II

Tax Treatment of Individuals

INDIVIDUAL TAX RATES AND THE PERSONAL CREDIT

Present Law

Three elements of the tax law that affect all individual taxpayers are the personal exemption, the general tax credit, and the schedule of tax rates. An individual is allowed an exemption of $750 for himself and for each dependent. On a joint return, both husband and wife are allowed exemptions. Additional $750 exemptions are allowed for individuals who are aged or blind.

The general tax credit is equal to (a) $35 for each personal exemption, or (b) two percent of the first $9,000 of taxable income, whichever is greater.

There are four rate schedules -- joint, single, married filing separately, and head of household. 1/ Under, the joint table, the first bracket, or zero bracket, includes $3,200 of taxable income. No tax is paid on income in the zero bracket. The other tax rates range from 14 percent (for the first $1,000 of taxable income in excess of this zero bracket amount) to 70 percent in the highest bracket (more than $200,000 over the zero bracket amount). For single taxpayers, the zero bracket includes the first $2,200 of taxable income. Rates range from 14 percent for the first $500 in excess of the zero bracket amount to 70 percent in the highest bracket (more than $100,000 over the zero bracket amount). The schedule for the separate returns of married persons is obtained from the joint schedule by dividing all dollar amounts by two. Finally, a single taxpayer with a dependent may qualify to use the head of household schedule. Under this schedule, tax liability is the average of the amounts that would be owed on a joint return and a single return with the same taxable income above the zero bracket amount.

Reasons for Change

The economy requires a substantial tax cut to ensure that the current recovery is sustained. In particular, individual income tax reductions are needed to offset both increases in social security taxes in 1978 and 1979 and to counteract the tendency of inflation to increase the share of personal income that taxpayers pay in Federal income tax. Although major income tax cuts are needed to offset the restraining effects, or fiscal drag, of rising tax collections on the economy, the opportunity is afforded at the same time for restructuring the tax system to achieve other important goals. In particular, rates and credits can 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 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	1978 Tax Proposal: Tax At Low End of Bracket	1978 Tax Proposal: 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	620	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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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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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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Table IIA-4

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

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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: Income tax 1/	Present Law Tax: FICA tax 2/	Present Law Tax: Total tax	1979 Proposed Tax: Income tax 3/	1979 Proposed Tax: FICA tax 4/	1979 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	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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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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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.

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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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

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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, 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		Casualty Deduction	Using Hardship Deduction	Not Using Hardship Deduction but Itemizing	Switching to Standard Deduction
		Insurance Premiums Only	Other Medical Expenses				
$ 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

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* 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%

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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 0.5 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.

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

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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.

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.)	All Taxpayers with Capital Gain or Loss: Amount of Net Gain ($ bil.)	All Taxpayers with Capital Gain or Loss: Percent of Total	Taxpayers Electing Alternative Tax: Number of Returns (thous.)	Taxpayers Electing Alternative Tax: Amount Taxed At: Alternative Rate ($ bil.)	Taxpayers Electing Alternative Tax: 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 %

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* 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.

<u>Summary of Proposals</u>

(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.

<u>Real Estate</u>. 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.

<u>Accounting by Agricultural Corporations</u>. 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.)

<u>Deferred Annuities</u>. 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.

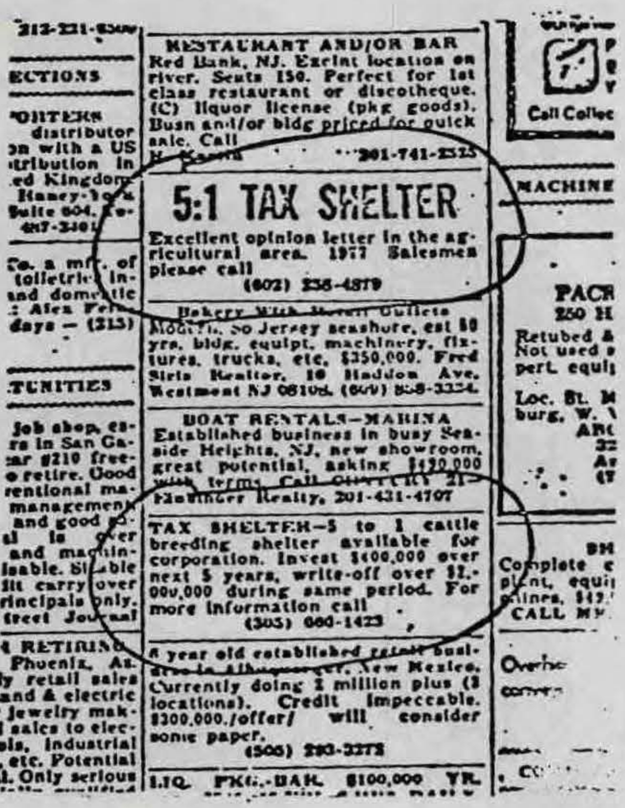
Investment Tax Credit. Currently, the investment tax credit and work incentive (WIN) credit may offset completely the first $25,000 and $50,000, respectively, of tax liability. This offset will be allowed instead only to the extent of 90 percent of tax liability.

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) 258-4879

Bakery With Outlets
So Jersey seashore, est 10 yrs, bldg, equipt, machinery, fixtures, trucks, etc. $350,000. Fred Siris Realtor, 10 Haddon Ave. Westmont NJ 08108. (609) 858-3334.

BOAT RENTALS—MARINA
Established business in busy Seaside Heights, NJ, new showroom, great potential, asking $190,000 with terms. Call ... 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) 660-1423

8 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

LIQ. PKG.-BAR. $100,000 YR.

AVAILABLE
INTERNATIONAL
BANK
Principals only
Box H-521, 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 610276 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

OCTOBER 2, 1977

Book Review

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.

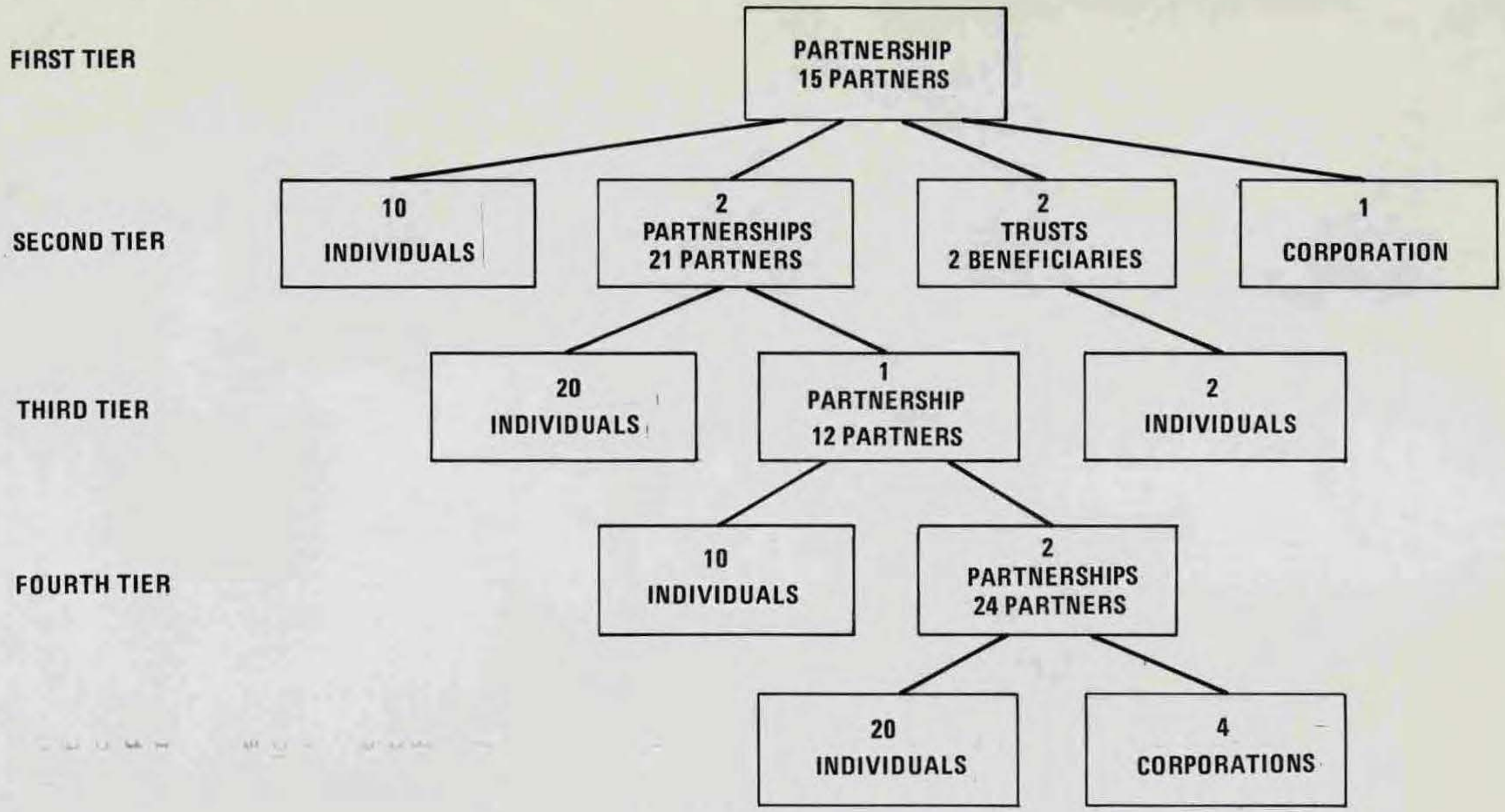
> . Even if you manage to escape challenge on your deductions and credits by the IRS, you still may have problems. Remember how you paid for the master recording: $20,000 down, $105,000 in a seven-year, nonrecourse note. Let's assume the record has failed to bring in more than a few dollars of income 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 (<u>e.g.</u>, 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.

<u>Reasons for Change</u>

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.

<u>Straight-line method more appropriate</u>.

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

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Office of Tax Analysis

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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.

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 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 Data by number of partners available only from 1972.

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%

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 patters 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 D-- 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: 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
Office of Tax Analysis

January 25, 1978

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-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 of-- 3/					
	$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-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
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-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.

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.

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.

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 <u>deferred</u> benefit (<u>i.e.</u>, 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

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

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.

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.

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

-- 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).

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.

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.

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.

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.

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 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.

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 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 '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

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 'wraparound' 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,

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 . . . ."

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 <u>not</u>, Shearson hastens to add, the kind of annuity now being offered -- 'a modern new deferred annuity which features high guaranteed interest rates.'" <u>2/</u>

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

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

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).

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.

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.

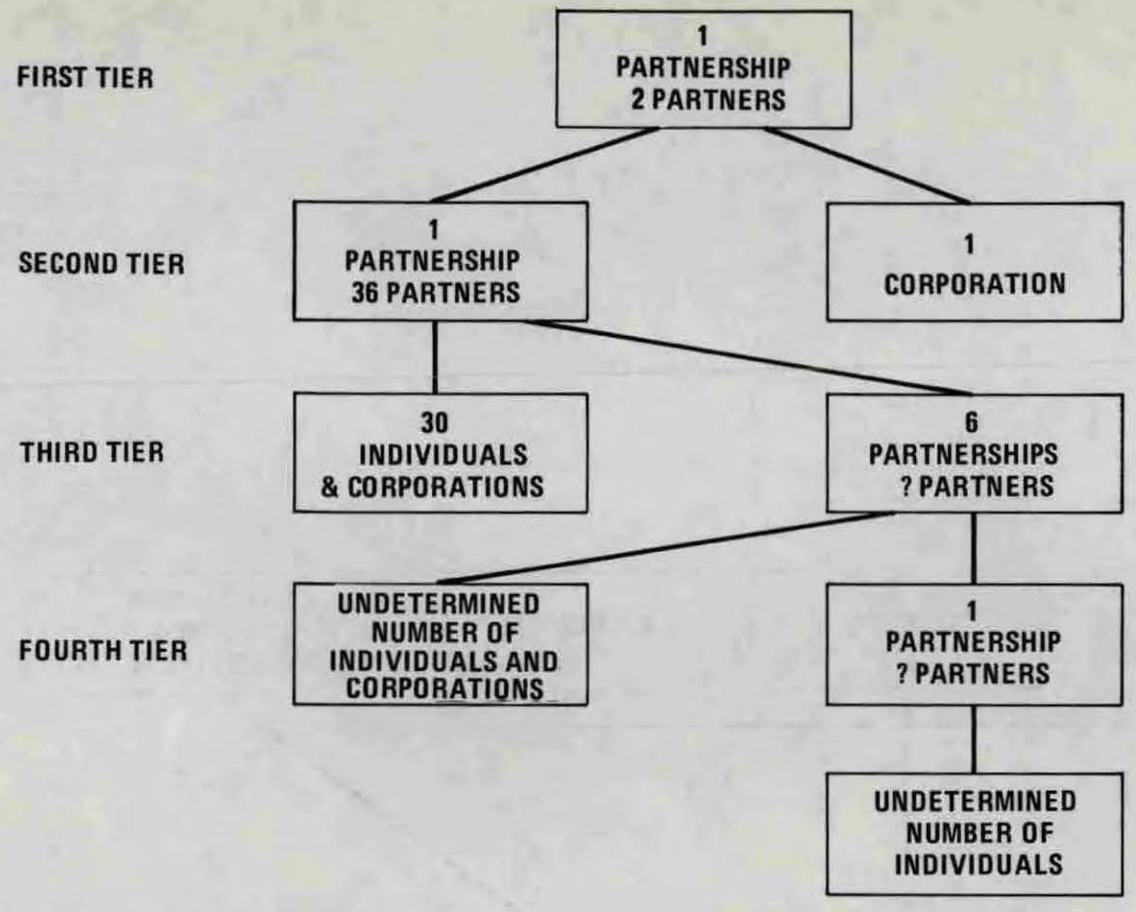
The partnership may seek judicial review of a final partnership determination, or bring an action for redetermination upon denial of, or inaction with respect to, a partnership-initiated proceeding. This judicial proceeding must be brought in the name of the partnership. The action may be brought in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

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.

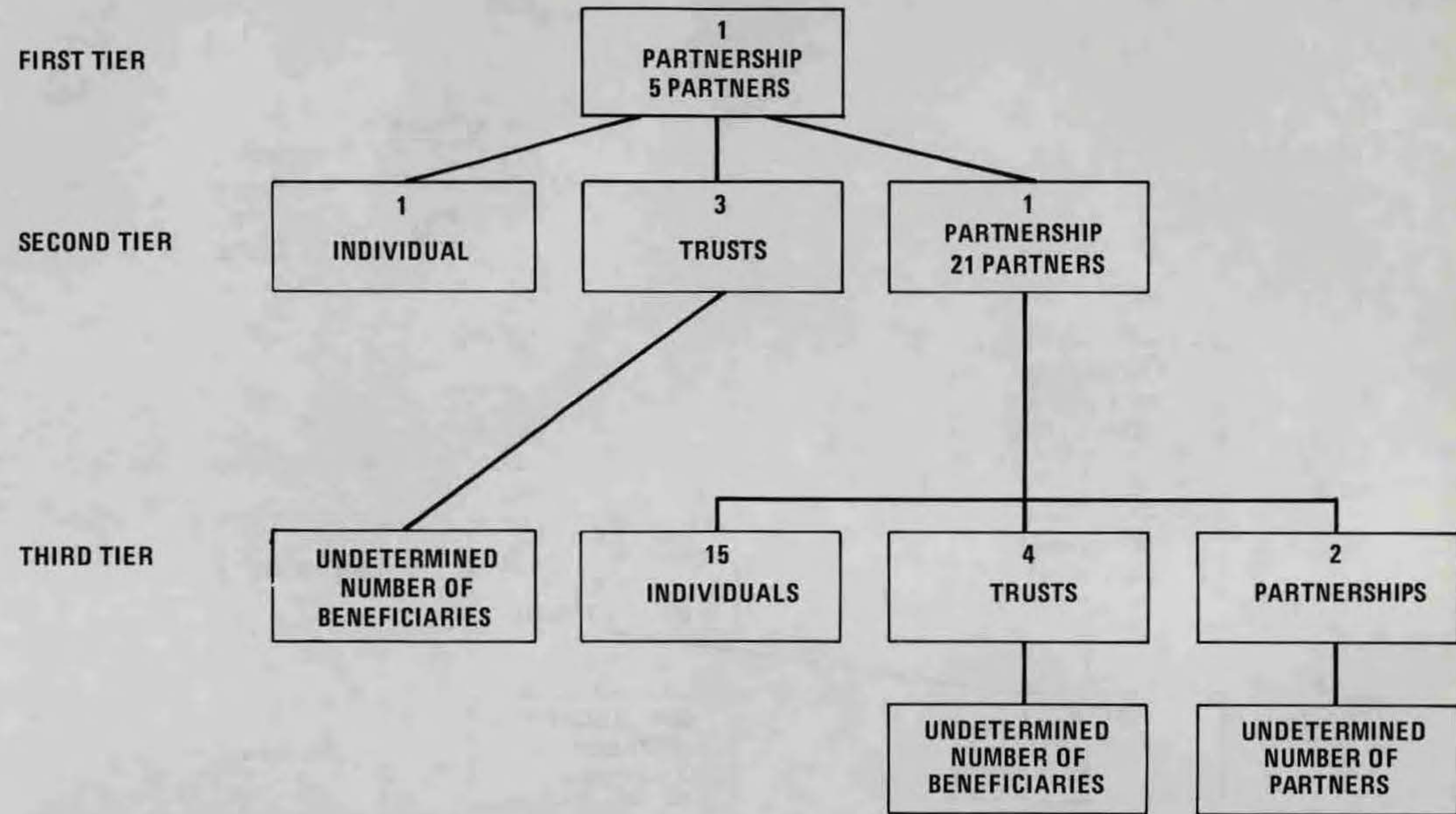
General Explanation

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.



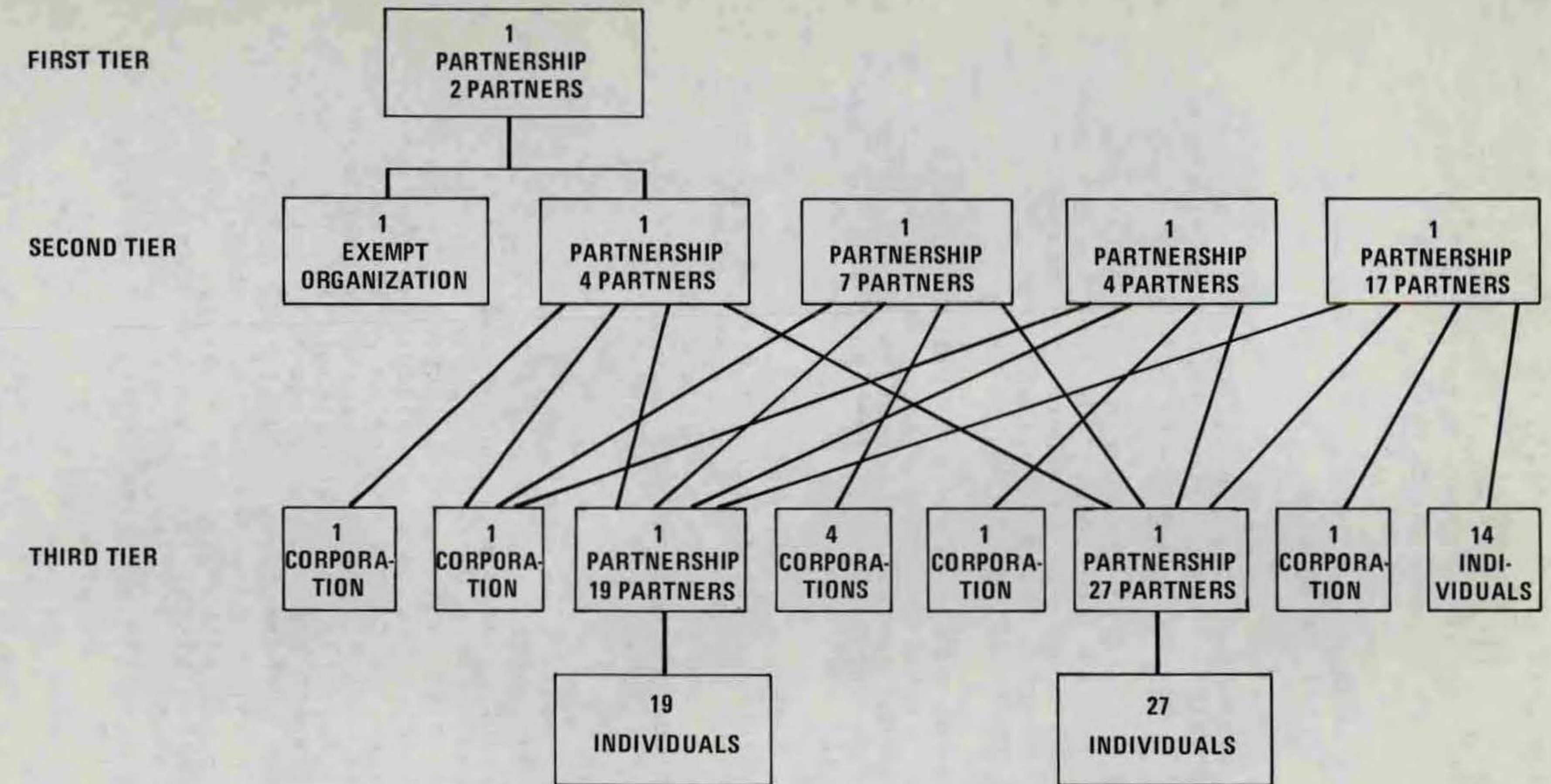
TOTAL RETURNS

Individual & Corporate	at least 80
Partnership	9
	at least 89



TOTAL RETURNS

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



TOTAL RETURNS

Partnership	7
Others	69
	76

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:

- 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.

- 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.

- 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.

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 of-- 3/					
	$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.

In 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 nondiscriminatory 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.

<u>Footnote</u>

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.

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.

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.

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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"our 15th year dedicated to the improvement of the fair administration of justice"

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Executive Director

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President

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DAY 1	Depart USA
DAY 2	Arrive Tel Aviv
DAY 3	8am-12pm: SEMINAR — LECTURE
	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
	Arrive USA

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Trial Advocacy

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An in-depth study of TRIAL ADVOCACY, with emphasis on current trial practice and techniques. Additionally, the leading cases in this area will be reviewed and the latest judicial and legislative developments will be discussed. An experienced trial attorney will discuss current practice and lead discussions on present and future developments. Written materials will be distributed to all those in attendance.

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ACTIVITY SCHEDULE	36 HOURS OF SCHEDULED ACTIVITY
DAY 1	Depart USA
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, most 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 <u>non</u>deductible 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.

<u>Analysis of Impact</u>

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 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.