the Treasury to promulgate regulations establishing the ADR system. Under the ADR system, the Treasury Department establishes useful lives for classes of assets based upon the activity in which the assets are used (e.g., mining or agriculture) or the type of asset (e.g., automobiles or office furniture). A taxpayer is permitted to compute depreciation on the basis of these lives without any showing of facts and circumstances.

Since the class lives are set so that 70 percent of all assets in a class have actual useful lives which are as long or longer than the prescribed class life, the use of class lives in itself is a benefit to the average taxpayer. Moreover, taxpayers are permitted to set useful lives within a range extending from 20 percent below to 20 percent above the established class lives.

Taxpayers who adopt the ADR system obtain other advantages in the treatment of salvage value and retirements of assets. On the other hand, the regulations require taxpayers who adopt the ADR system to comply with a number of formal accounting and reporting requirements.

Reasons for Change

The presence of many attractive features in the ADR system has led to its adoption by taxpayers holding more than half of all corporate assets. In 1974, 64 percent of all depreciable corporate assets were held by taxpayers who

22-302 O - 78 - 24

elected ADR. 1/ The largest corporations appreciate the advantages of the ADR system. In 1974, nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR. In contrast, little more than half of the corporate taxpayers with more than $100 million in depreciable assets elected ADR; only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. Thus, many corporations have not been sharing in the benefits of ADR to the same extent as the largest corporations. While it is not clear why these businesses have not elected ADR, it would appear that the mechanics of asset classification and the application of prescribed accounting procedures intimidate many businessmen and their accountants.

The Treasury Department has been studying ways to simplify the ADR system. It is expected that a simplified ADR system would lead to the use of ADR by additional taxpayers. However, because the Congress enacted the legislation which authorizes the existing ADR system with a particular set of regulations in mind, it is not clear that present law would authorize the Secretary of the Treasury to promulgate regulations substantially different from those contemplated when the statute was enacted.

A simplified ADR system could reflect a number of changes which experience with the existing ADR system suggests would be beneficial. For example, the current regulations set forth rules for the treatment of salvage value (section 1.167(a)-11(d)(1)). If a taxpayer does not follow "the practice of understating his estimates of gross salvage value," no change will be made to the taxpayer's estimate of salvage value unless the change would exceed 10 percent of unadjusted basis. In the case of most personal property, the taxpayer is allowed to decrease salvage value by an additional 10 percent (section 167(f) of the code). Thus, while the importance of salvage value has been significantly diluted, the Internal Revenue Service still must reexamine a taxpayer's choice of salvage values to determine whether it complies with the tests described above. A rule which eliminated this factual determination would be more consistent with the goals of ADR.

The existing regulations permit taxpayers to choose one of two conventions to determine the date from which they can begin claiming depreciation for property placed in service during the year (section 1.167(a)-11(c)(2)). Under the half-year convention, all assets placed in service during the year are deemed to have been placed in service on the first day of the second half of the taxable year (July 1 for calendar year taxpayers). Under the modified half-year convention, assets placed in service in the first half of the year are deemed to have been placed in service on the first day of the year (January 1 for calendar year taxpayers);

those placed in service in the second half of the year are deemed placed in service on the first day of the succeeding year (January 1 of the next year for calendar year taxpayers). These alternative conventions add complexity to both the operation of the ADR system and its description in the regulations. Moreover, one of the conventions--the half-year convention--offers a number of practical and theoretical advantages in the operation of the ADR system. The half-year convention does not require a taxpayer to determine exactly when the second half of his taxable year begins, a task which may not be simple if the taxpayer's taxable year has fewer than twelve months or if the taxpayer is on a 52-53 week year. The half-year convention also requires the taxpayer to create only one set of vintage accounts each year, rather than the two sets required under the modified half-year convention.

The ADR system simplifies depreciation by establishing a limited number of rules which, on the average, provide a reasonably accurate measurement of income, and which can be readily applied both by the taxpayer and by the Internal Revenue Service. It is inconsistent with that goal to allow complicated options and variations, such as the use of the double declining balance method followed by the sum of the years-digits method for the same asset. Moreover, with the sanction of Congress, the ADR system provides a favorable pattern of tax depreciation for the average taxpayer by setting the useful lives of assets below average lives and then permitting these lives to be reduced by up to 20 percent. Thus, it is unnecessary to allow taxpayers to overlay this guideline system with optional combinations of depreciation methods that further accelerate depreciation deductions.

At present, taxpayers electing ADR are subject to detailed reporting requirements (section 1.167(a)-11(f) of the regulations). The purpose of these reporting requirements is to enable the Treasury Department to determine and refine appropriate lives for different classes of assets. In practice, the reporting requirements are both ineffective and costly to taxpayers and the government. Their purpose can be more efficiently accomplished through survey techniques involving controlled sampling procedures.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue new regulations governing the ADR system. It is intended that the new regulations will be shorter and simpler than the present regulations. These regulations--which should encourage more taxpayers to adopt

the ADR system--will differ from the present regulations in several respects, including the following:

1. Salvage value will be disregarded for purposes of computing depreciation.

2. All assets will be governed by the "half-year convention," under which they will be deemed to be placed in service in the middle of the taxable year.

3. Taxpayers will be restricted to the straight-line and declining balance methods of depreciation.

4. The annual reporting requirements will be eliminated. Taxpayers will be required to respond to survey requests to be used in calculating ADR standards. It is expected that no industry will be subject to the survey procedures more often than once every five years, and thus most taxpayers electing ADR will rarely be required to respond to such surveys.

The result of these changes will be a simpler system for taxpayers who elect to depreciate assets under ADR.

Effective Date

The simplified ADR system provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on or after December 31, 1979 will have sufficient time to determine whether to elect the new simplified ADR system.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

Footnote

1/ Because assets placed in service before January 1, 1971 cannot be depreciated under ADR, only 25 percent of the assets of these corporations were depreciated under the ADR system. This percentage should increase over time.

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Revenue Estimate

Change In Tax Liability

($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-355	-1,200	-900	-500	--	--

VB

UNEMPLOYMENT TAX RATE REDUCTION

Present Law

The unemployment compensation program is financed by a combination of Federal and State employer payroll taxes. In general, the Federal tax effectively is equal to 0.7 percent of the first $6,000 of each worker's annual earnings. The nominal Federal tax rate is 3.4 percent; it is generally offset by a credit of 2.7 percent for State unemployment tax payments.

Unemployment benefits can be provided for up to 65 weeks. The first 26 weeks is referred to as "regular coverage," the next 13 weeks is referred to as "extended benefit coverage," and the final 26 weeks is referred to as "supplemental benefit coverage." State unemployment taxes are used to finance the regular coverage plus half of the extended benefit coverage. The Federal government through the Federal Unemployment Insurance Fund ("FUIF") finances the other half of extended benefit coverage plus all of the supplemental benefit coverage. In addition, States which have run out of money to pay unemployment benefits may borrow from the FUIF.

Federal unemployment taxes are deposited in the FUIF. Federal general revenues are loaned to the FUIF to the extent it does not otherwise have sufficient funds to meet its obligations.

Reasons for Change

The 1974-1975 recession had a severe impact on the unemployment insurance system. As shown in the following table, as of December 1977 the Trust Fund had borrowed about $8.9 billion from general revenues to finance those unemployment benefits which are a Federal responsibility.

Table VB-1

	Federal UI Costs			Costs Met By	
	Extended Benefits	Federal Supplemental Benefits	Total	Payroll Tax	Loans from General Revenue
		($ millions)			
Prior to CY 1975	661		661		661
CY 1975	1,306	2,271	3,577	130	3,447
CY 1976	1,237	2,946	4,183	160	4,023
CY 1977 Estimate	946	620	1,566	750	816
	4,150	5,837	9,987	1,040	8,947

Office of the Secretary of the Treasury
Office of Tax Analysis
January 18, 1978

Moreover, about half the States have exhausted their insurance reserves and have borrowed an additional $4.4 billion from the Trust Fund. The Trust Fund in turn has borrowed this money from the general revenues. Further, between 1979 and 1981, Federal unemployment tax revenues are expected to fall short of outlays by $600 million.

Congress has taken two steps in response to this extraordinary financing problem. The rate of Federal unemployment tax was effectively increased from 0.5 to 0.7 percent as of January 1, 1977. This increased rate is scheduled to remain in effect until the FUIF has repaid all general revenue advances other than those which financed loans to the States. Also, costs of the Federal supplemental benefit program incurred after April 1, 1977, are being funded directly out of general revenues.

The January 1977 increase in the rate of Federal unemployment tax has raised business costs, thereby increasing inflationary pressures. The Administration is committed to financing normal unemployment benefits out of employer payroll taxes. However, the Administration believes it is inappropriate for the extraordinary expenses resulting from the severe 1974-1975 recession and the continuing rate of high unemployment to be financed solely out of payroll taxes.

General Explanation

The Administration proposes to restore the Federal unemployment payroll tax to its normal effective rate of 0.5 percent, a reduction of 0.2 percentage points.

In addition, the Administration plans to consider whether further use of general revenues is necessary to strengthen the present financial position of the FUIF, or to ensure the financial strength of the FUIF for the future.

Analysis of Impact

The reduction in the effective rate of Federal unemployment tax will assist in reducing inflation. As the resulting reductions in employer wage costs are passed through in the form of price cuts, they will reduce inflation directly through lower consumer prices and, indirectly, as the lower prices result in lower cost-of-living wage adjustments. (As the employer cost reductions are passed through in the form of price cuts, the reduction in wage costs will eventually translate into a reduction in the GNP deflator of approximately 0.1 percent.)

The impact of the rate reduction, in terms of percentage of wages, will be greatest for costs associated with the employment of low-wage workers. Thus, the reduction will partially offset the increased employer costs associated with recent minimum wage legislation and will increase the demand for low-skilled labor.

Effective Date

The reduction in the rate of Federal unemployment tax will be effective as of January 1, 1979.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	-850	-900	-950	-1,000	-1,050

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

TESTIMONY OF

CHARLES L. SCHULTZE, CHAIRMAN
COUNCIL OF ECONOMIC ADVISERS

before the

HOUSE COMMITTEE ON WAYS AND MEANS

Tuesday, January 31, 1978

I am pleased at this opportunity to discuss with the members of the House Ways and Means Committee today the President's economic program for 1978 and 1979. That program is designed to maintain a strong economy over the next two years and to build the foundation for continued progress over the longer term.

Secretary Blumenthal has discussed with you the overall shape and specific components of the President's proposals for tax reduction and reform. I would like to concentrate upon those elements of the economic picture which require a tax program of the size and structure recommended by the President and how the tax proposals relate to other elements of the Administration's economic program.

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

The Major Tasks of Economic Policy

The American economy today is basically healthy. We are making good progress in recovering from the trauma of earlier years, when the nation was hit, in quick succession, by double-digit inflation and severe recession. Last year, our economy created a record number of new jobs and reduced the ranks of the unemployed by over one million people. The pace of activity, moreover, is moving well as we enter 1978.

Because the inflation was so great and the recession so deep, the progress we have made still leaves us short of full recovery. Substantial further progress is needed, and steps must be taken now if we expect to achieve our long-range economic goals.

- Economic growth will slow in late 1978 and in 1979 unless we act to relieve the growing tax burden on consumers. Payroll taxes are rising sharply, and inflation is pushing individuals

into higher tax brackets. Other sectors of the economy are not growing sufficiently to counterbalance this depressing effect on consumer spending. Tax reductions for individuals are therefore needed to maintain growth of consumer purchasing power and spending.

- Business investment is not rising fast enough. More investment will create additional jobs for a growing labor force and increase our industrial capacity for the future. Business tax reductions are needed to provide the incentives for a faster expansion of investment and the capital stock.
- The Federal tax system is too complex and in many respects unfair. Reform of our tax laws is needed and should be combined with tax reduction this year.
- Structural unemployment remains a major unsolved problem. Overall economic progress will help reduce the very high unemployment rates among youth and minorities. But these and other groups will not enjoy their fair share of the fruits of economic expansion unless their job opportunities are increased substantially. In addition to overall economic measures, we need to improve and expand

our employment and training programs to address their specific employment problems.

- Inflation is too high. We must take steps to prevent a worsening of inflationary pressures as the economy moves to higher levels of employment and production. And we must bend our efforts now toward reducing the present inflation.

These problems cannot be dealt with in a piecemeal fashion. Only with a coordinated effort to deal with all of them will we realize the potential that our national resources and the energy of the American people make possible.

The Economic Setting

Let me set the stage for an explanation of the President's proposals by reviewing briefly the major economic developments of the past year and the situation of the economy as we enter 1978.

The economy grew strongly last year. In the fourth quarter of 1977, the nation's real Gross National Product stood 5-3/4 percent above its year-earlier level. More than 4 million jobs were created in 1977 -- the largest employment increase of any single year. By December, the rate of unemployment had fallen to 6.4 percent, 1.4 percentage below its level 12 months earlier.

The benefits of growth were impressive. On a per capita

basis the real after-tax income of Americans rose almost 5 percent over the four quarters of 1977. The rate of capacity utilization in manufacturing increased, and corporate profits rose by 9-1/2 percent for the year.

The course of the expansion during 1977 was uneven. Output rose strongly early in the year, as businesses sought to rebuild depleted inventories, and unemployment declined sharply. When consumer spending slowed in the spring and summer months, retailers reduced their orders and manufacturers cut back on the rate of production and also their hiring. By year end, however, the pace of activity had begun to pick up again, led by a vigorous rise in consumer spending, and the economic stimulus program proposed by the President and enacted by the Congress earlier in the year.

We are entering 1978 with good prospects for continued strong expansion for the near term. Growth will be spurred for a time by increased inventory investment, as businesses catch up with the unanticipated surge in consumer spending late last year. Moreover, the 1977 stimulus programs are still gathering strength and will encourage recovery through the first half of 1978.

As we look further ahead, however, it is clear that unless steps are taken now to maintain economic growth, expansion will slow to an unacceptable pace and our efforts

to reduce unemployment will be frustrated.

The most important development threatening sustained recovery is the increasing burden of taxes borne by the average taxpayer. Under present law, large increases in payroll taxes are coming into effect to finance the social security programs. Some of these added taxes were scheduled by law in the 1973 social security amendments. Additional increases were enacted last year and are essential to the continued health of the social security system, since without them the trust funds would soon be depleted. But the economic impact of these higher taxes cannot be ignored. Payroll taxes will rise by $7 to $7-1/2 billion in 1978 and again in 1979. An additional drag on consumer purchasing power will occur because inflation and real economic growth push taxpayers into higher brackets. Unless steps are taken to lower individual income taxes, Federal revenues over the next two years will be absorbing a significantly rising share of personal income.

There are times, of course, when increased effective tax rates are needed to restrain an overheated economy. But that is not the case at present. On the contrary, growth in the private sector is not likely to be strong enough to overcome a substantial increase in the degree of fiscal restraint that would be emanating from the Federal budget.

For example, consumer spending will probably rise in 1978 and 1979 by somewhat less than the increase in after-tax

incomes. Americans are now saving about 5-3/4 percent of their income after taxes -- a lower rate than has prevailed for most of the past decade. The saving rate could easily increase somewhat in the near future. Consumer purchases cannot be expected to serve as the driving force for economic expansion, as they did early in the recovery.

Similarly, housing construction, which has risen very strongly since early 1975, will not continue to provide a major source of thrust to economic expansion. Backlogs of demand have been reduced, and financial markets have tightened somewhat. We do not expect housing construction to decline significantly over the next two years, but it is unlikely to show a substantial increase.

The foreign sector has been a major dampening factor on growth in our economy over the past two years. Last year, the U.S. current account deficit increased dramatically -- to about $18 billion - due largely to a surge in oil imports. Other imports also rose strongly, but our exports showed little growth. Economic expansion abroad is likely to improve somewhat in 1978, increasing the demand for U.S. exports, and the dollar volume of our oil imports will probably remain about unchanged this year. Our overall current account deficit, therefore, should not increase significantly further. But we cannot, unfortunately, expect it to diminish materially either.

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The source of growth that would be most welcome in 1978 and 1979 would be a strong rise of business fixed investment. Over the past several years, the labor force in our country has grown very rapidly. Growth of the capital stock has not kept up. Productivity is therefore increasing very slowly. And although there is, at present, substantial idle capacity in our plants and factories, a faster growth of capacity will be needed to avoid inflationary bottlenecks in later years as we approach a high employment economy. 1/

Average Annual Growth in the Stock of Business Fixed Capital and the Private Labor Force

(percent per year)

	1965-73	1973-76
Business capital stock	4.4	1.9
Labor Force	1.9	2.3

1/ Appendix 1 briefly discusses the problem of capacity utilization as the economy approaches high employment.

During the course of an economic recovery, business plans for investment spending typically strengthen -- as capacity utilization increases, profits improve, and the outlook for the long-term future brightens. There has been a significant improvement in the rate of investment over the past two years, but it is not sufficient. In real terms, business fixed investment in the final quarter of 1977 was still 3 percent below its peak in 1974. Moreover, surveys of business plans for investment in new plant and equipment in 1978 suggest a rise this year that may fall somewhat short of last year's performance. This is simply not good enough.

Given the absence of growing strength in these major sectors of the private economy, it would clearly be unwise to impose a major increase in the tax burden on the economy -- but that is what would happen without the President's tax program. As a consequence, economic growth would slow. We estimate that if the President's tax program were not enacted, growth in 1979 would be in a range of about 3-1/4 to 3-3/4 percent. The rate of unemployment would therefore stop declining, and it might begin rising again. We are still too far from full recovery to accept such a result, and the President's fiscal program for 1979 is designed to assure that it does not happen.

The Administration's Fiscal Program

The centerpiece of the Administration's economic program for fiscal 1979 is the proposal for substantial tax reductions,

integrated with recommendations for meaningful reform of the tax system. The elements of the program include:

1. Tax reductions of $24 billion for individuals combined with revenue-raising reforms of $7 billion. Tax reduction is achieved by substituting a $240 per capita credit for the existing $750 personal exemption and the general tax credit, and by reducing personal tax rates. The reduction in tax burden is greatest for low and middle-income taxpayers.

2. Business taxes are reduced by $8 billion. Tax reforms affecting businesses will raise $2 billion in revenue, for a net business tax cut of about $6 billion. Tax cuts are provided through a substantial reduction in the corporate tax rate -- the first since 1964 -- and through liberalization of the investment tax credit (ITC). The ITC is made permanent at 10 percent, and for the first time is extended to include industrial and utility structures, as well as equipment. Furthermore, businesses will be permitted to use the ITC to offset up to 90 percent of their tax liability, compared with the current 50 percent limit.

3. The Federal telephone excise tax, which under current law is now being gradually phased out, will be eliminated this year and the Federal unemployment insurance tax rate will be reduced to its pre-1977 level. The net tax reduction from these two provisions is $2 billion, which will be realized by consumers principally through lower prices.

These proposals do not include any provision relating to the energy legislation now pending before the Congress. If, when finally enacted, the energy program does not include a full rebate to consumers of the net proceeds of the wellhead tax on oil, the President has indicated that he will seek additional personal tax reductions to return those funds to consumers.

In total the President's program calls for tax reduction of $34 billion, partially offset by $9 billion in revenue-raising reforms. The two elements of reduction and reform go together. Without the tax reforms, the size of the tax reduction components of the program should be scaled back.

The reforms included in this package are achievable and desirable. They will make our tax system much more equitable by eliminating a variety of business deductions that have been greatly abused, by sharply curtailing tax shelters, and by strengthening the minimum tax. They also eliminate tax subsidies in the area of international business transactions whose public benefits do not justify the costs. And they will make the tax system simpler and easier to understand.

The amount of net tax reduction called for in the President's program has been scaled to the needs of our current economy, and designed to promote a sustainable economic growth rate of 4-1/2 to 5 percent in 1978 and 1979. It will amount to 1.1 percent of the 1979 GNP. This is

about half the size of the 1964-65 tax cut, but 60 percent larger than the tax cuts which went into effect in 1970 and 1972.

In the absence of the tax cuts, the share of personal income absorbed by Federal personal income taxes and the contribution of employees and the self-employed to social security would rise from 14.3 percent in 1977 to about 15.1 percent in 1979. Under the President's proposals, however, the share of personal income absorbed by these taxes will not increase between 1977 and 1979. Looked at from a different perspective, the President's tax proposal will mean that total Federal tax revenues as a share of GNP will rise only slightly between 1977 and 1979. Thus, by reducing taxes, we will conterbalance the prospective drag on the economy from the rising tax burdens which would otherwise occur.

Ratio of Taxes to Personal Income and GNP

Calendar Years 1977-1979

(percent)

	1977	1978	1979
Ratio of personal taxes plus employee and self-employed social security taxes to personal income:			
With tax cut	14.3	14.3	14.1
Without tax cut	14.3	14.5	15.1
Ratio of total Federal revenus to GNP:			
With tax cut	19.8	20.1	20.0
Without tax cut	19.8	20.4	21.2

The size of the tax proposal was not designed to achieve any particular ratio of tax revenues to income, however. Rather, it was formulated in concert with the President's expenditure recommendations, to keep the economy on a path of growth that will ensure significant further progress in reducing unemployment during 1978 and 1979.

A full appraisal of the contribution of the Administration's proposals to the performance of the economy must take into account both the expenditure and revenue sides of the budget. One simple, but useful, measure of the overall degree of

fiscal impact is the deficit in the high-employment budget. In this budget, the estimates of spending and revenues are those that would occur if the economy were at high employment. This budget thus abstracts from the increased spending and reduced tax revenues that result automatically when the economy is not at high employment. As a result, the discretionary elements in the budget stand out clearly. The movements in the high-employment budget, as measured in the national income and product accounts are shown below for calendar years 1977 through 1979.

	(billions of dollars)		
	1977	1978	1979
High employment deficit	-18	-27	-23

With the President's program, the high employment budget deficit would increase significantly in 1978. In 1979, it would decline somewhat, but remain $5 billion higher than in 1978. Thus, the Administration's overall budgetary program adds modestly to the degree of fiscal stimulus between 1977 and 1979.

If the President's program is enacted, we expect both 1978 and 1979 to be years of good economic growth. The nation's real output should increase each year by 4-1/2 to 5 percent -- a rate that would make it possible to reduce the

unemployment rate from 6.6 percent in the final quarter of 1977 to a range of 6 to 6-1/4 percent by the end of 1978, and to somewhere in the 5-1/2 to 6 percent range by the fourth quarter of 1979. We estimate that the tax package will create nearly one million additional jobs by the end of 1979.

The economic effects of this tax proposal, if enacted, will begin to show up in the latter part of 1978. Some additional stimulus to consumption should occur promptly in the last quarter of the year, as tax reductions are reflected in take-home pay. From the final quarter of 1978 to the same period in 1979, real personal consumption expenditures should rise at close to a 5 percent annual rate.

This strong and sustained growth in consumer markets should encourage businesses to augment investment plans in 1978 and 1979. The tax incentives proposed by the President should also encourage a step up of investment plans. The extension of the ITC to investmnet in structures will be made retroactive to January 1, 1978, and some effects may begin to be felt before final enactment of the tax proposals. Prospective reductions in the corporate tax rate, meanwhile, will increase the expected returns on investment and, once enacted, help to finance needed investments through greater

cash flow. We expect business investment in real terms to strengthen during the course of 1978 and to rise by about 8 to 9 percent in 1979 if this program is put in place.

Effects on the Deficit

Achieving these results through tax reduction means, of course, that the 1979 Federal deficit will be larger than it otherwise could have been. The President's fiscal 1979 budget carries a deficit of $61 billion in that fiscal year, only slightly below that in 1978. Had the proposed tax reductions been foregone, however, the deficit would have been $15 to $20 billion less. But the price would have been a weaker economy, almost a million fewer jobs, a substantially higher unemployment rate, and less growth of investment and industrial capacity. That is far too high a price to pay.

The 1979 budget deficit is large, but it is not inflationary. We recognize fully that deficits in the Federal budget do cause inflation if they create excess demand. We see no danger of that during the next two years, since unemployment is still high and there is ample slack capacity in the manufacturing sector to permit further increases in real output without encountering bottlenecks.

We know, however, that the Federal budget must be brought into balance as rapidly as the developing strength of the economy permits. That is an essential principle of the President's long-range budgetary strategy, and our recommendations for fiscal 1979 are entirely consistent with it.

Long-Range Budget Strategy

The President has stated on numerous occasions his intention to keep a tight rein on the growth of total Federal expenditures. The Administration's 1979 budget reflects this commitment -- Federal expenditures increase in real terms by less than 2 percent. Similar restraint will be shown in succeeding budgets. We intend to reduce gradually the share of the Nation's output devoted to Federal expenditures.

Budgetary restraint does not mean neglect of important social problems. The Federal Government should, and under this Administration will, continue to meet the pressing needs of the Nation. Through careful budgetary management -- using zero-based budgeting and multi-year planning -- we can improve efficiency and select priorities more carefully, thereby channeling budgetary resources to meet important social and other national needs. In the years ahead, sustainable economic growth can be promoted by such an expenditure policy, coupled -- when and as the need arises -- with tax reductions.

At each step along the way, the benefits of tax reduction will have to be weighed against the costs of a larger deficit. We intend to move toward a balanced Federal

budget. In a high employment economy, with strong growth in private demand, deficits must be avoided, since under those conditions they would create excess demand and generate inflationary pressures.

If the private economy grows very strongly between now and 1981, we can and will balance the budget by then. No decisions have been made in the 1979 budget that foreclose this possibility. If private economic growth appears to be insufficient in the future to achieve high employment, however, we are prepared to undertake additional fiscal measures to ensure that our economic objectives are realized. In that event, the date for achieving a balanced budget would have to be deferred.

One obvious question comes immediately to mind in relating these budgetary principles to the 1979 budget. Why is it necessary so far into economic recovery to have a budget deficit of $61 billion? Under the economic conditions which prevailed in the 1960s or the early 1970s this would not have been the case. But there are several characteristics of our present economy which make it very difficult to balance the Federal budget without sharply slowing economic growth. The difficulty stems, in the main, from developments affecting the budgets of State and local governments and from the drain of income associated with our foreign trade in goods and services.

In the past, State and local governments in the aggregate typically ran small budgetary deficits. More recently, however, the aggregate budgets of State and local governments have been in sizeable surplus. Last year, that surplus was nearly $30 billion, up from $18 billion in 1976 and $3 billion in 1970. Part of this growing surplus stems from the accumulation of monies in pension funds for the 13 million employees of State and local governments; another part stems from efforts by some of these governmental units to put their financial houses in better order after the recession of 1974-75. Within the aggregate, of course, there are some governments whose fiscal positions are quite difficult.

However pleasant the overall surplus may be from the standpoint of many State and municipal governments, they tend to restrain economic activity -- because they draw more out of the income stream in tax revenues than are put back by way of expenditures.

The current account deficit in our international transactions -- nearly $18 billion in 1977 -- poses a similar problem. It also represents a drain on the stream of national income; it means that we are sending more dollars abroad through purchases of goods and services than are returning to our country to buy goods and services here.

The table below shows the current size of these drains on income, and how large they are compared with earlier years of high employment: 1/

	1955-1956	1965-1966	1972-1973	1977
	(billions of dollars)			
State and local surplus	-1.1	0.2	13.4	29.2
Foreign sector	-0.7	-2.9	5.2	19.1
Total	-1.8	-2.8	18.5	48.3
Federal surplus or deficit (-)	5.2	-0.6	-12.0	-49.6

1/ Data are from the Department of Commerce national income accounts.

The aggregate surplus of State and local governments is likely to diminish somewhat in the next few years but it will probably remain large for many years to come. Adjustment of our trade deficit will also take time. That deficit can be traced to two major factors: we are importing large amounts of oil at high prices, and our exports have been depressed by slow rates of economic growth abroad. Enactment of an effective energy program, and improvement in the economic growth rates of other nations, will contribute to a gradual reduction in our foreign deficit; it can only occur gradually.

The State and local foreign sectors are, of course not the only economic forces which determine the appropriate fiscal stance for the Federal Government. But the size and recent growth of the income drain from these two areas are large and they must be taken into account in the formulation of Federal fiscal policy.

We cannot realistically expect that the unprecedented size of the income drain in the State and local and foreign sectors will automatically be counterbalanced by extremely strong spending propensities on the part of American businesses or consumers. Therefore, the Federal budget must stand ready to provide a counterbalance, in order to maintain a healthy economy.

Structural Unemployment

Fiscal and monetary policies are the basic tools at our command for promoting healthy growth in the overall economy and reductions in unemployment. But even in periods of relative prosperity some groups of American workers continue to suffer high unemployment rates. The current recovery has bypassed some Americans. Blacks and members of other minority groups particularly face disproportionately high rates of unemployment; the 40 percent rate of unemployment among black youth is simply not tolerable. Unless the government takes steps to bring all groups of citizens into the economic mainstream, we will be frustrated in our efforts

to achieve tolerable levels of unemployment.

A nation that prides itself on human rights cannot ignore a structural unemployment problem of the magnitude we face in the United States. The human and social costs are much too large. The economic costs are also substantial. If we can give those individuals who otherwise would be unemployed the training and experience they need to become productive workers, and open up job opportunities for them, the nation's potential to produce would be greatly enhanced. Millions of Americans out of work amount to an enormous waste of valuable resources.

In the longer run, dealing with structural unemployment successfully also has important implications for controlling inflation. Typically, as our economy approaches high levels of employment, some labor markets tighten up much more than others. Unemployment rates for experienced adult workers drop to very low levels, while large unemployment still exists for other groups. Employers, however, still tend to expand their work force by trying to fill vacancies with workers from the groups with low unemployment, rather than turning to those with higher unemployment rates. As a consequence, inflationary pressures on wages and prices ensue, even though unemploymnet among some segments of the labor force is still very high. Employment and training programs that provide skills and open up job opportunities

for disadvantaged groups of workers tend to reduce these inflationary pressures, and are essential if we are to achieve both our objective of price stability and our goal of high employment.

The task we face is a difficult one. We have already taken some important first steps, but much remains to be done.

In the 1977-78 stimulus package, the level of jobs under the Public Service Employment program was increased from 310,000 to 725,000. PSE employment has grown substantially since last spring, and now totals about 600,000. The remaining increase to 725,000 will occur over the next few months. The program was also modified to target it more carefully on the longer-term and low-income unemployed. The President is proposing to continue this program at the 725,000 job level in 1979.

The current public service jobs program is principally countercyclical in nature, and will be stepped down gradually after 1979 as the overall unemployment rate declines. A more permanent program, designed to provide work for 1.2 to 1.4 million persons, is part of the President's proposed overhaul of the nation's tangled welfare system. This program is aimed at offering work, rather than cash welfare, to those of the nation's poor who are able to work. The 1979 budget includes a request for a 50,000-job program to demonstrate the feasibility of the Program for Better Jobs and Incomes

proposals.

Special programs for young people were authorized under the Youth Employment and Demonstration Projects Act enacted by the Congress in 1977. These projects are aimed at testing a number of alternative approaches to combine work experience and training for young people. In the 1979 budget, we are requesting funding for 166,000 slots in the YEDPA programs, and to increase the Job Corps.

For most workers, the long-term answer to job opportunities must be in the private sector. Five out six new jobs will come from that sector. It is in the private sector that the greatest opportunities exist for job training, for advancement, and for meaningful life-time careers. It is important, therefore, that we find effective ways to channel those who ordinarily would go jobless into private sector employment. Later this year, the Administration will send to the Congress proposals to encourage the creation in the private sector of jobs for the structurally unemployed, and particularly for the young. Details of this program are under active development at the present time and will be sent to the Congress shortly. The 1979 budget includes $400 million for this new initiative.

Reducing the Rate of Inflation

Another critical problem with which we must deal more effectively is inflation. During the period immediately

ahead, there will still be some slack in the economy, and the likelihood of an increase in the rate of inflation is low. As the economy approaches higher levels of employment in 1980 and 1981, however, the risks increase that the rate of inflation will begin to move up. A significant worsening of inflation would undermine the confidence of consumers and businesses, causing them to cut back on purchases and investments. Moreover, we would be inhibited from taking the fiscal and monetary steps necessary to reduce the rate of unemployment. Progress against inflation is thus absolutely essential to reducing unemployment.

The inflation problem that we face today has two distinct aspects. We need, on the one hand, to pursue policies that will avoid a worsening of inflation as we regain high employment. And we must take steps now to begin unwinding from the high rate of inflation that we have inherited from the past.

The government can, by following prudent fiscal and monetary policies, ensure that inflationary pressures are not increased due to excess aggregate demand when the economy returns to high employment. During the period from 1965 to 1969, inflationary pressures were intensified by continuation of deficit spending in a high-employment economy. Overly expansive monetary and fiscal policies also

contributed to inflation during 1972, when a worldwide boom developed that put serious pressures on the basic resources of industrialized economies. With sound management of the budget and the economy, we can avoid such excesses in the future.

A second important step is to ensure that industrial capacity expands rapidly enough to prevent shortages and bottlenecks in individual industries as overall demand reaches higher levels. The President's economic program for 1979 recognizes this fact. It will encourage investment by promoting continued expansion of markets for the output of new plant and equipment, and by offering specific incentives to increased investment.

Third, a successful attack on the structural sources of unemployment also is essential to reduce the chances of higher inflation rates in the future. That fact, too, is recognized in the Administration's budget proposals for fiscal 1979.

Efforts to reduce the current inflation rate will encounter difficult problems. There is much that government can do to contribute to lower inflation. A modest step -- the proposed reduction in excise and unemployment insurance taxes that will contribute directly to lower prices and costs -- is incorporated in the President's tax program.

The government also can bring into line its own actions that raise costs and prices. A top priority of this Administration is to reduce the adverse impact on costs and prices of government regulatory actions. We have moved already to cut back significantly the sheer number of regulations, and to pare the paperwork burden imposed by regulatory agencies. We are establishing new procedures that will encourage regulatory agencies to seek out and apply the most cost-effective approach to accomplishing our regulatory objectives. The President has established under my chairmanship an interagency committee to review the adequacy of economic analysis of major regulations. Government can in this way make a direct contribution to reducing the cost-rising effects of its own actions.

However, such actions alone will not be sufficient to make dramatic progress against inflation. For the past three years, the rate of inflation has persisted in the general range of 6 to 6-1/2 percent. There have been temporary fluctuations in the inflation rate, due to movements in food prices and fuel prices, but the underlying rate of price increase has neither accelerated nor slowed throughout the recovery. Recent experience suggests that the rate of inflation is increasingly unresponsive to widespread unemployment and idle capacity.

The inflation we have inherited from the past is built-in to the process of setting wages and prices. Businesses raise prices to compensate for past and expected wage increases, because they expect consumers to pay the higher prices they charge. Workers, seeing prices rising and expecting more inflation in the future, push for higher wage settlements. This process cannot be brought to a halt by government decree, nor can it be eliminated through the action of any one group of workers or businesses. If the rate of inflation is to be brought down from its current plateau, we must all work at the job together.

Over the past several months, the Administration has examined closely a wide array of alternatives for dealing with the inflation problem.

Several approaches were rejected virtually from the outset. We cannot, for example, sit back and do nothing. Inaction could mean the eventual reemergence of bottlenecks and wage pressures that could lead to a worsening of inflation. Mandatory wage and price controls are not the answer. They do not effectively stop inflation, and the severe distortions, inefficiencies and inequities they cause are unacceptable.

We also have rejected policies of slow growth. We cannot wring the inflation out of the economy through high unemployment and economic slack. Such policies have only a limited impact on the kind of inflation we face, and then only at unacceptably high cost in human suffering and lost

output. Moreover, by discouraging businesses from commitments to increase capacity, slow rates of growth may lead to inflationary problems later on, when high employment finally is approached.

A number of innovative ideas to reduce inflation through the tax system were given serious consideration. Some of these proposals would give tax reductions to workers in return for restraint in annual wage increases. Others would tax wage increases above a specified level, or use general revenue sharing as a means of encouraging State and local governments to reduce sales taxes.

All of these plans, however, are subject to major questions with regard to administrative feasibility, economic impact and political acceptability. It would therefore be highly imprudent to propose introducing any of them before subjecting them to a much wider discussion and a more complete evaluation with respect to their economic effectiveness, administrative feasibility, and social equity. On the other hand, the momentum of inflation is so great and the consequences of either allowing it to continue or trying to wring it out with excessively slow growth are so large that they should not be dismissed out of hand. Further economic evaluation and a much broader public debate would be very healthy, whatever its outcome.

After reviewing a long list of policy options, the President has concluded that the most appropriate step

we can take at this time is to embark on a program of voluntary restraint in the setting of wages and prices. He has set forth a reasonable standard of behavior for gradually reducing inflation. Over the next year, labor and management in each industry have been asked to reduce rates of increase in wages and prices to below what they were on average in the prior two years.

This is a flexible and fair proposal. It recognizes that there will be some cases in which the profit margins have been badly lagging, and that there are some groups whose wages have not risen as rapidly as others. In those cases, deceleration may be more difficult to achieve, and in some circumstances, may not be possible at all. By the same token, those businesses and groups of workers that have done better than average recently should contribute more to the overall deceleration of inflation.

To implement this program, the Administration will initiate discussions with officials and representatives of firms and unions well in advance of decisions on price increases or the opening of wage negotiations. This is not a program that requires prenotification of wage or price decisions, now will the government attempt to interfere with the normal process of collective bargaining. But we will seek, through discussions that focus on conditions in each industry, to impress upon both workers and businesses the public's interest in wage and price restraint.

We fully recognize that this program will meet some skepticism. Given the nature of the current inflation, it is clear that no individual business or group of workers can afford to take steps to solve the inflation problem unless he is convinced that others will go along. Inflation poses a problem in which the interests of individuals coincide in the long run with the public interest. If the program succeeds in accomplishing a gradual reduction in inflation, we will all be better off. Money wages will grow less rapidly -- but real wages will continue to expand because prices will also rise more slowly. Profits will continue to rise and to provide adequate incentives. Our chances of sustaining economic growth will be improved, and the risk of new inflation reduced.

The International Economy

The problems which the American economy faces, and toward which the resolution of which the President's economic program is addressed, are not unique to our nation.

Throughout the world, in both industrial and developing countries, governments are struggling with the existence of inflation side-by-side with widespread unemployment.

Outside the United States economic recovery faltered in 1977. Unemployment is high and rising in most industrial countries abroad. The quadrupling of world oil prices in 1973-74, that contributed so much to the world-wide acceleration

of inflation and the global recession, is still troubling the world economy through its effect on the balance of payments of oil-importing countries. And because they were so severe, the economic disruptions of several years ago still cast a shadow over current economic events, as their memory affects the attitudes of businessmen and consumers.

Continued economic recovery is critical to the health of the world economy. Growth in the U.S. economy -- the largest and strongest in the world -- is essential to that recovery. It is also important that other strong nations join with us to promote growth in their own economies. World recovery cannot proceed if nations rely upon exports as the principal source of economic expansion.

The problem of imbalances in international payments will also require concerted action. Because of the surpluses of oil-exporting countries, many nations have sizeable deficits. Some industrial countries are also running large and persistent surpluses, thus increasing the pressures on countries in deficit.

Reduction of these imbalances will demand several parallel steps. To begin with each individual country must ensure that its own policies help relieve the strains. The United States must do its part. In 1977 we had a current account deficit of $18 billion. The large rise in oil imports was a major factor in producing this result. We can

take a most constructive step toward correcting this deficit by moving quickly to put a National Energy Plan in place.

Our 1977 trade deficit also stemmed from our better economic performance. Slow growth abroad held down our exports while expansion at home raised the demand for imports. The appropriate response to these developments is not a halt in U.S. recovery -- that would seriously worsen the economic problems of the world. It is important, however, that in our recovery we encourage a faster growth in business investment, to improve productivity growth, provide adequate industrial capacity, and combat inflation, thereby enhancing our competitive position in world trade.

Countries in surplus should also do their part. Balance of payments surpluses in some countries have contributed to the economic stagnation among their trading partners. Where their own economies have slack, it is appropriate for nations in surplus to stimulate the growth of domestic demand -- thereby increasing their imports and improving the prospects for growth in deficit countries. In some countries, lifting restraint on imports from abroad and reducing excessive government efforts to promote exports would be useful. After consultations with the United States, the Japanese have indicated they will take a series of steps toward reducing their large surplus.

During 1977 the U.S. dollar fell in value against

several key currencies. The decline in the dollar's value has occurred primarily against the currencies of those nations that have large trade and payments surpluses, and was not surprising in view of our large payments deficit and their surpluses. Late in 1977, however, movements in our exchange rate became both disorderly and excessively rapid. The United States reaffirmed its intention to step in when conditions in exchange markets become disorderly and to work in close cooperation with our friends abroad in this effort.

Under the flexible exchange rate system basic economic forces must continue to be the fundamental determinant of the value of currencies. However, we will not permit speculative activities in currency markets to disrupt our economy or those of our trading partners. We recognize fully our obligation in this regard, and we have taken steps to fulfill it.

Although substantial progress can be made toward a balanced world economy, some imbalances will persist for a substantial period of time. Financing requirements will remain large while adjustments occur. The private markets can and will continue to channel the bulk of the financing from surplus to deficit countries. But it is essential that adequate official financing also be available, in case of need, to encourage countries with severe payments problems to

adopt orderly and responsible corrective measures. To meet this critical need the United States has strongly supported a proposal to strengthen the International Monetary Fund by the establishment of a new Supplementary Financing Facility.

Along with other nations, we are dealing with some stubborn problems. They will not be solved overnight. But ours is a remarkably resilient economy. It will respond to carefully designed economic policies that address both short-run and long-run needs. The President's economic program meets that criterion. I believe it is essential to the continued healthy growth of the American economy, and I urge your favorable consideration and prompt action upon the President's proposals.

APPENDIX 1

Capacity Utilization through 1981

To reach an unemployment rate of approximately 5 percent by the end of 1981, GNP would have to grow by about 4.8 percent a year. A rough indication of the rise in manufacturing capacity utilization that may accompany the projected real GNP growth of 4.8 percent per year between 1977 and 1981 can be obtained by observing the capacity utilization growth experienced in 1962-68, when real output grew steadily at above-trend rates, and real investment grew more rapidly than real output. If the relation between real GNP growth and capacity utilization in 1962-68 is matched in 1977-81, an annual 4.8 percent growth in real GNP would raise the manufacturing capacity utilization rate by 1.5 percentage points a year. By 1981 the utilization rate would reach 89 percent, slightly above 1973 but less than the 1966 level. In view of the current capacity utilization differences

among industries and particularly the current large unused capacity in materials industries, such an outcome should be consistent with the avoidance of inflation stemming from capacity shortages. If, on the other hand, investment and capacity growth proceed at a significantly lower rate, capacity utilization would rise to levels previously associated with inflation.

FOR RELEASE UPON DELIVERY

EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

STATEMENT OF THE HONORABLE JAMES T. McINTYRE, JR.
DIRECTOR ACTING, OFFICE OF MANAGEMENT AND BUDGET
ON
THE PRESIDENT'S TAX PROGRAM
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
WASHINGTON, D.C., TUESDAY, JANUARY 31, 1978 1:30 P.M.

Mr. Chairman and members of this distinguished committee:

It is appropriate that my first appearance before the Committee is in support of the President's tax proposals, since they are critical to his budget strategy for the years immediately ahead. Secretary Blumenthal has discussed the specifics of the President's tax reduction and reform proposals and Chairman Schultze has set them in the context of the economic outlook for the next few years. I will focus primarily on the relationship of these proposals to the budget and on a description of the outlay setting within which the President's tax proposals are being made.

The President's budget embodies a fiscal policy that will strengthen the economic recovery. It proposes a progressive tax reduction of $25 billion to help assure continued economic recovery and reduction in unemployment. An integral part of this tax reduction proposal is a set of recommendations for tax reform, which the Secretary has discussed, that will make the tax system simpler and more equitable. Without the reduction, the President would have been able to announce a

decline in the deficit of $15 to $20 billion between 1978 and 1979. With the reduction, the budget deficit will still decline slightly because of careful restraints on expenditures. But the President judged that the most important priority this year is to reduce the burdens on taxpayers. Only in this way can we ensure a vigorous economy, a declining unemployment rate, a strong expansion of private investment, and a stable budget balance in future years.

In total the 1979 budget proposes outlays of $500 billion and receipts of almost $440 billion. This estimates of receipts assumes enactment of the President's proposals in time to reduce withholding rates and corporate tax rates on October 1, 1978.

The extension of the investment tax credit to industrial and utility structures is proposed to be retroactive to January 1, 1978. The proposed reforms would generally go into effect on January 1, 1979. These include reforms which would;

- sharply certail tax shelters
- eliminate the deductions claimed by businesses for theater and sporting event tickets, club dues, yachts, and first-class airfare
- limit the deduction for business meals to 50 percent

- provide a taxable bond option for local Governments and modify the tax treatment of industrial development bonds
- eliminate deductions for sales, gasoline and miscellaneous taxes
- include unemployment compensation in the taxable income of upper income taxpayers
- eliminate the special bad debt deduction for commercial banks
- reduce the bad debt deduction available to savings and loan associations and mutual savings banks
- remove tax exemption for credit unions
- phase out tax subsidies for Domestic International Sales Corporations (DISC)
- phase out the deferral of tax on foreign profits.

While the expenditures recommended in this budget are retrained, they are, nevertheless, directed toward overcoming our Nation's crucial problems. The Administration looked carefully at existing approaches to these problems and improved those approaches where possible. The spending priorities of the past are now being shifted toward long-neglected areas. I will summarize a few of these new priorities:

An effective national energy plan is essential to reduce our increasingly critical dependence upon diminishing

supplies of oil and gas, to encourage conservation of scarce energy resources, to stimulate conversion to more abundant fuels, and to reduce our large trade deficit.

The essential human needs of our citizens must be given high priority. In the spring of 1977, the President proposed a long-overdue reform of the Nation's welfare system that included a combination of employment opportunities and incentives for those who should work, and a basic income for those who cannot. The 1979 budget reiterates the President's proposed program for better jobs and income, and begins the process of careful planning for the implementation of an efficient and equitable system.

The budget also recognizes that ensuring the opportunity to compete and excel remains very important ot our people. Toward this end it proposes:

- major expansion of medical care and nutritional supplements for low-income expectant mothers and infants to give all children the healthiest possible start in life;
- major increases in educational assistance at all levels;
- continuation of public employment programs at high levels for another year to help reduce the current rate of unemployment, particularly among minorities;

- major increases in programs stressing employment for unemployed youth; and
- a new effort to place more disadvantaged persons in private sector jobs by increasing the involvement of the business community in local employment and training programs.

Because a workable urban strategy is an important link in a well-articulated domestic program and is essential to the continuing recovery of the national economy, the budget includes increases for many programs benefiting urban areas and supports several efforts to improve these programs. The President anticipates sending to the Congress early in the spring a set of further proposals dealing with the Nation's urban problems.

The Nation's armed forces must always stand sufficiently strong to deter aggression and to assure our security. The 1979 budget provides for the steady modernization of our strategic forces, and for substantial improvements in the combat readiness of our tactical forces. To parallel commitments made by our European allies, it proposes significant increases in our overall defense effort, with special emphasis on those forces and capabilities most directly related to our NATO commitments at the same time defense expenditures are being restrained by introducing important efficiencies and by

placing careful priorities upon our defense needs. The 1979 defense budget is prudent and tight.

The Federal Government has an obligation to nurture and protect our environment--the common resource, birthright and sustenance of the American people. Accordingly, this budget provides for substantially increased emphasis on protection of all our environmental resources, for new attention to our common heritage, and for substantial additions to our system of public lands.

The Federal Government must lead the way in investing in the Nation's technological future. Shortly after taking office, the President determined that investment in basic research on the part of the Federal Government had fallen far too low over the past decade, and he directed that a careful review be undertaken of appropriate basic research opportunities. As a result of that review, this budget proposes a total of $3.6 billion in obligations--a real rate of growth of almost 5%--for basic research in 1979. This emphasis is important to the continued vitality of our economy.

The Federal Government must change its program priorities as the needs of the Nation change. This adjustment is reflected in the 1979 budget in the programs noted above and in the following programs, too:

. For agriculture, fiscal year 1978 outlays for farm price supports and related programs are estimated to be $7.3 billion. This is a record high and is 92 percent above the $3.8 billion paid out in 1977. For 1979, the budget assumes a return to more normal weather. As a result, outlays for farm price supports are estimated to decline to $4.3 billion, still a very high level by historical standards.

. For transportation, the Administration is proposing a major new highway and transit bill that will provide more than $45 billion in the next four years. The most important feature of this legislation is the increased flexibility it would provide State and local governments in planning the use of highway and transit funding.

. For subsidized housing programs, outlays:

-- Will increase more than 17 percent; and

-- Will provide rental and home-ownership assistance to an additional 450,000 lower-income families, about 10 percent more than the 1978 level.

To summarize, President Carter's 1979 budget is realistic, responsible, and responsive to the Nation's most critical needs. Spending has been held to an overall increase of eight percent, the smallest increase since 1973. True, the deficit for 1979 is only one billion less than the

deficit in 1978. Had no tax cut been proposed, we could have shown a decrease of $15 to $20 billion. As all three of us have emphasized, however, it is more important now that we have a tax cut to help the economy continue to grow and to encourage the increased capital investment that will improve productivity. The President's proposed reductions also mean that Federal taxes will represent a smaller share of our gross national product. This, in turn, will provide an additional incentive for both the Congress and the President to restrain the growth in spending and hasten the day when a balanced budget will be both desirable and appropriate economic policy.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer the Committee's questions.

STATEMENT OF PETER HENLE
DEPUTY UNDER SECRETARY FOR ECONOMIC POLICY REVIEW
U.S. DEPARTMENT OF LABOR
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

February 1, 1978

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to appear before you today to discuss the Federal unemployment tax component of the Administration's Tax Reduction and Reform Act of 1978. With me is Lawrence E. Weatherford, Director of the Unemployment Insurance Service.

The Tax Reduction and Reform Act proposes to reduce the net Federal unemployment tax from 0.7 percent to 0.5 percent of the first $6,000 of an employee's earnings effective January 1, 1979. The increase in the tax from 0.5 percent to 0.7 percent had taken place on January 1, 1977 in order to obtain revenue to repay advances made to the Federal extended unemployment compensation account for payments of extended benefits and Federal supplemental benefits during the severe recession of the past few years. I would first like to outline the rationale for this proposal and then discuss the accompanying financing issues for the unemployment insurance system.

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Rationale

The President's proposal to reduce the Federal unemployment tax reflects a concern about both inflation and unemployment. Our present economic recovery is well underway, with the economy growing by nearly five percent in 1977; however, this growth was accompanied by a rise in retail prices of nearly seven percent and a level of unemployment well above six percent. The proposed reduction in the unemployment tax is expected to have a favorable effect on both prices and unemployment.

One of the Administration's major concerns during the past year has been the increasing burden of employer payroll taxes, including both the Federal unemployment tax and the social security payroll tax. These increased payroll taxes tend to lead to both higher prices and higher unemployment. Payroll taxes of course add to employer labor costs. To the extent that such costs are passed through to consumers by higher prices, the higher payroll tax will lead to increased inflation. At the same time, the increased labor costs could also tilt the balance between the costs for labor and the costs for capital equipment. The employer will be given an added incentive to substitute capital for labor. As a result, unemployment will tend to be higher than otherwise would be the case.

The President's concerns about the dual effects of payroll taxes, leading not only to inflation but also unemployment, were reflected in the Administration's earlier proposal to introduce general revenues for partial funding of the social security system. Under the enacted law, the combined social security tax for both employers and employees is now scheduled to rise above 15 percent by 1990. Although the 1977 amendments to the Social Security Act put the social security program on a sound financial basis both for the immediate future and well into the next century, the Administration continues to be concerned about the potential effects of these scheduled payroll tax increases on inflation and unemployment.

While we realize, of course, that the magnitude of the present unemployment insurance tax proposal is small relative to scheduled increases in the social security tax, the proposal will result in a tax reduction of $800 million in 1979 and about $900 million to $1.1 billion in succeeding years.

The proposed reduction in the unemployment tax is a positive step in the battle to lower inflation and unemployment. There is no one policy that solves this twin problem. We must instead develop a number of incremental strategies that attack specific problems in our economy. Lowering the Federal unemployment tax is one such strategy.

UI Financing

We are not unmindful of the reasons why Congress raised the Federal unemployment tax to 0.7 percent as of January 1977. There is admittedly a large repayable debt in the Federal extended unemployment compensation account as a result of extended and Federal supplemental benefits paid in recent years.

The Administration, in making its proposal, recognizes that the 0.7 percent rate will have been effective for only two years, and in that time will not have generated sufficient revenues to repay the advances. The revenues generated by a 0.5 percent tax rate, however, will be nearly sufficient to cover current and future benefit payments under EB. In 1979, there will not be a deficit in the Federal account because of the positive balance that is expected to be carried over from 1978. The Federal account will need an advance from general revenues of $300 million in 1980, but, given current economic projections, no such advances will be needed in the following three years.

In the Unemployment Compensation Amendments of 1976, a National Commission on Unemployment Compensation was established to deal with the financing of, and other issues affecting, the unemployment compensation system. Indeed, the establishing legislation directs the Commission to consider

> "issues and alternatives concerning the relationship of unemployment compensation to the economy, with special attention to long-range funding requirements and desirable methods of program financing."

We remain committed to sound financing of unemployment compensation. The National Commission will soon be appointed and begin its work. In the meantime, we believe the proposed reduction in the tax will help alleviate the burden of payroll taxes, thereby helping fight inflation and unemployment.

We would be happy to answer any questions you may have.

Testimony of the
The Honorable Frank Horton, M.C.
formerly Chairman, Commission on
Federal Paperwork before the Ways
and Means Committee of the House
of Representatives
February 1, 1978

Mr. Chairman and Members of this distinguished Committee.

I am honored to appear before the full Ways and Means Committee, and wish to thank Mr. Gibbons for making these arrangements.

With me today is Tom Steed from Oklahoma who served with me on the Commission on Federal Paperwork. Also, Warren Buhler, who served as Director of the Commission, has joined me.

The Commission, Mr. Chairman, terminated yesterday on schedule and with $1,250,000 reverting to the Treasury in unspent funds. It made some 810 recommendations, and already 60% of these have been acted upon by Congress and the agencies. One recommendation which this Committee accepted and enacted in the Social Security bill was a change from quarterly to annual eligibility. This small change results in savings in excess of $500 million a year to the private sector. Our Commission found the paperwork burden imposed on the American public exceeds $100 billion, and that much of it is unnecessary, wasteful, and actually crippling some very worthy programs. Copies of our Final Summary Report and Report on Taxation have been put before you.

This Committee has responsibility for some very major tax issues: how big should the tax cut be, what should be done about the foreign tax credit, etc. Today, I would like to call your attention to another aspect of our tax system -- one which the press doesn't dwell on but which means much more to most people. That issue is, how easy is it to fill out your tax return?

Consider these facts. In 1975, some 80 million people filled out individual income tax returns. The 1040 and 1040A are filled out by more people than any other piece of Federal paperwork. And because of its importance, an individual's view of the sensibility of his government will be greatly shaped by what he has to go through in meeting his tax obligations.

Let's look at what the Commission found when we started.

The 1040A instructions, our simplest tax return, in 1975 required a college level reading ability to understand.

More than 17 million people filed the more complicated 1040 when they could have used the 1040A in 1974.

Eight million people had to go to the trouble of filing a return to get back withholdings becaus they owed no tax.

A major tax relief provision for the elderly was not being used. Why? Because it was too complicated to understand.

In the past we have too often felt nothing could be done about these problems. Taxes are complicated, and besides, there are important issues like loopholes and deducations.

Loopholes and deducations are important issues, but not to 53 million Americans, 66 percent of all taxpayers, who do not take deducations. And not to the average American who feels insult is added to financial injury when he faces a tax system that seems put together with very little attention to the problem it causes him or her.

Mr. Chairman and Members of the Committee, I suggest we passed a watershed last year when more than 50 percent of American taxpayers felt it necessary to have someone else fill out their tax return. As the President said in his State of the Union address, we have reached the point when individuals feel they need emissaries to deal with their own government. As one man said at one of our hearings, "I don't know whose government this is, it certainly isn't working for me."

The Commission came to understand, and I hope this Committee will understand, that peoples' complaints are not just about taxes, but in too many cases about the silly ways government goes about collecting taxes, and the way we run our other programs for that matter. The American people understand they have to pay taxes, and while they don't like it, they will do so. But they have every right to object if they can't understand the instructions, the forms are complicated, there is a lot of unnecessary paperwork, unnecessary filings, a lack of coordination among Federal, State and local tax systems, and the like. They pay enough for this government, and they expect a little more attention to their problems.

The Commission on Federal Paperwork focused on the problems faced by the great majority of taxpayers: the income tax payer and small businessman. We found that many of their problems had solutions, and I am pleased to say that IRS, first under the leadership of Don Alexander who was a member of our Commission, and now under the able leadership of Commissioner Kurtz, has implemented most of our recommendations. For example:

- o IRS greatly simplified the instructions to the 1040A, lowering the readability level by four grades. An interesting note is that IRS contracted with an outside firm which was unable to make any real improvements, so IRS did the work itself. And I think you and all our constituents will find the actual forms much simplified this year, so we will be spending less time and aggravation on this unpleasant task.
- o IRS has an active program underway to get those 17 million people who can but do not use the 1040A to do so. This will save individuals and the government money since it is more costly to fill out and process the 1040.
- o IRS made a single change combining the W-4 withholding form with the W-4E exemption from withholding form so that the opportunity to avoid withholding is always available, which if fully effective would save several million dollars in wasted time and paperwork.

o Congress last year changed the retirement income credit provisions to make them understandable and workable.

In just two areas the Commission recommendations have not been adopted. Income tax returns for farmers are more complicated than those of other small businessmen. We recommended, on pages 26 and 27, that they be simplified. IRS had taken steps to implement this recommendation, but progress was halted when the compliance section complained. We hope more work will be done in this area.

The second area, and potentially the most important of any of our recommendations, has to do with coordinating Federal, State, and local tax systems. Of the 80 million citizens who filed Federal returns in 1974, 72 million had to file State or local returns as well. Piggybacking State and local returns on the Federal return is one way to accomplish this coordination. The Commission's several recommendations on piggybacking have now been implemented through the Tax Reform Act of 1976 and action by the Treasury Department on implementing regulations. But piggybacking is not the answer for most States.

Recognizing the varying situations of the States, the Commission felt the difficult task of coordinating Federal, State and local tax systems requires continuous attention and staff resources to do the work. Therefore, as you will note on pages 37 and 38, the Commission recommended there be established a permanent, bipartisan commission to:

- o bring together representatives of Federal, State, and local governments for consideration of common tax problems;
- o provide a forum for discussing the administration, coordination, and simplification of tax laws and administrative procedures;
- o make available technical assistance to executive and legislative branches of Federal, State, and local governments in the review of proposed legislation;
- o encourage discussion and study at an early stage of emerging intergovernmental tax problems;
- o recommend and advocate methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less complicated fiscal relationship between the levels of government and to reduce the burden of compliance for taxpayers; and
- o promote the continued development of model State tax laws by working with the States to identify those parts of the Federal tax code which the States would be most likely to adopt.

Subsequent discussions with ACIR and several people in the tax field have indicated an interest in beefing up ACIR's resources and responsibilities to do the job, rather than creating a separate commission. We would like to see the job done; we believe it will take legislative direction and resources

not now available, and I urge this Committee to include appropriate language in this year's tax bill.

What should this Committee do? We estimated that in 1975, some 2 billion tax forms were completed, and that does not include supporting documentation. We found that our tax code was so complicated people were not obtaining intended benefits and there was a great waste of money and energy. In the last chapter, we discuss some of the issues involved in tax legislation. The discussion of equity considerations always overwhelming attempts at simplification is important because we have gotten to the point in some instances where provisions to achieve equity have become so complicated they have become themselves inequitable. Our findings are summarized on pages 60 and 61. They are:

- o Avoid complex provisions of the tax law that are designed to promote equity but which, in fact, are so difficult to understand that the intended beneficiaries are unable to take advantage of them;
- o Carefully determine whether tax law provisions aimed at non-revenue producing objectives really represent the most efficient way for the Federal Government to achieve these goals;
- o Improve the language of the Code to increase readability and comprehension;

- Provide sufficient lead time between enactment and effective rate of tax legislation to help ease the administrative and, thus, the reporting burden associated with tax law compliance;
- Avoid making retroactive tax laws;
- Wherever possible, write tax regulations clearly enough so that further explanatory materials are not needed; and
- Make the regulations on Federal income tax more readily available to taxpayers.

The Commission tried to summarize its findings steming from 36 studies of Federal programs, including taxation. We concluded that what amounts to a new philosophy of how we run our government is needed; a set of principles and techniques we called Service Management. I would like to illustrate our suggestion using the issues you face as an example.

The key to the Service Management philosophy is having those of us in government accept responsibility for the problems and burdens we cause others outside government, such as with paperwork and red tape. This responsibility would be in addition to the traditional ones of responsibility for tax dollars and efficient management of government programs.

We must recognize that the principal burden of administering our tax system rests not with the government, but with the individual taxpayers, and businesses and employers, who must generate, report and retain information. This burden cannot be eliminated, but it can be made sensible, efficient, and the whole system more effective.

The first step is to use full-cost accounting. Just as we control Federal expenditures we must begin to identify and control expenditures forced on others by Federal programs. We must begin to identify where the costs or other problems of our tax system are the greatest so we can make changes to bring these costs within reasonable limits. What you might try is an accounting for the tax administration costs of tax provisions. I am pleased to note that the Joint Committee on Internal Revenue Taxation recently reported it would try to do more full-cost accounting in analyzing tax proposals.

The second step is alternatives analysis. The very complexity of our government and society presents alternative ways of achieving governmental objectives. What objectives should we be trying to achieve through our tax system, and which ones properly belong in other types of Federal programs? Our committee structure here in Congress militates against this type of analysis: every committee tries to attack national problems from its own focus. We are not against attacking national problems on multiple fronts; but we are against programs that are not cost-effective. We must spend more time considering alternatives.

Finally, a partnership of effort is required in designing and evaluating programs among all the parties who must contribute to make the program succeed. We must involve taxpayers more in designing and evaluating our tax system. We must learn

from them when it is unnecessarily complex and too costly. Ours is (or will be we saying was) a system of voluntary tax compliance. We have not been listening and paying attention sufficienily to the problems taxpayers are having. This Committee should monitor and support the IRS effort to simplify the tax system. This Committee should consider itself checking out what the problems are, monitoring costs, and possibly even setting reasonable limits on readability, average time to complete, and other aspects of the costs and burdens our citizens bear in figuring and paying their taxes.

Mr. Chairman, a Citizens Committee of distinguished leaders from all sectors of our society is being established to push for implementation of the Commission on Federal Paperwork's recommendations. I am sure they would be happy to work with the Committee in analyzing this year's tax legislation.

As the Commission stated in its Final Summary Report, our work is both epilogue and prologue: An epilogue to the work of the Commission, its tenure expired and its mandate fulfilled, and a prologue for the work yet to be done. The record of the Commission and the principles for significant and successful reform hopefully will help you grapple with the difficult issues you face in developing both an equitable and a sensible and understandable tax system for the American people.

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