IV

Tax Treatment of Business

CORPORATE TAX RATE REDUCTION

Present Law

Under present law, the corporate income tax rates are 20 percent of the first $25,000 of corporate taxable income, 22 percent of the next $25,000 of taxable income and 48 percent of all taxable income in excess of $50,000. These rates will be in effect through taxable years ending in 1978. For subsequent years, the corporate rates are scheduled to become 22 percent of the first $25,000 of taxable income and 48 percent of taxable income over $25,000.

Reasons for Change

Two major objectives of the Administration's tax proposals are to promote long-term capital formation and to strengthen and maintain the current economic recovery. To achieve these objectives, it is necessary to reduce the effective rates of tax on income from capital to provide business with additional incentives to invest.

A reduction in the corporate tax rates will achieve the objective of stimulating capital formation in two ways. First, the reduction in corporate tax liabilities will have an immediate, favorable effect on corporate cash flow. This will facilitate the financing of higher levels of capital spending. Second, the reduction in tax rates will increase expected after-tax profits for any given investment project. This higher expected profitability on investment will constitute a significant incentive to corporations to increase planned capital appropriations. In addition, since these higher after-tax earnings may be expected to lead to either an increase in dividends or a more rapid anticipated growth in share prices, the stock market should be favorably affected, and corporations will find it somewhat easier to obtain external equity financing.

The proposed extension of the investment tax credit to industrial structures, as discussed below, will also help to stimulate investment. However, there are specific reasons why it is desirable to include corporate tax rate reductions in the package as one of the principal tools for stimulating capital formation:

1) A change in the corporate tax rate structure is the most straightforward method of reducing the tax burden on the return from corporate investment.

2) Not all corporations will receive significant benefits from the proposed extension of the investment

tax credit to structures. Reduction of the corporate tax rate will enable all corporations to realize some benefits from the business tax cuts.

3) In the context of the entire proposal, the corporate tax rate reductions are required to prevent a shift of capital away from corporate investments. Given the reduction in the personal income tax rates included in the package, maintenance of a rough balance between taxes on corporate equity income and taxes on other forms of capital income (including debt) requires an accompanying cut in the corporate tax rates.

For these reasons, it is desirable to reduce the rates of tax on corporate income for both small and large corporations.

General Explanation

Effective October 1, 1978, the corporate income tax rates will be reduced to 18 percent of the first $25,000 of corporate taxable income, 20 percent of the next $25,000 of taxable income and 45 percent of all taxable income in excess of $50,000. Effective January 1, 1980, the tax rate on taxable income in excess of $50,000 will be 44 percent. The reductions will be permanent.

Revenue Estimate

Change in tax liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-1,349	-5,965	-8,516	-9,228	-10,010	-10,764

Note: These estimates are based on permanent extension of the present rates.

Technical Explanation

Effective October 1, 1978 the normal tax imposed by section 11(b) of the Code, which currently is 20 percent of the first $25,000 of taxable income plus 22 percent of taxable income in excess of $25,000, will become 18 percent of the first $25,000 of taxable income plus 20 percent of taxable income in excess of $25,000.

The surtax imposed by section 11(c) of the Code, which currently is 26 percent, will be reduced to 25 percent effective October 1, 1978. A further reduction to 24 percent will become effective January 1, 1980. The surtax exemption, which currently is $50,000, will remain at $50,000.

Thus, effective October 1, 1978, the corporate rate will be 18 percent of the first $25,000 of taxable income, 20 percent of the next $25,000 and 45 percent of taxable income in excess of $50,000. Effective January 1, 1980, the top rate will decline to 44 percent.

In the case of a corporate taxpayer whose fiscal year does not begin with the effective date of a rate reduction (in this case, October 1, 1978 and January 1, 1980), existing law provides for the taxpayer to determine its tax liability for the taxable year of transition by computing tentative taxes based on the application to its full year's taxable income of the rates in effect before and after the date of the change, and paying a tax that consists of a portion of each tentative tax determined by reference to the number of days during the taxable year to which the old and new rates applied. In other words, the tax rate for the entire year is a weighted average of the tax rates applicable to the periods before and after the rate change with the weights being the number of days in the year before and after the change.

For example, suppose a calendar year corporation has taxable income of $100,000 in 1978. Under present law, its tax liability for the full year would be 20 percent of the first $25,000 of income ($5,000), 22 percent on the next $25,000 of income ($5,500) and 48 percent on all taxable income over $50,000 ($24,000) for a total tax of $34,500. Under the proposal, the full year's tax liability for the corporation will be 18 percent of the first $25,000 of taxable income ($4,500), 20 percent of the next $25,000 of taxable income ($5,000) and 45 percent of taxable income over $50,000 ($22,500) for a total tax liability of $32,000. There are 273 days in the transition year before the effective date of October 1, 1978, and 92 days on or after that date. Therefore the tax on the corporation for the transition year will be equal to 273/365 of $34,500 (or $25,804) plus 92/365 of $32,000 (or $8,066). Thus, the calendar year corporation's tax liability on $100,000 of taxable income in 1978 is $33,870.

INVESTMENT CREDIT

Present Law

Taxpayers are presently entitled to a credit against their tax liability equal, in general, to 10 percent of their investment in certain qualified productive assets. The rate of this investment credit was temporarily increased to 10 percent from 7 percent as of January 25, 1975, and is scheduled to revert to 7 percent on January 1, 1981. (In the case of investments in certain public utility property, the credit is scheduled to revert, in effect, to 4 percent on January 1, 1981.)

In general, property eligible for the investment credit consists of depreciable property having an estimated useful life of three or more years which is either tangible personal property or other tangible property (such as fixtures and heavy machinery) that is used as an integral part of the productive process. Buildings and their structural components, however, do not qualify for the credit.

To reduce the cost of pollution control equipment required to be installed in plants in use before January 1, 1976, a taxpayer may elect to amortize the cost of such equipment over a 5-year period in lieu of depreciating the equipment over its useful life. However, if pollution control equipment is amortized under this special rule, the investment credit is limited to 5 percent of the cost of such equipment.

The amount of investment credits for any year may be used, dollar-for-dollar, to offset completely tax liability of up to $25,000. Credits in excess of $25,000 may, in general, be used to offset up to 50 percent of tax liability in excess of $25,000. Special provisions, scheduled to be phased out over time, permit public utilities, railroads and airlines to offset more than 50 percent of their tax liability in excess of $25,000 with investment credits. In any year in which the amount of a taxpayer's investment credits exceeds the applicable limits, the excess may be carried back to the three taxable years before, and forward to the seven taxable years after, the year in which the asset was placed in service.

Reasons for Change

The investment credit, originally proposed in 1961 to stimulate the lagging modernization of the country's productive facilities, has proven to be an effective incentive to capital investment. However, the unavailability of the credit for investments in industrial buildings has impaired somewhat its utility in promoting investment in long-lived manufacturing facilities.

As first proposed by the Treasury in 1961, the investment credit would have been available for investments in industrial buildings. However, while the Congress was examining the Treasury's 1961 proposal, it became apparent that investment in equipment, by historical standards, was lagging behind investment in non-residential structures. By the end of 1961, equipment investment had still not regained the peak level (in real terms) achieved in the third quarter of 1957, while investment in non-residential buildings had surpassed its earlier peak during 1960. Thus, the Committee on Ways and Means concluded that buildings and their structural components should not be eligible for the credit:

> "The credit is available for investments in most tangible personal property. It is also available for limited types of real property, other than buildings. The greater emphasis is placed on equipment and machinery because it is believed the need for such investment is the major requirement of the economy."1/

The decision in 1961, while appropriate at that time, has had a distorting effect on the composition of business fixed investment in the United States. While annual expenditures (in current dollars) for total fixed investment have increased by some 295 percent since 1961, expenditures for industrial structures have increased by only 145 percent. Moreover, during the recent cyclical recovery phase, annual expenditures for industrial structures have actually declined, while other investment expenditures have mildly increased. These developments are reflected in Table IVB-1.

Table IVB-1

Comparison, in Current Dollars, of Outlays for Total Business Fixed Investment and for Industrial Structures

	Business Fixed Investment	Expenditures for Industrial Structures
	1960 - 61 = 100	
1960	100.6	101.3
1961	99.4	98.7
1962	108.1	100.9
1963	113.1	103.2
1964	125.9	126.6
1965	150.3	201.3
1966	171.8	259.2
1967	173.2	235.4
1968	188.3	213.9
1969	208.8	240.9
1970	211.9	232.2
1971	219.5	192.6
1972	246.5	166.1
1973	286.9	221.7
1974	317.8	280.7
1975	314.6	284.8
1976	341.7	255.1
1977	395.6*	245.6*

Office of the Secretary of the Treasury
Office of Tax Analysis

January 19, 1978

* Based on first three quarters only.

Source: Survey of Current Business.

The decision in 1962 to deny the investment credit to buildings was also based, in part, on the favorable depreciation for Federal income tax purposes afforded buildings at that time. In contrast with the situation in 1962, there has been a substantial tightening in the tax treatment of depreciation of structures. Depreciation recapture rules have been extended to real property and it is proposed elsewhere in the President's tax program that the rules governing depreciation of buildings be changed to conform more closely to economic reality. See REAL ESTATE DEPRECIATION. Thus, industrial buildings will no longer enjoy the exceedingly favorable depreciation treatment available in 1962.

Accordingly, it is now appropriate to extend the stimulus provided by the investment credit to investments in industrial structures. This change will eliminate the bias of current tax law against balanced programs of industrial expansion, and will promote increased investment in long-lived productive facilities. Expansion of private investment in manufacturing facilities is essential to avoiding capacity shortages, with resulting inflationary pressures, as the economy continues to move ahead. Modernization of the stock of productive capital is likewise essential to further gains in labor productivity. Finally, this change will eliminate the many disputes occasioned under present law by the need to distinguish between equipment, for which the credit is available, and buildings and their structural components, for which it is not.

The investment incentive provided by the credit can be strengthened further by modifying the provisions of present law that limit current availability of investment credits to 50 percent of a taxpayer's tax liability in excess of $25,000. This limitation both dampens the investment incentive provided by the credit by delaying actual use of credits, and adds to the complexity of the tax laws by compelling some taxpayers either to resort to the use of carryovers, or to engage in complex and costly leasing transactions, to obtain the benefits of the investment credit. Furthermore, in years in which an excess credit can be fully utilized by carrybacks, the procedure for effecting a refund entails cumbersome recomputations of prior years' tax accounts with no compensating gain to either the taxpayer or the Treasury. Relaxing this limitation would thus simplify the tax laws, stimulate capital investment by accelerating the actual availability of investment credits, and promote economic efficiency by reducing the disparity, caused solely by variations in current tax liabilities, in the use of credits by enterprises that have made similar amounts of eligible investment.

It would, however, be incompatible with the goals of the President's tax program to permit investment credits to eliminate completely a person's tax liability. See TAX SHELTERS -- INTRODUCTION. Under present law a taxpayer whose tax liability is $25,000 or less may use investment credits to eliminate that liability in its entirety. Permitting investment credits to offset up to 90 percent of a taxpayer's tax liability for any year would strike an appropriate balance between strengthening the investment incentive provided by the credit, on the one hand, and not permitting the credit to eliminate 100 percent of tax liability for any year, on the other.

The temporary increase in the credit to 10 percent, scheduled to expire in 1981, has had some beneficial effect on the rate of capital investment. However, the temporary nature of the 10 percent rate is an additional variable that must be taken into account by businesses in making long-range investment decisions. This uncertainty diminishes the incentive effect of the credit and is undesirable, particularly when the rate of capital investment is inadequate. For that reason, and because capital formation remains a long-term economic policy objective, the present 10 percent rate of the investment credit should be made permanent.

To reduce further the rising cost of compliance with environmental standards, pollution control equipment added to pre-1976 plants should, in addition to its eligibility for 5-year amortization, be eligible for the full 10 percent investment credit. It is proposed elsewhere in the tax program to eliminate the availability of tax-exempt financing to provide pollution control facilities. However, it is expected that, for eligible taxpayers, the benefit of the additional 5 percent investment credit for pollution control investment in pre-1976 plant generally will offset the loss of tax-exempt financing. See INDUSTRIAL DEVELOPMENT BONDS.

General Explanation

As an incentive to business to expand and modernize its investment in long-lived industrial facilities, thereby reducing the likelihood of future capacity shortages, the investment credit will be extended to industrial structures. This change will extend to otherwise eligible investments made in new industrial buildings as well as investments made to rehabilitate existing buildings.

An industrial structure will include a building and its structural components, but only if the building is used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or if the building constitutes a research facility used in connection with any of these activities. Thus, for example, buildings used for residential purposes (e.g., apartment buildings, hotels and motels), commercial buildings (e.g., office buildings and retail stores), and buildings used for storage or distributional purposes (e.g., warehouses) will not be industrial structures eligible for the credit. Bulk storage facilities (e.g., grain storage bins and oil storage tanks) will continue to be eligible for the credit. This change in general will be accomplished by deleting the provision of present law that specifically excludes a building and its structural components from the definition of property eligible for the investment credit.

Because property eligible for the credit is generally subject to the depreciation recapture rules applicable to equipment rather than the less stringent rules applicable to real property, buildings for which an investment credit will now be allowed will also be subject to the depreciation recapture rules (section 1245) for equipment.

The provision of present law that limits the current availability of investment credits for any year to $25,000 plus 50 percent of tax liability in excess of $25,000 will be changed to provide that investment credits may offset up to 90 percent of tax liability in any year. Until this change becomes effective (See Effective Dates), airlines, railroads and public utilities will remain subject to the special limitations of current law. Permitting the credit to offset 90 percent of tax liability will both strengthen the incentive provided by the credit and simplify its administration. In addition, a uniform percentage limitation on the use of the credit will eliminate the inequity of present law that allows a complete offset of tax liability through the use of investment credits; the investment credit will no longer be permitted to offset completely the first $25,000 of tax. 2/

To assist business enterprises in making long-range capital investment decisions and to encourage long-term capital formation, the 10 percent rate of the investment credit will be made permanent. Investments in public utility property will remain eligible for the permanent, 10 percent credit.

Investments in pollution control equipment will be eligible for the full 10 percent investment credit, even if an election is made to amortize the cost of such equipment over the special 5-year period.

Effective Dates

Industrial structures placed in service after December 31, 1977 will qualify for the investment credit, but only to the extent of the portion of the adjusted basis of such structures properly attributable to construction after that date. Otherwise eligible expenditures to rehabilitate existing industrial structures will also qualify for the credit, but only to the extent of the adjusted basis of such structures properly attributable to rehabilitation after December 31, 1977.

For taxable years beginning after December 31, 1978, the investment credit (and investment credit carryovers to such years) will be usable to offset up to 90 percent of a taxpayer's liability for tax. For taxable years beginning after December 31, 1978, investment credits will no longer be available to offset completely the first $25,000 of tax. These changes will apply to all taxpayers, including public utilities, railroads and airlines.

The 10 percent rate of the investment credit will not revert to 7 percent on January 1, 1981, but will be made permanent.

Certified pollution control facilities eligible for the special 5-year amortization period will be eligible for the full 10 percent investment credit, provided that as of December 31, 1977 no election has been made to amortize such equipment over the 5-year period.

Revenue Estimate

Change In Tax Liability
($ Millions)

	Calendar Years					
	1978	1979	1980	1981	1982	1983
Extend 10 percent investment credit to structures	-1147	-1443	-1714	-1942	-2153	-2354
Full Investment credit for pollution abatement facilities	- 142	- 93	- 107	- 127	- 115	- 144
Change investment credit limit to 90 percent for corporations		- 882	- 576	- 114	- 194	- 205
Change investment credit limit to 90 percent for individuals		52	58	64	71	79

Note: These estimates are based on permanent extension of the 10 percent investment credit.

Footnotes

1/ House Report No. 1447, 87th Cong. 2d Sess. (1962), at 9.

2/ The same rule -- that credits may offset 90 percent of tax liability -- will apply to the work incentive credit (section 40 of the Code) which, under present law, may be used to offset the first $50,000 of tax liability plus 50 percent of tax liability in excess of $50,000.

SMALL BUSINESS

INTRODUCTION

The corporate tax cuts described elsewhere in the Administration's tax proposals will particularly benefit small corporations with incomes of $50,000 or less; for these corporations the tax reduction will be nearly 10 percent. The Administration is also making three proposals specifically to assist small businesses. The first proposal will simplify and liberalize the rules (Subchapter S) that treat certain small corporations like partnerships. The second proposal will simplify methods of depreciation for small businesses. And, if an investor loses money on stock in a small business, the third proposal will make it easier for him to deduct his losses. The revenue effect of these changes is estimated to be $400 million in 1979, virtually all of which is accounted for by the reduction in corporate rates.

LIBERALIZATION OF SUBCHAPTER S

Present Law

In general, present law treats a corporation as an entity separate and apart from its shareholders. Income earned by a corporation is taxed to the corporation and distributions are taxed to the shareholders. Losses affect the tax liability of the corporation but not that of the shareholders. Under Subchapter S, however, a qualifying domestic coporation may elect not to pay the regular corporate income tax. Instead, the income of the corporation is taxed to the shareholders whether it is distributed as a dividend or retained by the corporation. In addition, the shareholders are allowed to deduct losses sustained by the corporation. This results, in a general way, in a pattern of taxation similar to that of partnerships. Subchapter S is available only to small corporations with simple structures that are essentially similar to partnerships.

Reasons for Change

Subchapter S reflects concern regarding the tax-induced distortions of business behavior that result from double taxation of corporate income. Such distortions include favoring debt over equity financing, unnecessary retention of earnings in corporate solution, and widespread resort to partnerships for certain types of business activities. Therefore, it is appropriate to revise Subchapter S to eliminate unnecessary barriers to its use. Such barriers arise from the fact that the Subchapter S rules, although revised since enactment, remain complex and are frequently misunderstood in ways that lead to unintended hardships. Complexity in this area is particularly undesirable because Subchapter S generally is limited to, and is best suited for, small businesses. Accordingly, the proposal simplifies and liberalizes Subchapter S.

General Explanation

The proposal will liberalize three sets of rules governing treatment of a small business corporation under Subchapter S. First, it will increase the permitted number of shareholders and relax certain other restrictions on the shareholders of a Subchapter S corporation. Second, it will liberalize the rules governing election and termination of election under Subchapter S. And third, it will liberalize treatment of losses sustained by a Subchapter S corporation. Under present law, a shareholder's deduction for losses cannot exceed his investment in the corporation. The proposal will permit the shareholder to carry excess losses over to subsequent taxable years.

Effective Date

In general, the proposed changes will apply to taxable years of corporations beginning after December 31, 1978. The change permitting carryovers will apply to losses sustained in taxable years beginning after December 31, 1978.

Revenue Estimate

This proposal will have no significant revenue effect.

Technical Explanation

(a) Eligibility for Subchapter S Election

The proposal will make it easier for a corporation to qualify under Subchapter S.

Number of Shareholders. Under present law, a corporation (with certain exceptions) must have ten or fewer shareholders to qualify as a small business corporation (section 1371 of the Code). Under the proposal, a corporation can qualify if it has fifteen or fewer shareholders.

Certain Trusts Permitted as Shareholders. In general, present law requires the shareholders of a qualifying small business corporation to be individuals. Exceptions are provided for grantor trusts and voting trusts, and for transitory ownership (for a period of not more than sixty days) by trusts established under the will of a deceased shareholder (section 1371(f) of the Code). The inability to transfer stock to a testamentary trust except on a transitory basis may cause shareholders difficulty in planning their estates. To alleviate this problem, the proposal will permit the transfer of shares to a testamentary trust established under the will of a deceased shareholder for the term of the trust. Similarly, an *inter vivos* grantor trust that now qualifies as a shareholder will continue to qualify after the grantor's death. A qualifying trust will be required to distribute all income currently to its beneficiaries in shares fixed by the governing instrument of the trust. For purposes of determining the number of shareholders in the electing small business corporation, each beneficiary having a present interest in the trust income will be treated as a shareholder. Because of the general increase to 15 shareholders, special rules that permit the corporation to have more than 10 shareholders in certain limited circumstances (section 1371(e) of the Code) will be repealed.

Husband and Wife as One Shareholder. The rules treating a husband and wife as one shareholder will be simplified and liberalized. In particular, the proposal will eliminate the requirement that the stock be community property or be held as joint tenants, tenants by the entirety, or tenants in common.

(b) Election to be Taxed Under Subchapter S

The rules governing elections to be taxed under Subchapter S and terminations of such elections (including inadvertent terminations) are unduly complicated and restrictive. These rules will be simplified and liberalized.

Time for Election. Under present law, an election under Subchapter S may be made for a taxable year at any time during the first month of the year or at any time during the preceding month (section 1372(c) of the Code). For a new corporation, the first month of the taxable year does not begin until the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. Unless an election is terminated, it continues in effect and does not have to be renewed annually.

The requirement that an election may not be made more than 30 days before the beginning of a year is an unnecessary trap. For example, a corporation that has decided to make an election six months before the first day of the year may inadvertently fail to make the election in a timely fashion. This possibility will be eliminated by permitting the corporation to make the election at any time before the beginning of the taxable year. Thus, if a corporation decides in June of 1979 to elect Subchapter S for calendar year 1980, it will be able to do so immediately. In addition, an election will be permitted for 60 (instead of 30) days after the beginning of a taxable year.

Termination of an Election. Under present law, termination of an election is generally retroactive to the first day of the taxable year, even if it is caused by an event occurring at the end of the year (section 1372(e) of the Code). This had led to hardship in some cases and opportunity for manipulation in others. Therefore, under the proposal, a termination will generally take effect on the day of the triggering event. However, this rule could enable taxpayers to cut short an electing year -- particularly an initial electing year -- prior to the realization of income while permitting losses to be passed through to shareholders. Therefore, a termination during the first year of an election will take effect retroactively.

Election following Termination. If an election is terminated, present law precludes the corporation (or its successor) from making a new election until the fifth taxable year after the termination (unless the Treasury consents to a new election). This rule has caused difficulty in cases of inadvertent termination. In many such cases, the termination is not discovered until it is too late for a new election. Moreover, the corporation has acted in reliance on the old election. Therefore, under the proposal, if an election is terminated because a corporation ceases to be a small business corporation (e.g., it has 16 shareholders or it owns 100 percent of the stock of another corporation) and if the corporation qualifies for a later year, filing a timely return as a Subchapter S corporation for the later year will be treated as a binding request for consent to a new election. In determining whether to grant such a consent, the fact that termination was inadvertent will be taken into account.

(c) Net operating loss carryover

Under present law, a shareholder may deduct losses sustained by a Subchapter S corporation to the extent of his adjusted basis in stock and debt of the corporation. The shareholder is not permitted to carry excess losses over to subsequent taxable years. Therefore, if a shareholder's pro rata share of the corporation's losses exceeds his adjusted basis in stock and debt, the excess is not deductible. Under the proposal, these excess losses will become deductible by the shareholder in subsequent years to the extent of subsequent increases in the shareholder's basis in stock and debt. This change is consistent with the present treatment of partnerships. The excess loss will not be transferable and will be deductible only by the same shareholder in a subsequent year.

While the Subchapter S election remains in effect, the carryover will be allowed as a deduction at the end of each subsequent taxable year of the corporation. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt of the corporation at the end of the year (giving effect to all adjustments made during the year). Any unused portion of the carryover will be allowed as a deduction twelve calendar months after the Subchapter S election is terminated. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt at the end of the twelfth month. Whenever the carryover is allowed as a deduction, there will be a corresponding reduction in basis.

Depreciation for Small Business

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

As discussed more fully in connection with the President's proposal for simplifying ADR depreciation, the use of ADR depreciation permits a taxpayer to depreciate assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service and offers substantial other benefits. See SIMPLIFICATION OF ADR DEPRECIATION. On the other hand, the ADR system imposes a number of formal accounting and reporting requirements which may differ from a taxpayer's past depreciation practices.

Reasons for Change

The ADR system provides many advantages for those who adopt it. However, while nearly 92% of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36% of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. The proposal for simplifying the ADR system should encourage more smaller businesses to adopt ADR. However, it is also appropriate to allow the smallest taxpayers to obtain the major benefits which the ADR system allows without requiring them to learn a system which, while simpler in its ultimate operation than depreciation based on facts and circumstances, may seem strange and complex to small businessmen and their bookkeepers.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue special regulations governing depreciation by small businesses. Under these regulations, qualifying small businesses will be permitted to depreciate their assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service. The electing small business will be able to adopt a useful life within the same 20 percent range above and below the prescribed life as is permitted under the ADR system. For example, if the prescribed useful life for furniture is 10 years, a taxpayer will be permitted to compute depreciation on the basis of any period between 8 and 12 years.

A simple table will be published to help taxpayers determine the range of useful lives over which they can depreciate their assets.

Small businesses electing to depreciate assets on the basis of the prescribed useful lives will be able to ignore salvage value in claiming their depreciation deductions (as will taxpayers who elect the new simplified ADR system).

Small businesses will be permitted -- but not required -- to adopt a convention (the "half-year convention") that will enable them to begin computing depreciation for all assets placed in service during a taxable year from the first day of the second half of the taxable year (July 1 for calendar year taxpayers). If a small business does not elect the half-year convention, it may claim depreciation for each asset from the date that asset was placed in service during the taxable year.

Unlike taxpayers who elect the ADR system, qualifying businesses generally will not be required to participate in any special information gathering surveys. When they are required to furnish information, it is expected that the surveys will be conducted in a manner consistent with the limited professional resources normally available to small businesses.

In all other respects, taxpayers will be able to continue to depreciate their assets as they have done in the past.

A qualifying business will be any business whose depreciable assets have an aggregate initial cost of $500,000 or less. For this purpose, only assets for which prescribed lives are in effect will be taken into account. The $500,000 test will be applied at the level of the business (for example, at the partnership level rather than at the level of each partner). Special rules (similar to those now applicable for purposes of the Jobs Credit) will be applied to prevent the division of a large entity into a number of smaller ones in order to take advantage of this provision.

The opportunity to take advantage of this special depreciation system will be available to more than 90% of all corporations, partnerships and sole proprietorships.

Effective Date

The special depreciation system for small businesses provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on December 31, 1979, will have sufficient time to determine whether to elect the new special depreciation system for small businesses on their returns.

Revenue Estimate

The proposal will have no significant revenue effect.

SMALL BUSINESS STOCK

Present Law

Generally, the full amount of an ordinary loss is allowed as a deduction under present law. On the other hand, an individual may deduct capital losses only to the extent of capital gains plus $3,000 of ordinary income. Moreover, $2,000 of net long-term capital loss is required to offset $1,000 of ordinary income. Thus, at most $6,000 long-term capital loss can be used to offset $3,000 of ordinary income in any taxable year. Unused capital losses can be carried over indefinitely to future taxable years.

Under present law, unless an individual is a dealer, a loss on stock is generally treated as a capital loss. However, an exception is provided for "section 1244 stock." A loss sustained by an individual on section 1244 stock is treated as an ordinary loss, up to a maximum of $25,000 in any one year ($50,000 in the case of a husband and wife filing a joint return). This exception is designed to encourage investment in small business by decreasing the risk of such investment.

The exception applies only if the stockholder is an individual (and not a corporation, estate, or trust). The stockholder may purchase section 1244 stock in his individual capacity or in partnership with others. However, the exception applies only to losses sustained by the original purchaser of section 1244 stock, and not to losses sustained by any subsequent purchaser.

Section 1244 stock must be common stock in a domestic corporation. Furthermore, section 1244 stock must be issued pursuant to a plan adopted by the issuing corporation, and must be issued for money or other property (not including stock or securities).

Two additional requirements are imposed in order to limit the benefits of section 1244 to small business. First, a corporation may not issue more than $500,000 worth of section 1244 stock. Second, the total stock offering plus the equity capital of the corporation may not exceed $1,000,000. Thus, a corporation whose equity capital exceeds $1,000,000 cannot issue section 1244 stock.

A further requirement limits the benefits of section 1244 to operating companies. Under this requirement, in the five years before the taxpayer sustains a loss on his stock, the corporation must derive more than 50 percent of its gross income from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Reasons for Change

Small businesses need capital to modernize and to maintain a rate of expansion that will permit them to contribute fully to the well-being of the economy. To assist small business in raising the capital it needs, additional steps should be taken to decrease the risk of investment in small business stock.

General Explanation

The proposal will liberalize the rules relating to section 1244 stock. A small business corporation will be permitted to issue up to $1,000,000 of section 1244 stock, which is double the amount permitted by present law. The maximum amount allowed as an ordinary loss in any one year will be increased to $50,000 ($100,000 in the case of a husband and wife filing a joint return), which is also double the amount allowed under present law. The proposal will also eliminate the requirement of a plan and other technical requirements that needlessly restrict the ability of small business corporations to issue section 1244 stock.

Effective Date

The proposed changes will apply to stock issued by corporations in taxable years of the corporation beginning after December 31, 1978.

Revenue Estimate

The proposal will have no significant revenue effect.

Technical Explanation

Generally, the rules relating to section 1244 stock will be liberalized. The size limits on the issuing corporation will be relaxed. A corporation will be permitted to issue up to $1,000,000 of section 1244 stock, instead of the $500,000 permitted by present law. Moreover, the existing $1,000,000 limit on the corporation's equity capital will be completely eliminated.

In addition, the requirement of a plan will be eliminated. All stock issued during a taxable year of the corporation will be section 1244 stock if the aggregate worth of all stock ever issued by the corporation is $1,000,000 or less. (For this purpose, the worth of stock will be the value of the consideration paid for the stock at the time it was issued.) If the aggregate worth of all stock exceeds $1,000,000 at the end of the taxable year, but was less than $1,000,000 at the beginning of the year, then an allocable portion of the stock issued during the year will be treated as section 1244 stock. For example, assume that the aggregate worth of all stock issued by a corporation is

$400,000 on the first day of its taxable year, January 1, 1979. If the corporation issues $900,000 of common stock at $9 per share during 1979, then two out of every six shares issued during 1979 will be section 1244 stock. The corporation will be able to designate certain shares specially as section 1244 stock at the time they are issued. In the absence of such a special designation, each shareholder who purchases stock during 1979 will treat two out of every three of his shares as section 1244 stock. (Fractional shares will not, however, be treated as section 1244 stock. Thus, if a shareholder purchases ten shares of stock during 1979, only six shares will be treated as section 1244 stock.)

Further, a loss sustained by an individual on section 1244 stock will be treated as an ordinary loss up to a maximum of $50,000 in any one year ($100,000 in the case of a husband and wife filing a joint return). These are twice the maximum amounts allowed under present law.

CORPORATE PREFERENCES

REPEAL OF DISC

Present Law

A Domestic International Sales Corporation (DISC) is a special corporation established to shelter export income from taxation. Often it is only a paper corporation with no employees or real business activity. The profits of a DISC are not taxed to the DISC, but are taxed to the DISC shareholders when such profits are distributed or deemed to be distributed.

The shareholders of a DISC (typically a parent corporation which is an operating company) are deemed to receive an annual dividend equal to a portion of the DISC's profits. This deemed dividend is fully taxable to the shareholders. Federal income taxation is deferred on the remainder of the DISC's profits. Because the tax is deferred indefinitely and because the parent can use the DISC's retained profits to finance its own export activity, the deferral of taxation is in effect equivalent to exemption.

Prior to 1976 the deemed dividend was fixed at one-half of a DISC's total profits. However, the Tax Reform Act of 1976 reduced DISC benefits. The incremental provision adopted in that legislation limits DISC deferral to one-half of export profits in excess of 67 percent of average export profits over a four-year base period. For taxable years beginning in 1976 through 1979, the base period years are 1972 through 1975. In 1980 and thereafter, the base period will move forward on a year-by-year basis.

A DISC usually acquires goods from its parent corporation or an affiliated corporation (a "related supplier") and sells them abroad. Alternatively, a DISC may act simply as a commission agent on export sales. Even if the DISC does nothing, paper profits are allocated to it.

The method used for allocating profi s between a DISC and its related suppliers is an important part of the DISC statute. The allocation is achieved through special intercompany pricing rules permitting the DISC to realize profits which do not exceed the greater of:

(a) 4 percent of the qualified export receipts attributable to the sale of export property plus 10 percent of related "export promotion expenses," defined as ordinary and necessary expenses incurred to obtain export profits;

(b) 50 percent of the combined profits of the DISC and its related suppliers attributable to exports, plus 10 percent of related export promotion expenses;

(c) profits based on an arm's-length price.

Neither the 4 percent method nor the 50 percent method may be applied in such a way as to produce a loss to the related supplier while the DISC is earning a profit. These special rules serve, however, to allow U. S. exporters to allocate more income to a DISC, and thus to defer a larger portion of their total tax burden, than they could under the normal arm's-length rule.

Reasons for Change

The principal objectives of the Revenue Act of 1971 were "to increase our exports and improve our balance of payments." 1/ To help accomplish these objectives, the Act added the DISC provisions to the Internal Revenue Code.

The contribution of the DISC legislation to the promotion of exports has, however, been minimal. A 1977 Treasury Department report to Congress estimates the net effect of the DISC program on 1975 U.S. exports to have been between $1 billion and $2.5 billion, less than 3 percent of total U.S. exports of $98 billion for 1975. This estimated increase in exports attributable to the DISC program was achieved at a cost of $1.2 billion in tax revenue. Although U.S. exports have increased dramatically since the enactment of the DISC legislation, this expansion is largely attributable to other factors, including major dollar devaluations, inflation of export prices, and a sharp increase in the real volume of world trade associated with a rapid rate of real economic growth, especially in the Mideast.

The balance of payments arguments originally advanced in support of the DISC legislation are substantially weakened under a system of flexible exchange rates. To the extent that DISC promotes exports, it lessens the depreciation of the dollar in foreign currency markets. Although sudden and abrupt depreciation may be undesirable, a slower and more orderly depreciation encourages U.S. companies to export more and import less. The balance of payments adjustment process may take time, but it does take place. Between 1971 and 1977, the U.S. merchandise trade balance has swung from deficit to surplus to deficit to surplus and now back to deficit again. DISC is thus an anachronism in a world of flexible exchange rates, and a costly and wasteful anachronism at that.

If the United States wishes to assist the balance of payments adjustment process, other programs, such as the contemplated $2.2 billion increase in direct loans and $1.8 billion increase in loan guarantees by the Ex-Im Bank, are clearly preferable to DISC. Not only can Ex-Im Bank loans be more effectively aimed at producing genuine increments in U.S. exports, but the program can be scaled down in periods of balance of payments surplus. DISC is not an appropriate or a particularly effective policy for coping with transitional problems of balance of payments adjustment.

Congress has consistently been more skeptical of the DISC program than previous Administrations. In 1971, Congress cut in half the Nixon Administration's request for a complete deferral of taxation of DISC income. And Congress required the Treasury to report annually on the operation of the DISC legislation in practice. As the revenue cost of the DISC program soared far above initial projections, Congress overrode the opposition of the Ford Administration and further pared the cost of the DISC program. Nevertheless, the revenue cost of the DISC program once again exceeds a billion dollars per year, with little evidence that this money is being wisely spent.

Like all tax reductions, DISC tends to make its beneficiaries more competitive. But the beneficiaries of the DISC legislation tend to be the largest and most profitable of U. S. companies; DISC helps little, and may actually harm, footwear, textile, and steel producers facing competition from imports. Moreover, the substantial domestic costs of the DISC program are out of all proportion to the dubious value of DISC as a "bargaining chip" in international trade negotiations. Thus, continuing skepticism of the value of DISC is well-founded. The DISC program should be repealed.

General Explanation

Tax benefits granted to DISCs and their shareholders are to be phased out over a three-year period beginning in 1979 and ending in 1981.

The phase-out of DISC benefits will be accomplished by increasing the deemed distribution from the present 50 percent of DISC profits attributable to "incremental" exports. For taxable years ending in 1979, DISCs will be deemed to distribute 66-2/3 percent of such profits, and for taxable years ending in 1980 the deemed distribution will rise to 83-1/3 percent. DISC is repealed for the first taxable year ending after 1980. Accumulated past earnings of a DISC will continue to be tax deferred as long as they remain invested in export-related assets.

Analysis of Impact

(1) Impact on Exports, the Balance of Trade, and U.S. Employment

Companies benefiting from the DISC program can cite impressive statistics on the growth of their exports since the DISC legislation was enacted in 1971, on the number of jobs in their company that are dependent on export sales, on the number of jobs in supplier industries indirectly dependent on export sales, etc. Naturally, workers will be alarmed if told that their jobs depend on the continuation of the DISC program. A close examination of company statements reveals, however, little information on the specific contribution of DISC either to export sales or to employment. Disinterested economic analyses of the rapid growth of U. S. exports since 1971 indicate that such growth is largely due to factors other than DISC. The primary contributors to this growth have been:

-- From 1971 to 1974 the dollar fell in value relative to foreign currencies by 13 percent.2/ This decline meant that foreign currency prices of U.S. exports fell relative to prices of goods from other countries, thus making U.S. goods more attractive to foreign purchasers.

-- About half of the increase in the value of U.S. exports from 1971 to 1974 was attributable to general increases in all prices, reflecting worldwide inflation. The price rise was especially rapid for certain agricultural products and industrial supplies.

-- A sharp increase in the real (price deflated) volume of world trade was associated with a rapid rate of real growth. According to United Nations estimates, the real volume of world trade was 30 percent higher in 1974 than in 1971. During this period U.S. exports grew more or less in proportion to world trade; as a consequence, the U.S. share in the exports of industrialized countries rose by only 0.6 of a percentage point, from 18.9 percent in 1971 to 19.5 percent in 1974.

The Treasury Department's most recent report to Congress on the DISC program concluded that, had exchange rates been fixed, DISCs would have contributed only $1 billion to $2.5 billion to net U.S. exports. Much of the growth in exports benefiting from the DISC legislation may have come at the expense of non-DISC exports. The Treasury report pointed out, moreover, that under the system of flexible exchange rates adopted in 1973, an increase in U.S. exports will increase the demand for dollars in foreign countries. This will, in turn, stimulate U.S. imports by reducing import prices in terms of dollars. The increase in U.S. exports due to DISC is thus offset by an increase in U.S. imports, and the net impact of DISC on the balance of trade is much less than the impact on exports.

DISC supporters often argue that flexible exchange rates have not been successful in restoring the U.S. balance of payments, and that DISC is necessary to reduce the current balance of trade deficit. To support their argument, proponents of the DISC program note that many foreign governments intervene in foreign exchange markets to keep the dollar from depreciating, that foreign import quotas and other trade barriers prevent U.S. exports from expanding as the dollar depreciates, and that foreign demand for many of the goods which the U.S. exports (e.g., agricultural products) does not expand much as their price falls. Even if these assertions were factually correct, however, they would not support the retention of the DISC program.

If depreciation of the dollar does not promote U.S. exports, neither does DISC. Both must work through the same mechanism: making exporting more profitable. As the dollar depreciates, the foreign currency price for U.S. exports translates into a higher dollar value, which raises export profits before and after taxes. With a DISC the tax burden on export income is decreased, so that after-tax profits increase even if before-tax profits are unchanged. If U.S. manufacturers cannot expand their exports when depreciation of the dollar makes foreign sales more profitable, they should not be able to expand those exports because DISC makes those sales more profitable. Thus, the argument that flexible exchange rates do not work is also an argument that DISC does not work.

To assess the further argument of some persons that DISC promotes U.S. employment, it is necessary to translate the impact of DISC on the balance of trade into an impact on employment. This requires estimates of the labor intensity of exports versus imports. If imports indirectly induced by DISC are highly labor intensive, it is possible that the DISC program actually produces a decline in U.S. employment.

DISC represents only one of many ways of reducing taxes, and a tax reduction is only one of the available macroeconomic tools -- expenditure programs, monetary expansion, and debt policy are alternatives -- for stimulating the economy. Therefore, a complete evaluation of the employment impact of DISC would require an analysis of the costs and benefits of alternative programs. Concern about U.S. employment should be -- and is-- reflected in the President's overall budget proposals, rather than in any one part alone.

(2) Impact on the Competitive Position of U.S. Corporations

U.S. exporters often argue that repealing DISC will make them less competitive in world markets. It is true that any tax increase leaves a corporation with fewer funds available for new investment, research and development, and so forth. But it is also true that competitiveness is a fact of business life for all firms, not just the corporations benefiting from DISC. Because of the legal and accounting costs of complying with the complex DISC legislation, larger corporations necessarily make more use of the DISC legislation than smaller corporations do. According to the 1977 Treasury report on DISC, over 60 percent of total DISC tax benefits went to parent companies with more than $250 million in assets.

Moreover, the profit margin on DISC export sales was 14.7 percent, which was more than twice as large as the comparable 6.5 percent margin on sales to the domestic, U. S. market. Those U. S. industries standing most in need of assistance, and which benefit not at all from DISC, are those facing stiff import competition (e.g., footwear, textiles, steel); they often incur losses that they cannot sustain for any extended period of time. Thus, while the DISC program perversely tends to help those industries that need help least, it also helps least those industries that need help most. Clearly, if the ultimate goal is making U.S. corporations more competitive, other measures such as the Administration's proposed corporate tax rate reduction and changes in the investment tax credit are more equitable and effective than the DISC program.

(3) Revenue Cost of DISC

The revenue cost of DISC in calendar year 1975 was $1,390 million. The cost in 1976 was reduced to $870 million because of the "incremental" provisions of the Tax Reform Act. The costs in 1977 and 1978 are projected to be $1.0 billion and $1.2 billion, respectively. A rough estimate of the cost of each additional dollar of net exports due to DISC can be derived by dividing the estimated additional exports of between $1 billion and $2.5 billion by the revenue cost for fiscal year 1975 of $1.2 billion. Each dollar of additional exports thus cost between $1.20 and $.48 in tax revenue -- a very expensive cost-benefit ratio.

Because of its growing concern over the high cost and limited benefits of the DISC program, Congress sought in 1976 to limit DISC benefits to "incremental" exports. Although concern with the DISC program is easy to understand, the 1976 changes appear to have reduced the incentive to export at the same time that they reduced the revenue cost. This is because an increment to exports in 1976 and thereafter will be reflected in a higher base against which "incremental" exports will be measured in future years. As a consequence, the greater the taxes that are deferred now, the less will be the taxes deferred in the future. The Treasury's most recent report on DISC concluded that the 1976 changes reduced by 40 percent the tax incentive to expand exports. Because the reduction in the revenue cost of the DISC program was also roughly 40 percent, there is no reason to believe that the DISC program is any more cost-effective now than it was prior to 1976. The incremental approach may have produced less waste in absolute terms but it is not a solution to the waste inherent in the DISC program.

(4) Impact on U.S. Trade Relations

The European Community lodged a formal complaint with the Contracting Parties of the General Agreement on Tariffs and Trade (GATT) in July 1972, asserting that DISC was incompatible with Article XVI:4 of the GATT because it constituted a tax subsidy on exports. The United States entered a counter-complaint against the export tax practices of France, Belgium, and the Netherlands.

Four panels of experts were appointed by GATT, one to consider the complaints of the European Community against DISC and three to consider the complaints brought by the United States against the tax practices of France, Belgium, and the Netherlands. Each panel, however, consisted of the same persons.

The panels reported their findings to the GATT Council on November 2, 1976. Each of the panels concluded that the tax practices subject to complaint "in some cases had effects which were not in accordance with [that country's] obligations under Article XVI:4." Therefore, each of the panels found that "there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement (GATT)."

The GATT Council discussed the panel reports at meetings held in November 1976, March 1977, and, most recently, November 1977, but it could not reach agreement on their adoption. Upon adoption, the GATT Council would be in a position to make recommendations to the parties regarding appropriate settlement of the disputes. At the November 1977 GATT Council meeting, U. S. representatives proposed that the Council adopt the reports of all four panels. The U. S. representatives also stressed that the United States was not concerned about European tax systems *per se*, but only with the possible tax-haven abuse of those systems. The United States expressed the hope that the Europeans shared this concern and that this would form a basis for adoption of the four reports.

France, Belgium, and the Netherlands continued, however, to express reservations about the panel findings on their respective tax practices, particularly the definition of export activity, and refused to agree to the adoption of the panel reports by the GATT Council. Since these countries refused to agree on the simultaneous adoption of all the panels' reports, the United States refused to accept unilaterally the panel report on DISC.

Supporters of DISC assert that DISC has certain value as a "bargaining chip" in international trade negotiations. But this factor must be weighed against DISC's substantial and growing domestic cost. When DISC is repealed, the United States will still have every right to expect other countries to bring their tax practices into conformity with GATT. If other countries do not make conforming adjustments, the Treasury, using the very same reasoning as it did before GATT, could find that these foreign tax practices violate U.S. domestic law and, accordingly, are subject to countervailing duties. In repealing DISC unilaterally, the United States will thus not be defenseless in protecting itself against the tax practices of foreign countries.

Effective Date

The phased repeal of DISC will begin for the first taxable year of a DISC ending on or after January 1, 1979 and will be complete in taxable years of DISCs ending after December 31, 1980.

Revenue Estimates

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
193	664	1,228	1,513	1,613	1,751

Footnotes

1/ H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 1 (1971); S. Rep. No. 92-437, 92nd Cong., 1st Sess. 1 (1971).

2/ The 13 percent figure represents the decline in the effective trade-weighted value of the dollar against ten major currencies. Source: Board of Governors of the Federal Reserve System.

TERMINATING DEFERRAL

Present Law

Under present law U. S. citizens, residents, and corporations are subject to U. S. taxation on their worldwide income. Foreign corporations, including foreign corporations controlled by U. S. taxpayers, are generally subject to U. S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U. S. shareholder is usually consolidated with the income of the U. S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U. S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U. S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U. S.-controlled foreign corporation until that income is distributed to the controlling U. S. shareholders. The term "deferral" is employed because the net U. S. tax liability -- equal to the difference between the U. S. tax and the credit for foreign taxes -- is "deferred" until such income is distributed as a dividend.

Deferral does not apply when the nature of the controlled foreign corporation and its income exhibit "tax haven" characteristics. Tax haven income (so-called "subpart F income") is taxed currently to U. S. shareholders regardless of whether they actually receive the income in the form of a dividend. Likewise, U. S. shareholders are taxed on their pro rata share of the retained earnings of a foreign personal holding company, and on the earnings of any controlled foreign corporation which are in effect repatriated to the United States through the purchase of certain U. S. property.

Since the practice of deferral permits the income of controlled foreign corporations to escape current U. S. taxation until that income is repatriated as a dividend, it is important that transfer prices for transactions between U. S. shareholders and their controlled foreign corporations be properly determined. It is also necessary to ensure that reorganizations involving controlled foreign corporations are not undertaken for the purpose of tax avoidance. The tax law presently contains complex provisions designed to carry out these purposes.

Reasons for Change

The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U. S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U. S. taxpayers now have to locate new investment overseas rather than in the United States.

Terminating deferral will permit the rationalization and simplification of U. S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporations and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U. S. taxpayers to avoid U. S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.

(1) Terminating Deferral Will Preclude Substantial Tax Benefits From Turning on the Choice of Corporate Structure

When losses or large foreign tax credits are desired for U. S. tax purposes, a U. S. taxpayer may obtain these benefits currently by operating overseas through a branch. When foreign income does not generate sufficient foreign tax credits to offset U. S. tax, a current U. S. tax may be avoided by interposing a foreign corporate entity. A U. S. taxpayer is thus permitted to choose, through the form of its overseas operations, between two very different sets of substantive U. S. tax rules.

There is no good reason for this state of affairs. A choice of tax rules should not be accorded simply because business operations are situated abroad rather than in the United States. Such operations, in the case of a controlled foreign corporation, are an integral part of the overall activity of the U. S.-based firm, and the profits from such operations should, for this reason alone, be subject to current taxation in the United States.

In 1969 Congress dealt with a similar situation involving the availability of the $25,000 surtax exemption for each entity in a group of related domestic corporations. Congress took the view that a commonly owned business enterprise should be entitled to only one such exemption, whether it was operated under a single corporate charter or multiple charters and regardless of any genuine business reason for having multiple charters. The issue in the case of deferral is essentially the same: even if fully justified by business considerations, the interposition of foreign corporate charters should not affect the substance of U. S. taxation.

This point is, in fact, already recognized by some provisions of the Internal Revenue Code dealing with foreign income. U. S.

corporations are allowed a foreign tax credit (the so-called "deemed paid" credit) for taxes paid by their foreign subsidiaries. This allowance, which in 1975 amounted to more than $3 billion, reflects a recognition that the existence of a foreign corporate charter should not determine tax substance.

(2) Terminating Deferral Will End a Present Tax Incentive To Invest Overseas

Deferral gives U. S. taxpayers a substantial incentive to invest overseas for purely tax reasons. This incentive arises from a combination of the absence of current U. S. tax on the retained earnings of controlled foreign corporations, and the presence of tax inducements in many foreign countries. These foreign inducements take the form of low tax rates, rapid depreciation, tax holidays, and other special tax advantages not available in the United States.

U. S. investors need not look very far for tax holidays, for such benefits are heavily marketed in the United States. One foreign country, for example, publishes a brochure urging American business to "Get in on the . . . bonanza!" The bonanza includes "tax holidays, unlimited remittance of profits, repatriation of capital, protection against risks and the assistance offered by a friendly government from application to the start of production." Another recent advertisement in a business publication has a banner headline: "Exceptional Return on Investment Continues ...." As the advertisement explains, "export profits . . . . are completely free of tax until 1990. So a U. S. subsidiary . . . . grows faster, and at less cost to the U. S. parent. In spite of the fact that profits can be freely repatriated, U. S. companies ploughed back 65 percent of them and notched up an expansion of U. S. investment of 30 percent." With an exemption from foreign tax and a deferral of U. S. tax, it is easy to understand why profit margins in this country are abnormally high.

Tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U. S. capital where it will be most productive, whether in the United States or overseas. The elimination of deferral will advance this policy, since it will tend to ensure that foreign investment will be motivated by genuine economic factors.

(3) Ending Deferral Will Permit Simplification of the Rules Relating to Taxation of Foreign Income

The termination of deferral will permit the simplification of U. S. rules relating to the taxation of foreign income. Subpart F, the rules relating to foreign personal holding companies, the rules governing the foreign tax credit, and the rules regarding reorganizations of foreign corporations will all be affected.

The subpart F anti-tax haven provisions originated in a proposal submitted to Congress in 1961 by President Kennedy. The purpose of that proposal, and of the provisions of subpart F, was to prevent U. S. businesses from exploiting the multiplicity of foreign tax systems and tax treaties so as to reduce or eliminate both U. S. and foreign tax liabilities.

Subpart F as drafted was not, however, structured to eliminate international tax avoidance by U. S. firms. It is focused exclusively upon a narrow class of so-called "tax haven" income. And its provisions are so complex that only a relative handful of persons are capable of understanding all of their implications. Although subpart F has doubtless discouraged many companies from undertaking blatant tax haven operations, highly sophisticated means of circumventing both the specific subpart F rules and their general objectives are available. Moreover, the Internal Revenue Service does not have the resources to mount an effective administrative effort to combat such schemes.

Terminating deferral for all controlled foreign corporations, as this proposal recommends, will permit the replacement of subpart F with a simpler, more comprehensible set of rules for U. S. taxation of foreign income. Terminating deferral will also permit repeal of the Internal Revenue Code provisions relating to taxation of foreign personal holding companies -- another series of provisions aimed at tax haven abuses.

Furthermore, terminating deferral will reduce the importance of the complicated rules relating to both the "deemed paid" foreign tax credit and multinational corporate reorganizations. The rules relating to the credit are not limited to controlled foreign corporations, and will have to remain in effect to cover foreign corporations owned in part, but not controlled, by U. S. persons. They will not, however, generally be required with respect to controlled foreign corporations if deferral is terminated, because a foreign tax credit will be available without regard to the "deemed paid" credit. The rules regarding corporate reorganizations will become less important because the potential for tax avoidance on the transfer of assets abroad will be diminished.

Eliminating deferral will thus have the highly desirable effect of making the U. S. system of taxing foreign income more comprehensible. The present system, complex and internally inconsistent, understood in all its detail by only a very few highly trained individuals, is simply not appropriate in the U. S. tax system. The rationalization of U. S. rules in this area will permit the Administration and Congress to see more clearly where real problems exist and to structure appropriate solutions having no unintended and unforeseen consequences for either taxpayers or the government.

(4) Terminating Deferral Will Help Equity and Competition

The present system of U. S. taxation of foreign income, with deferral as its centerpiece, has produced increasingly sophisticated methods of tax planning by those involved in multinational transactions. As the Internal Revenue Service has issued new Regulations limiting opportunities for tax avoidance, and as Congress has tightened various rules in the system, taxpayers have become more and more ingenious in avoiding their impact. Offshore financial subsidiaries, holding companies, and captive insurance affiliates have proliferated. Computer programs to guide tax planning efforts have been developed. The major accounting and law firms have devised ever more refined planning techniques.

For example, the "rhythm method" of distributing dividends from foreign companies has become increasingly popular. Under this method foreign corporations only pay dividends to their U. S. parent companies in those years in which their effective foreign tax rate is high, rather than paying smaller dividends on an annual basis. Because of deferral and the "deemed paid" credit for foreign taxes paid by the foreign corporation, U. S. companies are able through this method to minimize U. S. tax on repatriated earnings. The technique illustrates how the existence of contradictory principles for taxing foreign income -- the "deemed paid" foreign tax credit which effectively treats parent and subsidiary as one enterprise, while deferral treats them as separate -- inevitably gives rise to opportunities for tax avoidance.

(5) Terminating Deferral Will Help Stop Practices Used To Avoid U. S. Tax

U. S. taxpayers have many opportunities today to avoid U. S. tax by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations, or imports the same from them. It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States.

In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. To determine whether the assigned transfer prices are appropriate for tax purposes, the United States and many other countries apply an arm's-length standard -- i.e., they require terms that would have been fixed in comparable transactions between an independent buyer and seller. The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.

Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.

Since the elimination of deferral will subject U. S. shareholders to current tax on the income of controlled foreign corporations, it may be expected to reduce if not eliminate the incentive to use techniques which serve to transfer excessive income to foreign corporations.

General Explanation

This proposal will phase out deferral over a three-year period. Beginning in 1981 the income of a controlled foreign corporation will be taxable as if it had been earned directly by the U. S. shareholder. This is the rule that has always obtained under the U. S. tax system where foreign operations are conducted by a U. S. taxpayer through a branch, rather than through a foreign corporation. Thus, U. S. tax liability under the proposal will closely approximate the amount that a U. S. shareholder would incur if it operated through a foreign branch. For 1979 and 1980 the above rule will apply to one-third and two-thirds, respectively, of the controlled foreign corporation's income.

The approach taken in this proposal will result in an accurate assessment of the U. S. shareholder's U. S. tax liability. Losses incurred by a controlled foreign corporation will be allowed to offset the U. S. source income of the shareholder. Similarly, foreign taxes imposed on the controlled foreign corporation will be treated as if they had been imposed on the U. S. shareholder and thus will be taken into account currently for purposes of the foreign tax credit rather than when the underlying income is actually repatriated.

The proposal allows the Treasury to consider the negotiation of tax treaties providing, in appropriate situations, that U. S. shareholders will not be taxed currently on certain income of their controlled foreign corporations operating in a treaty country.

Analysis of Impact

(1) Effect on Investment

Investment which is responding to real market forces will not be affected by the termination of deferral. Such investment represents a significant part -- but not all -- of U. S. overseas investment.

Most developed countries impose, in addition to corporate income taxes, withholding taxes on dividends, interest, and royalties paid to U. S. investors. Although the total tax burden in such countries is comparable to or higher than that in the United States, U. S. investment still flows to these countries because their markets are large and growing, consumer incomes are high, the demand for U. S. products is substantial, and a U. S. company can maintain its market position only by investing locally. Likewise, petroleum and other natural resource investments flow to countries with abundant natural resource deposits despite substantial tax and other payments to the governments in those countries. Finally, many less-developed countries attract labor-intensive production with low wage rates rather than tax incentives. These investments are far more typical of U. S. investment abroad than those motivated solely by tax considerations, and they will continue without the added benefits of deferral. Terminating deferral will thus operate to restrict only tax-induced investments.

The United States does not have any general interest in encouraging tax-induced investments. Foreign countries that offer tax incentives are not usually interested only in the type of investment that attracts exports from the United States and thus promotes domestic employment. To the contrary, foreign tax incentives are frequently aimed at the type of investment that promotes exports to the United States and thus displaces U. S. jobs. The United States has no reason to favor the latter category of investments.

There is good reason to believe that eliminating deferral will provide a moderate stimulus to total U. S. investment and employment. For some companies production in the United States is a direct and viable alternative to producing abroad. Some U. S. companies may have been induced by the combination of deferral and foreign tax incentives to stop exporting and start producing overseas. Alternatively, some companies may have stopped supplying the domestic U. S. market with goods made in the United States, electing instead to rely on imports from their own foreign affiliates. Moreover, even when domestic investment is not a direct substitute for foreign investment, domestic production can still benefit indirectly from the repeal of deferral. The capital that would have been used to finance a tax-induced foreign investment can be retained in the United States and used to finance an unrelated, but job-producing, domestic investment. The gains may be substantial in specific industries where foreign tax practices have hastened the export of jobs and capital.

(2) <u>Competitiveness of U. S. Corporations Overseas</u>

Some U. S. companies maintain that they cannot remain competitive in world markets without deferral. Any change which alters corporate tax burdens tends to alter the funds available for new investment, new research and development, and other programs aimed at expansion. But if this is true of deferral, it is equally true of other tax measures such as changes in the corporate tax rate or the investment tax credit.

These other methods of promoting competitiveness are better and fairer than deferral. In order to benefit from deferral, a corporation must invest abroad, not in the United States. As noted above, deferral may encourage companies to invest abroad for export back to the United States, thereby undermining the competitiveness of U. S. companies that choose to stay at home. Zenith Corporation, for example, was forced to go overseas not only by its Japanese competitors (Sony, Panasonic, etc.) but also by its <u>American</u> rivals (RCA, Motorola, etc.) that went abroad to carry out assembly operations. Finally, deferral promotes continued investment overseas; repatriation of profits, which would help domestic investment, is actually discouraged by deferral. None of these perverse side effects of deferral characterizes reduction of the corporate tax rate and expansion of the investment tax credit, measures which the Administration has proposed.

It should be noted, finally, that the competitiveness of a corporation depends on its overall tax burden, not on any single tax provision. Terminating deferral represents only a small offset to the benefits envisioned for companies in the Administration's tax package.

(3) <u>Reactions of Foreign Governments</u>

It is often argued that if the United States terminates deferral, foreign countries will retaliate by discriminating against U. S. investors so that U. S. companies will pay higher taxes to foreign governments rather than the United States. Foreign countries, it is said, may revoke the eligibility of U. S. subsidiaries for tax holidays or accelerated depreciation, or they may deem all earnings distributed and thereby subject to high withholding taxes.

Such developments are, however, unlikely in the case of developed countries. The tax rates in most of these countries match those of the United States. Furthermore, most developed countries have tax treaties with the United States that require nondiscriminatory treatment of U. S. investors. Since residents of developed countries often have substantial investments in the United States, it is doubtful that these countries would risk abrogation of their treaties with the United States.

The United States has tax treaties with only a few less-developed countries, and the tax burden in some of these countries is lower than that in the United States. However, in many cases there will be no reason for these countries to retaliate against U. S. investment, because the termination of deferral will not produce higher U. S. taxes for many of the multinational companies operating within their borders.

Numerous U. S. companies already have an overall excess of foreign tax credits, and more will fall into this category if the U. S. corporate tax rate is reduced to 44 percent, as the Administration proposes. Under the "overall" foreign tax credit limitation -- the only limitation now in effect -- operations in low and high tax countries are combined. In the case of taxpayers with excess foreign tax credits, the United States will not, upon the elimination of deferral, impose any tax on profits from low-tax countries which are "sheltered" by excess credits from high-tax countries. Thus, many U. S. companies operating in foreign countries with a low rate of tax will not bear any more U. S. tax upon the elimination of deferral, and therefore those foreign countries will not have an incentive to raise taxes in retaliation to this proposal.

Furthermore, it is by no means clear that even a low-tax country believing that the end of deferral will subject U. S. investors to a higher U. S. tax burden will choose to retaliate. In the first place, it will be made clear that discriminatory taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States are not creditable under U. S. law. Low-tax countries desirous of promoting U. S. investments may not wish to take actions that could have the effect of actually penalizing such investments. More likely, such countries may wish to "validate" some of the tax incentives that they offer by seeking treaty provisions under which U. S. investors within their borders would continue to be entitled to deferral.

In some cases the United States may wish to validate the tax incentives that a developing country offers to U. S. investors. For example, investments that promote genuine economic development, have a minimal impact on U. S. employment, or increase U. S. access to critical raw materials may serve the national interest. But rather than giving a blanket incentive to foreign investment of all types and in all countries, the United States should focus the benefits of deferral through its tax treaty program. If deferral is terminated subject to exceptions by tax treaties, less-developed countries will be far more eager to conclude treaties with the United States than they have been in the past and developed countries that have treaties with the United States or are engaged in treaty discussions may be persuaded to offer favorable concessions.

(4) Administrative Impact Upon Taxpayers

It is sometimes argued that terminating deferral will involve serious administrative problems for U. S. companies. U. S. taxpayers, it is said, will not be able to maintain or obtain adequate records reflecting the income and deductions of controlled foreign corporations, particularly when there is no majority U. S. shareholder. It is also argued that the difficulty of translating books and records kept in foreign currency and under foreign standards into U. S. currency and standards justifies the retention of deferral.

The Administration is aware that there may be some administrative difficulties in some situations. However, U. S. companies with overseas branches, which have always been required to report foreign operations currently, have been able to solve these problems. U. S. parent corporations have long reported the earnings of controlled foreign corporations for SEC and general accounting purposes. And since 1962, controlled foreign corporations of U. S. shareholders have translated their books and records into U. S. standards for the purposes of subpart F. Finally, the provisions allowing for a "deemed paid" foreign tax credit, which have been in the law since 1918, require every U. S. corporation owning 10 percent of _any_ foreign corporation (whether or not controlled by U. S. interests) to translate foreign books and records into U. S. standards in order to obtain the benefit of the indirect foreign tax credit. Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

Effective Date

The phase-out of deferral will apply to the first taxable year of each controlled foreign corporation ending in 1979 and to taxable years of U. S. shareholders with which or within which such taxable years of such foreign corporations end.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years

1978	1979	1980	1981	1982	1983
0	88	280	768	830	897

These estimates do not take into account the effect of the proposed reductions in the corporate tax rate. The revenue gain from terminating deferral depends on the spread between the U.S. and average foreign tax rates. Therefore even a relatively small decrease in the U.S. tax rate can substantially reduce the revenue gain from terminating deferral.

Behavioral adjustments could also affect these estimates. Some investors may, for example, increase their actual dividends and thereby incur foreign dividend withholding taxes; this would reduce net taxes paid to the United States.

Other behavioral adjustments could, however, increase U. S. tax revenues beyond the above estimates. U. S. investors may invest more at home and less abroad than they would if deferral were maintained. The reduction of tax incentives to manipulate intrafirm transfer prices in order to shift taxable income away from the United States could produce substantial revenues not taken into account in the estimates. Although the potential revenue gains from these location-of-investment and transfer-pricing adjustments are impossible to estimate, they could easily outweigh any adverse revenue consequences of other behavioral adjustments attributable to the elimination of deferral.

Technical Explanation

(1) Current Inclusion of Income Earned by Controlled Foreign Corporations

The proposal will currently include in the income of U. S. shareholders their pro-rata share of the gross income and deductions of controlled foreign corporations. Income and deductions of each controlled foreign corporation will be treated as having been earned and incurred by the U. S. shareholder. The character of the income or deduction will be the same in the hands of the U. S. shareholder as it would have been if the activity had been carried out abroad directly rather than through a foreign corporation. Controlled foreign corporations will, however, continue to be treated as corporations for the purposes of rules affecting transfer prices, corporate reorganizations, and other provisions of current law.

(2) Controlled Foreign Corporation

A controlled foreign corporation will be any foreign corporation of which either: (a) more than 50 percent of the total combined voting power of all classes of stock is owned, or is considered owned, by U. S. shareholders; or (b) more than 50 percent in the value of the outstanding stock is owned, or is considered owned, by U. S. shareholders. The use of a voting power test is consistent with present subpart F provisions. The use of a value test is consistent with the foreign personal holding company provisions.

(3) U. S. Shareholder

A U. S. shareholder is a U. S. person who owns, or is considered as owning, either: (a) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation; or (b) 10 percent or more in the value of the outstanding stock of a foreign corporation. For purposes of determining whether a company is a controlled foreign corporation and whether a person is a U. S. shareholder, the meaning of "U. S. person" as well as the constructive stock ownership rules will be substantially the same as those now contained in subpart F.

(4) Percentage Inclusion

The amount of a controlled foreign corporation's gross income and deductions attributable to a U. S. shareholder will be determined in proportion to that shareholder's rights to the net earnings of the corporation. This approach is substantially the same as that set forth in the current Regulations under section 1248.

(5) Treatment of Noncorporate Shareholders

Noncorporate shareholders required to include income and deductions currently will be treated as though such amounts were initially received by a domestic corporation. This rule, the mechanics of which have been developed under subpart F, will ensure equality of treatment between noncorporate and corporate shareholders.

(6) Losses

The excess of deductions over the gross income of a controlled foreign corporation will be treated as if realized directly by a U. S. shareholder, regardless of whether a corporate shareholder meets the stock ownership requirements for filing a consolidated return domestically.

If a U. S. shareholder has an overall foreign source loss attributable in whole or in part to the shareholder's pro-rata share of the losses of one or more controlled foreign corporations, the loss may offset his U. S. source income but will be subject to the recapture rules currently in section 904.

(7) U. S. Branch Rule

Gross income, deductions, and U. S. taxes of a U. S. branch of a controlled foreign corporation will be attributed to the U. S. shareholders of that corporation. This income will not, accordingly, be twice subjected to U. S. tax.

(8) Blocked Income

For the purpose of exchange control, certain foreign countries do not allow the expatriation of earnings derived within their borders. The proposal recognizes that it is inappropriate to tax currently all the earnings of a controlled foreign corporation in cases where distributions to U. S. shareholders have been "blocked" by currency or other restrictions imposed by a foreign country.

The Administration recognizes that the current rules with respect to blocked income may not be appropriate when deferral is terminated. It is anticipated that Regulations will be promulgated to describe those situations that prevailed prior to 1978 that will be treated as creating blocked income. However, any currency or other restrictions that are imposed solely against U. S. shareholders or imposed solely on a shareholder-by-shareholder basis will not be recognized as blocking income.

(9) Repatriation of Previously Taxed Income

Previously taxed income will be excluded from gross income of a U. S. shareholder when such income is distributed to the shareholder or any other U. S. person who acquires any portion of the U. S. shareholder's interest in the controlled foreign corporation.

(10) Basis Adjustments

As gross income and deductions of a controlled foreign corporation are recognized by the U. S. shareholder, an adjustment will be made to the basis of the shareholder's stock in the controlled foreign corporation. Actual distributions from the corporation that are excluded from gross income because they are attributable to previously taxed income will decrease such basis.

(11) Foreign Tax Credit

Since income and deductions will be treated as if realized directly by U. S. shareholders, foreign taxes paid by controlled foreign corporations, regardless of tier, will be treated as if paid directly by U. S. shareholders. This rule simplifies the foreign tax credit by making unnecessary the "deemed paid" foreign tax credit calculation in the case of U. S. shareholders of controlled foreign corporations. Further, the rule removes an inequity in current law, under which a foreign tax credit is denied for any year in which a foreign corporation has a deficit calculated under U. S. principles, even though taxes were paid to a foreign country.

Eliminating deferral reduces both a corporation's ability to control the effective rate of foreign tax by controlling the source and rate of dividend distributions and the corporation's ability to minimize timing differences in deductions between the United States and foreign countries. To allow for such timing differences, it is proposed that the foreign tax credit carryback be lengthened from 2 to 3 years and that the foreign tax credit carryforward be lengthened from 5 to 7 years. It will be made clear that a foreign tax credit will not be allowed for withholding taxes applied only to U. S. investors, or on a shareholder-by-shareholder basis, or to deemed distributions.

(12) Exchange Gains and Losses

The proposal provides that unrealized exchange gains and losses will be taken into account by a U. S. shareholder. This is the rule for financial accounting purposes and it is similar to a tax rule available to U. S. branches overseas and to the rule used to determine earnings and profits under subpart F. The proposal provides, however, that a U. S. shareholder may elect, with respect to all of its foreign operations, not to take into account unrealized exchange gains and losses. This election is revocable, on a prospective basis, ten years after it has been made.

(13) Accounting, Record Keeping, and Reporting Requirements

Rules will be provided for making elections with respect to controlled foreign corporations, translating amounts from foreign currency, the computation of taxable income and earnings and profits, the keeping of records and accounts, and the reporting requirements of U. S. shareholders.

In general, taxable income and earnings and profits will be computed under U. S. standards. The Administration recognizes, however, that there are differences between U. S. and foreign standards, and will prescribe Regulations describing the extent to which deviations from U. S. standards will be allowed.

(14) Tax Treaties

The proposal allows the Treasury to consider the negotiation of income tax treaties allowing deferral to continue, in appropriate situations, in treaty countries.

(15) Corporations Organized in Puerto Rico and U. S. Possessions

A current provision of subpart F allows a controlled foreign corporation organized in Puerto Rico or a possession of the United States to be excluded from subpart F if it meets certain tests with regard to the source and nature of its income and business. This provision parallels slightly broader statutory protection from U. S. tax granted by way of a special "possessions" tax credit available to electing domestic corporations doing business in Puerto Rico and the possessions (except the Virgin Islands).

This proposal allows U. S. shareholders to continue deferral with respect to income of corporations organized under the laws of the Commonwealth of Puerto Rico or a possession of the United States (including the Virgin Islands). Income that would have been eligible for the possessions tax credit currently provided by the Internal Revenue Code if the controlled foreign corporation had been a domestic corporation will not be taxed currently to U. S. shareholders. Instead, such income will be treated in the same manner as "blocked income."

(16) Transition Provisions

In 1979 and 1980, U. S. shareholders will be required to take into income 1/3 and 2/3, respectively, of the gross income and deductions of controlled foreign corporations. The provisions of subpart F will also apply during these two years, although most of subpart F will be repealed for years after 1980. The 1/3 and 2/3 inclusion in 1979 and 1980 will apply to the income and deductions of a controlled foreign corporation after adjustment for amounts included in income by a U. S. shareholder under the subpart F provisions. Thus, if in 1979 a U. S. shareholder's controlled foreign corporation has $150 of taxable income of which $30 is foreign base company income under subpart F, the inclusion under this proposal for the U. S. shareholder will be $40 (1/3 x ($150 - $30) = $40) and the U. S. shareholder's total taxable income attributable to the controlled foreign corporation will be $70.

The rules of subpart F will apply for purposes of calculating the foreign tax credit attributable to income included under subpart F, and the rules under this proposal will apply for purposes of calculating the foreign tax credit attributable to the additional amounts included in the U. S. shareholder's income under the proposal.

(17) Other Provisions

Various provisions of the Internal Revenue Code are modified or repealed under this proposal. The foreign personal holding company provisions are repealed after 1980. Subpart F is repealed for future operations, although it will be necessary to maintain certain historical aspects. For example, the rules relating to taxation of investments in U. S. property will continue to apply to previously accumulated earnings. Also, it will be necessary to determine whether actual distributions had been previously taxed under subpart F, and to determine the tax on certain amounts previously excluded from a U. S. shareholder's gross income under subpart F because they were reinvested in qualified shipping assets or in less-developed countries; any amounts thus excluded will be taxable when they are withdrawn from such investment. Section 1248 is also kept in force to handle accumulated earnings.

FINANCIAL INSTITUTIONS

Present Law

Depository financial institutions are not taxed in a manner comparable to other corporate taxpayers. Credit unions are completely exempt from tax; commercial banks, savings and loan associations, mutual savings banks and cooperative banks are allowed to take artificially large deductions for additions to bad debt reserves in computing taxable income. These deductions are allowed under liberal statutory formulas which apply only to these institutions, while other taxpayers must generally compute these deductions on the basis of experience.

Commercial banks are permitted until 1988 to accumulate bad debt reserves equal to a specified portion of their outstanding eligible loans, without regard to actual loss experience. The present statutory provision for commercial banks is a phase-out, enacted in the Tax Reform Act of 1969, of even more generous treatment under prior administrative practice. Until 1982, commercial banks are permitted to build up their reserves for tax purposes to 1.2 percent of eligible loans (in general, loans made in the course of normal customer loan activities). Beginning in 1982 and before 1988, the build-up is permitted to 0.6 percent of eligible loans. Once the tax reserve is built up to these maximum levels, or the higher levels permitted prior to 1969, a bank can in effect continue to deduct actual losses rather than charge losses against its reserve, so long as there is no decrease in outstanding eligible loans. To date, this rule has permitted banks to shelter from tax approximately $4 billion of income. Beginning in 1988, however, commercial banks will have to base further additions to their reserves on actual loss experience.

Mutual savings banks, savings and loan associations, and cooperative banks (commonly referred to as "thrift institutions") are allowed to deduct annual additions to their bad debt reserves equal to a specified percentage of net income. In contrast to the treatment of commercial banks, the preferential treatment accorded thrift institutions will continue indefinitely; the allowable addition is, however, being phased down from 60 percent of net income (allowed prior to the Tax Reform Act of 1969) to a permanent level of 40 percent in 1979. Eligibility for this special percentage method depends on compliance with a comprehensive set of investment standards, adopted by Congress to limit these tax benefits to institutions engaged primarily in home mortgage financing.

The full percentage deduction is allowed only if a specified portion (82% for savings and loan associations and 72% for mutual savings banks) of an institution's investments consist of qualifying assets, primarily home mortgages. The deduction is reduced if the institution has a smaller portion of qualifying assets. The basic standards, however, are easily met by most savings and loan associations because of other regulatory requirements.

Thrift institutions are allowed only half of the investment tax credit available to other taxpayers. The dividends-received deduction otherwise allowable to a thrift institution is also reduced by a percentage equal to the percentage of net income exempted from tax by virtue of the special bad debt deduction.

In addition, in the case of both commercial banks and thrift institutions, the excess of the bad debt reserve deduction, computed under the statutory percentage method, over the deduction which would have been allowed based on experience is an item of tax preference, subject to the minimum tax.

Reasons for Change

Commercial Banks. The allowable bad debt deduction for commercial banks greatly exceeds actual losses. In the period 1955-66, commercial bank bad debt deductions of $5.7 billion exceeded actual losses of $2.1 billion by more than 167 percent. From 1969 through 1975, under the present statutory provisions, deductions exceeded losses by over $400 million. (See Tables IVD-1 & IVD-2). If not corrected the revenue loss from excessive bad debt deductions by commercial banks for the period 1979 through 1982 is expected to exceed $710 million.

The preferential bad debt treatment for commercial banks was developed by administrative action. In 1947, the Treasury Department permitted a bank to accumulate a reserve to reflect a loss rate not exceeding three times its average losses during the previous 20 years; in 1955, banks were permitted to select as a base period any 20 consecutive years after 1927, thus permitting inclusion of the depression years. In 1965, in order to eliminate the disparity in allowable deductions among individual competing banks, the Treasury Department broadened the availability of this special tax treatment to all commercial banks by permitting bad debt reserves equal to 2.4 percent of outstanding loans not insured by the Federal government. This figure is roughly three times the average annual bad debt loss of commercial banks during the period 1928-47.

Table IV-D-1

Bad Debt Losses and the Bad Debt Deduction: 1969-1975

Insured Commercial Banks
($ millions)

	1969	1970	1971	1972	1973	1974	1975	1976
Bad debt losses	489	982	1087	887	1159	1957	3243	3503
as a percent of uninsured loans	0.18	0.36	0.37	0.26	0.28	0.42	0.68	0.72
Bad debt deductions	521	703	867	973	1265	2286	3612	3691
as a percent of uninsured loans	0.20	0.26	0.29	0.29	0.31	0.49	0.76	0.75

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-2

Income, Income Shares, Income Taxes and the Bad Debt
Deduction: Insured Commercial Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$30,299	$34,456	$36,710	$40,439	$52,994	$68,018	$66,640	$81,004
Percentage distribution:								
Administrative and operating expenses	40.4%	42.6%	42.1%	41.4%	35.8%	32.3%	36.4%	43.6%
Interest paid depositors & creditors	37.7	35.8	36.6	38.1	45.7	51.2	44.9	39.3
Net losses on loans	1.3	2.9	3.0	2.2	2.2	2.9	4.9	4.3
Income attributable to equity	20.5	18.7	18.2	18.4	16.3	13.7	13.8	12.7
Federal income tax	4.3	4.7	3.7	3.2	2.5	2.0	1.8	1.7
Net income after tax	16.3	14.0	14.5	15.2	13.8	11.7	12.0	11.0
Federal income tax as a percent of income attributable to equity	20.7	25.1	20.4	17.3	15.5	14.6	13.3	13.3
Provisions for loan losses as a percent of gross income	1.7	2.0	2.4	2.4	2.4	3.4	5.4	4.6
Excess of provisions for loan losses over net losses	120	-279	-220	86	106	329	369	188
As a percent of gross income	0.4	-0.8	-0.6	0.2	0.2	0.5	0.6	0.2
Additional tax liability that would result from the taxation of loan loss provisions in excess of net losses at 48 percent	58	-134	-106	41	51	158	177	90
As a percent of gross income	0.2	-0.4	-0.3	0.1	0.1	0.2	0.3	0.1
Bad Debt Reserves as a percent of loans other than Federal Funds, Insured Loans, and Loans to other banks	2.2	2.2	2.1	2.0	1.8	1.8	1.8	1.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation.

This very generous treatment was justified as a measure to protect commercial banks from possible catastrophic losses. It was argued that a commercial bank should be allowed to allocate a large portion of its income to reserves to protect its solvency during periods of extreme economic distress. However, since banks are not required to set aside the resultant tax saving in the form of cash or other liquid assets, the tax provision does not assure commercial bank solvency. Indeed bank solvency in periods of cyclical financial crises can only be assured by actions of the Federal Reserve system, which is authorized by law to make loans to member banks secured by their business loans and to make purchases of government bonds in the open market. Similarly, security for depositors is provided through deposit insurance. These institutional safeguards, along with continual surveillance of the lending policies of individual banks by Federal and state bank regulatory agencies, protect the banking system and its depositors.

In the Tax Reform Act of 1969 Congress recognized that continuation of the preferential tax treatment of commercial banks was not justified and required the adoption by 1988 of the experience method used by other taxpayers. Further, since 1976 commercial banks and other financial institutions have enjoyed special protection from extraordinary losses in the form of a ten year carryback and five year carryforward of net operating losses. (In contrast, other taxpayers are generally allowed a three year carryback and seven year carryforward of net operating losses.) It is, therefore, appropriate to place commercial banks on the same footing as other taxpayers in determining their bad debt deductions.

Thrift Institutions. Thrift institutions were originally exempt from tax on the same theory that now justifies the exemption for social clubs: there is no income if one deals with oneself. This exemption for mutual savings banks and savings and loan associations was ostensibly ended in 1951. Congress recognized at that time that savings and loan institutions "are no longer self-contained cooperative institutions as they were when originally organized..." (S. Rep. No. 781, 82d Cong., 1st Sess. 28 (1951).) In the long run, "membership" in these institutions was not restricted so that a member's investments and debts were approximately equal, nor was it certain that any given member would receive a proportionate share of the accumulated earnings of the organization. More generally, both mutual savings banks and savings and loan associations offered a full range of depository and lending services to a broad group of persons on terms differing in no significant way from the terms on which the same services were offered by taxable financial institutions. The size and character of thrift institutions required parity between them and their competitors.

Nevertheless, the movement from tax-exempt to taxable status has proceeded slowly. Notwithstanding the 1951 legislation, thrift institutions were virtually tax exempt until 1962 because of their special deduction for bad debt reserves. Even after a revision of the bad debt reserve deduction in 1962, and until the Tax Reform Act of 1969, mutual savings banks were able to avoid substantially all Federal income taxes, and savings and loan associations were subject to effective tax rates of approximately 15 to 18 percent, only 30 to 35 percent of the then prevailing corporate rate. The 1969 Act increased the effective tax rate for thrift institutions to approximately 50 to 60 percent of the regular corporate rate.

The preferred tax treatment accorded thrift institutions is frequently justified because of the role played by these institutions in the home mortgage market. The thrift institution statutory bad debt deduction, however, is an insignificant factor in encouraging the supply of home mortgages. The ability of thrift institutions to hold mortgages depends critically on the willingness of depositors to hold savings accounts in those institutions; this willingness to hold deposits depends on the pass-book interest rates which the thrift institutions can pay. In turn, the interest rate thrift institutions can pay their depositors depends primarily on mortgage interest yields and the deposit interest rate ceilings imposed by Federal authorities. Finally, mortgage interest yields are governed by the activity of such federally sponsored institutions as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and a long list of public and private mortgage insurance agencies.

Allowance of the artificially high statutory bad debt deduction for thrift institutions undermines the basic policy decision that these entities should be taxable. The bad debt deductions of thrift institutions are typically three to six times their actual losses. (See Tables IVD-3 through IVD-5). Allowance of these deductions at the present statutory levels will result in a revenue loss of $4 billion over the six-year period 1977-1982. Artificial bad debt deductions do not afford thrift institutions protection from insolvency; as in the case of commercial banks, there is no requirement that the institution's untaxed income be set aside to provide for losses. Federal and state regulation and examination, along with the maintenance of secondary mortgage markets by federally sponsored agencies, protect the solvency of thrift institutions The special provision allowing ten year carryback and five year carryforward of net operating losses adequately protects thrift institutions from the tax effects of extraordinary, unprecedented losses.

Table IV-D-3

Bad Debt Deductions and Actual Bad Debts

Savings and Loan Associations and Mutual Savings Banks

($ million)

	1972	1973	1974	1975	1976
Savings and Loan Associations					
Actual bad debts	34	58	86	149	140
Bad debt deduction	923	1042	865	806	1109
Ratio of bad debt deductions to actual bad debts	27.15	17.97	10.06	5.41	7.29
Mutual Savings Banks					
Actual bad debts	36	34	61	52	58
Bad debt deduction	173	204	193	205	218
Ratio of bad debt deductions to actual bad debts	4.81	6.00	3.16	3.94	3.76
Total					
Actual bad debts	70	92	147	201	198
Bad debt deductions	1096	1246	1058	1011	1327
Ratio of bad debt deductions to actual bad debts	15.66	13.54	7.20	5.03	6.70
Losses on bad debts as a percent of uninsured loans	0.03	0.04	0.06	0.07	

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Table IV-D-4

Income, Income Shares and the Bad Debt Deduction:
Insured Mutual Savings Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$3,523	$3,754	$4,471	$5,280	$5,973	$6,335	$7,116	$8,333
Percentage distribution								
Administrative and operating expenses	13.6%	14.7%	14.2%	14.0%	14.4%	14.9%	15.6%	15.7%
Interest paid depositors and creditors	80.0	80.1	76.6	74.8	75.5	78.7	78.0	76.0
Net losses on loans	0.05	0.05	0.1	0.1	0.2	0.2	0.3	0.9
Income attributable to equity	6.4	5.1	9.1	11.1	9.9	6.3	6.1	7.4
Federal income tax	0.4	0.7	1.4	2.1	1.9	1.3	0.9	1.3
Net income after tax	6.0	4.5	7.7	9.1	8.0	5.0	5.1	6.1
Federal income tax as a percent of income attributable to equity	6.3	13.0	15.7	18.6	19.2	20.4	15.5	17.6
Bad debts as a percent of income attributable to equity	0.4	0.5	0.7	0.7	1.5	2.5	5.1	12.8
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	94	68	131	173	171	110	140	187
As a percent of gross income	2.7	1.8	2.9	3.3	2.9	1.7	2.0	2.2

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-5

Income, Income Shares, and Income Taxes:
Insured Savings and Loan Associations, 1972-1975

	1972	1973	1974	1975
Gross Income: (millions)	$15,323	$18,392	$21,102	$23,905
Percentage distribution				
Administrative and operating expenses	17.2%	17.5%	17.5%	17.5%
Interest paid depositors and creditors	68.2	68.5	72.6	73.7
Net losses on loans	0.2	0.3	0.4	0.6
Income attributable to equity	14.4	13.7	9.5	8.1
Federal income tax	3.4	3.4	2.5	2.1
Net income after tax	11.0	10.3	7.0	6.1
Federal income tax as a percent of income attributable to equity	23.5	24.7	26.4	25.7
Bad debts as a percent of income attributable to equity	1.5	2.3	4.3	7.6
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	541	588	435	435
As a percent of gross income	3.5	3.2	2.1	1.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Combined Financial Statements, Federal Savings and Loan Insurance Corporation

Credit Unions. Credit unions were excluded from the decision to make other thrift institutions taxable in 1951. Equity now demands, however, that these entities be placed on a parity with thrift institutions, their competitors.

Many credit unions are no longer truly mutual institutions with limited "common bonds" required for membership. The legal concept of common bond has been expanded so that mere residence in a state may be sufficient for membership in a credit union, and even those persons who leave an area may continue to be members. A Federal appeals court even held recently that an institution may qualify as a credit union despite the absence of membership restrictions if most depositors in fact have similar characteristics, a "de facto" common bond. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

Many credit unions also are expanding beyond the factory and farm worker constituency that they represented when they were first regulated nationally in 1934 by the Farm Credit Administration. The residential common bond, although presently the least frequently used, is the fastest growing one among Federal credit unions. Furthermore, the size of individual accounts is growing. In Federal credit unions, accounts larger than $5,000 aggregated $2.1 billion at the end of 1970 and $11.1 billion at the end of 1976. This increase and the increase in the median income of depositors indicate that credit unions are appealing to other than low-income workers who have been excluded from access to banking services elsewhere.

The powers and services of credit unions have also expanded enormously, especially over the past seven years, so that they are becoming indistinguishable from other financial institutions. In 1970, Congress enacted Federal share insurance legislation, which insures the accounts of Federal credit unions and about half of the savings in state credit unions. In the Depository Institutions Amendments Act of 1977, Federal credit unions were granted the power to offer credit cards, to loan funds without specific dollar limits for up to 12 years, and to make real estate loans for up to 30 years. Many state-regulated credit unions have similar powers, including the authority to offer interest-bearing checking accounts. There is no correlation between an individual's credit union loans and deposits; persons who become members with a $5 share may borrow up to the institution's lending limit. The state regulated La Caisse Populaire Ste. Marie (St. Mary's Bank), a "credit union," invested more than 80 percent of its loan funds in real estate and had substantial demand deposits.

The sheer growth of these financial intermediaries in the decades since 1951 demonstrates that they should be treated equally with their competitors. In consumer installment credit, credit unions hold 17 percent of the market and have been the largest factor in the increase in installment credit in the past few years. The assets of some of the largest credit unions exceed or rival large savings and loan associations in some states, and a few credit union groups have even purchased banks. Since the end of 1970, the total assets of Federal credit unions have nearly tripled and those of state credit unions have more than doubled to a total of $45.1 billion for their 33.6 million members. (See Tables IVD-6 and IVD-7.) The numbers are even more striking when compared to the 1951 figures when thrift institutions were made taxable. At that time credit unions had $1 billion in assets and 5.2 million members.

The blurring of the distinction between credit unions and other thrift institutions argues for the same tax treatment for these entities. In the absence of such treatment the tax system elevates form over substance by encouraging banks and other thrift institutions to be organized in the form of credit unions.

General Explanation

The Administration's proposal will require commercial banks to use only the experience method for computing additions to their bad debt reserves. They will thus be allowed to deduct additions to loss reserves based on the larger of their average loan loss experience over the current and five preceding years or actual losses. The present transition rules, which until 1988 allow a build-up in reserves to a percentage of outstanding loans, will be repealed.

The percentage of taxable income method of determining bad debt deductions for thrift institutions will be phased down from its current 41 percent level to 30 percent by 1983. Credit unions will be made subject to tax on the same basis as thrift institutions, and will be permitted to claim the thrift institution bad debt deduction; they will not, however, be subject to the investment restrictions which apply to thrift institutions. The bad debt deduction available to credit unions will be phased down ratably from, in effect, 100 percent of net income under present law to 30 percent over a period of five years.

As a result of these changes, the investment tax credit available to thrift institutions (and credit unions) will be increased to 70 percent of the credit available to other taxpayers. In addition, thrift institutions and credit unions will be made eligible for the full (generally, 85 percent) dividends-received deduction. Dividends received will be excluded, however, from income for purposes of determining the maximum bad debt deduction.

Table IV-D-6

Federal Credit Unions

	1972	1973	1974	1975	1976
Gross Income: (millions)	$1,046	$1,251	$1,504	$1,749	$2,124
Percentage distribution					
Administrative and operating expenses	32.2%	31.3%	29.5%	30.4%	31.9%
Interest refunds	3.5	3.1	2.5	2.2	2.0
Other interest payments	1.4	1.8	2.6	2.9	3.0
Net losses on loans	3.2	3.1	4.4	4.2	2.4
Dividends to shares	49.4	50.8	50.7	52.9	53.2
Income attributable to equity	10.4	9.9	10.4	7.4	7.5
Growth Rate	18.0%	19.7%	20.2%	16.3%	21.5%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the National Credit Union Administration

Table IV-D-7

Federally-Insured State-Chartered Credit Unions

	1971	1972	1973	1974	1975	1976
Gross Income (millions)	$163	$278	$382	$554	$757	$958
Percentage distribution:						
Administrative and operating expenses	35.1%	35.4%	34.6%	34.4%	32.7%	31.8%
Interest Refunds	3.2	3.1	2.6	2.7	2.2	2.2
Other interest payments	1.4	1.5	1.9	2.4	2.1	2.4
Dividends on shares	48.5	46.8	48.7	47.8	48.2	46.4
Income attributable to equity	11.9	13.2	12.3	12.7	14.7	17.2
Growth Rate	-	70.9%	37.4%	45.1%	36.7%	26.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the National Credit Union Administration

Analysis of Impact

Depository institutions may be organized as stock corporations (generally, commercial banks and some savings and loan associations) or as mutual associations (generally, mutual savings banks, credit unions, and non-stock savings and loan associations). Institutions organized as stock corporations derive most of the funds used to acquire income producing assets from depositors and a relatively small portion from equity investors. A correspondingly large portion of the stock institution's income must be allocated to the cost of deposits and a relatively minor portion to equity. Since the interest cost of deposits and capital debt is deductible in computing taxable income, the burden of federal income tax falls initially on that portion of the institution's income attributable to equity.

Stock financial institutions adjust to changes in the rate of tax on income attributable to corporate equity in the same manner as other corporations. Possible responses by stock institutions to the increased tax burden resulting from these proposals include one or both of the following:

(a) Adjustment of portfolios to increase gross income sufficiently to cover the higher corporate income tax. This could be accomplished by increasing lending rates to customers or switching investment to higher yielding assets.

(b) Reduction of either the nominal interest paid depositors or the battery of "free" services provided them.

Since the gross income and interest expense of these institutions is quite large in comparison to the increase in tax resulting from these proposals, it is anticipated that the proposals ultimately will result in approximately a .03 to .04 percent increase in lending rates by all affected institutions, or in a .02 to .04 percent reduction in rates paid depositors. However, in the case of credit unions, if the full adjustment were borne by shareholders, the reduction would be slightly more than one-half of one percent.

The equity interest in mutual institutions is held, in effect, by depositors. Since "share dividends" (i.e., interest on deposits) are deductible by the institution, the burden of the Federal income tax falls solely on the income of the corporation which is not paid to depositors. A mutual institution will respond to the proposed changes in a manner substantially the same as a stock institution if it desires to maintain the same level of retained earnings as under present law, i.e., it will seek to increase the spread between gross income and its cost of funds to compensate for the additional Federal tax. A mutual institution may, on the other hand, avoid the imposition of additional tax by decreasing that spread. It may reduce its lending rates or, more probably, increase its "dividend" to depositors.

Effective Date

Repeal of the commercial bank percentage method of computing bad debt deductions will be effective for taxable years beginning after 1978. The phase-down of the percentage method for computing bad debt deductions for thrift institutions and the phase-in of the taxation of credit unions will commence in the first taxable year beginning after 1978. Thrift institutions and credit unions will be allowed the increased investment tax credit and the full dividends-received deduction for taxable years beginning after 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	286	367	460	367	487

Technical Explanation

The percentage of outstanding loans method of computing deductible additions to bad debt loss reserves for commercial banks under present law will be repealed.

In the case of thrift institutions, the change in the percentage of net income method (from 41 percent in 1978 to 30 percent in 1983) will be made gradually, with a phase down similar to that in current law. The taxation of credit unions will be introduced gradually by allowing a deduction for bad debts phased down ratably from, in effect, 100 percent of net income for 1978 to 30 percent in 1983. Thrift institutions and credit unions will be permitted a 30 percent bad debt deduction beginning in 1983.

Bad Debt Deduction for Savings and Loan
Associations and Mutual Savings Banks
Under the Percentage of Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	38%
1980	36%
1981	34%
1982	32%
1983 or thereafter	30%

Bad Debt Deduction for Credit Unions Under the Percentage of Taxable Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	86%
1980	72%
1981	58%
1982	44%
1983 or thereafter	30%

Under present law the bad debt deduction for thrift institutions is computed as a percentage of taxable income, with certain modifications. Since the dividends-received deduction is reduced for thrift institutions using the percentage bad debt deduction, these institutions are permitted to include the taxable portion of their dividends received in taxable income for purposes of computing their bad debt deduction. Since thrift institutions and credit unions will be allowed a full dividends-received deduction under the proposal, dividends received will be excluded from taxable income for purposes of computing the bad debt deduction.

ACCRUAL ACCOUNTING FOR AGRICULTURAL CORPORATIONS

Present Law

The Internal Revenue Code requires that the accounting method used in preparing a taxpayer's return "clearly reflect income." This restricts the taxpayer's flexibility in choosing among the cash receipts and disbursements method, the accrual method and other permissible accounting methods in computing taxable income. 1/ Most taxpayers who are in the business of selling products are required to use the accrual method of accounting under which the cost of the product must be accumulated in inventory and offset against sales receipts. Expenses are thus properly matched with the income they produce, and taxable income is "clearly reflected" within the meaning of the tax law.

By virtue of administrative rulings issued more than 50 years ago, however, farmers have generally been exempted from the accrual accounting requirement. The reason for this exemption was the impression that farmers lack the financial resources and the expertise necessary to match farming expenditures with the particular farming income. As a result, the simpler cash receipts and disbursements method was permitted, even though it tended to misstate farmers' taxable income.

Limited exceptions from the cash method privilege for farming operations were introduced by the Tax Reform Act of 1976. That Act established the general rule that corporations (and partnerships with a corporate partner) engaged in farming must use the accrual method of accounting and capitalize preproductive period expenses. However, exemptions were provided for (1) nurseries and farms engaged in raising or harvesting of trees (other than fruit and nut trees); (2) corporations with annual gross receipts of $1 million or less; (3) Subchapter S corporations; and (4) corporations where 50 percent or more of voting stock and 50 percent or more of all classes of stock are owned by members of the same family. 2/

Accrual accounting requires that firms match the deductions for farming expenditures with the income related to those expenditures. For example, an accrual farmer cannot deduct currently the cost of feed for his beef cattle; rather, the feed cost is reflected in the opening and closing inventory values of the cattle. Similarly, a farmer on the accrual basis cannot deduct the cost of such items as seed and fertilizer until the resulting crops are sold. In the case of multi-yield assets such as dairy cattle or apple orchards, the costs of developing the assets to maturity must be capitalized and deducted after maturity through depreciation or, in the case of livestock, through inclusion in inventory values. However, an exception is provided from the capitalization requirement for taxes and interest and any expenses incurred on account of casualties.

In addition to the accounting requirements for corporate farms, the 1976 Reform Act contains related, but less stringent, accounting rules for "farming syndicates." A farming syndicate cannot deduct amounts paid for feed, seed, fertilizer, or other farm supplies until those supplies are actually used or consumed. Moreover, the cost of poultry purchased for use in a syndicate's trade or business must be capitalized and deducted ratably over the lesser of 12 months or their useful life; the cost of poultry purchased by a syndicate for resale can be deducted only upon disposition. And the expenditures incurred to raise a grove, orchard or vineyard to maturity must also be charged to a capital account. For these purposes, a "farming syndicate" is a partnership, subchapter S corporation or other enterprise, such as an agency relationship, which has its participation interests registered or required to be registered with a State or Federal securities agency, or in which more than 35 percent of the entity's losses are attributable to limited partners or other persons not actively participating in the management of the farming enterprise (referred to in the Code as "limited entrepreneurs").

Accordingly, the accounting rules for farm corporations and farm syndicates are similar with respect to limited categories of farm assets. Specifically, both corporations and syndicates are required to capitalize the cost of poultry, whether used for egg-laying or sold for meat. Both are required to capitalize the preproductive period costs of groves, orchards or vineyards, even though there are variations in the respective rules relating to the time over which capitalized amounts can be recovered. With respect to all other farm products, however, the accounting requirements relating to corporations are substantially more restrictive than the syndicate rules. Current law does not require that the feed, seed or fertilizer expenses of syndicates be matched with the income produced from such assets as field crops and cattle. As long as a syndicate actually uses the farm supplies during the taxable year, a current deduction is permitted. Corporations, on the other hand, are subject to the general requirement that all preproductive period expenses be matched with related income through use of the accrual accounting method and the capitalization of expenses incurred before the realization of income.

Reasons for Change

In enacting the Tax Reform Act of 1976, Congress recognized instances where the rationale for farmers' cash accounting privilege is no longer applicable. Large farming corporations cannot fairly claim that they lack access to the sophisticated accounting and recordkeeping procedures involved in the accrual method of accounting. In fact, most large companies are already required to keep financial records on the accrual basis in order to obtain certification of financial statements by an accountant. As a result, the cash method of accounting serves not to relieve large corporations from recordkeeping burdens, but rather to misstate substantially the taxable income of those enterprises.

The 1976 Act did not go far enough in its application of the accrual requirement. During consideration of the Tax Reduction and Simplification Act of 1977, Congress was presented with claims that the "one-family corporation" exception to the accrual accounting requirement arbitrarily granted a substantial competitive advantage to several multimillion dollar farming operations at the expense of other large farm corporations that failed to fall within the definition of a family corporation. The approach taken by Congress in the 1977 Act was to extend for one year the family corporation exemption to cover at least two additional corporations that allegedly had been placed at a competitive disadvantage in spite of the fact that these corporations each had annual gross sales in excess of $50 million. The 1977 Act did not address the fundamental cause of the inequity; the fact that a distinction between family and non-family corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers who truly lack access to the necessary accounting and recordkeeping procedures involved in the accrual method of accounting.

By eliminating the family corporation exemption, the Administration's proposal will result in the application of the accrual method requirement to all large farming corporations (aside from subchapter S corporations, which are treated for tax purposes essentially like partnerships). Farming corporations with annual gross receipts of $1 million or less will still be exempted in order to preserve the availability of the cash method of accounting for those corporate farms that may lack access to accounting and recordkeeping expertise. Moreover, the Administration's proposal will extend the accrual accounting requirement to all farming syndicates, regardless of size. In those instances where interests in farming operations are required to be registered with Federal or State securities officials or where a substantial portion of the enterprise is owned by passive investors, the rationale for cash accounting is also inapplicable. Persons who are involved in farming as outside investors, whether for tax shelter opportunities or for positive economic return, should not share in a cash accounting privilege designed for farmers unaccustomed to sophisticated financial transactions.

One additional change is desirable in order to remove an exception to the accrual accounting requirements that no longer seems warranted. The Administration has proposed that state and local taxes, aside from income taxes and real property taxes, not be deductible as taxes. Sales taxes, personal property taxes and other miscellaneous taxes will instead be expensed or capitalized by a taxpayer in accordance with the rules relating to other business expenditures. Following this general treatment of state and local taxes, the taxes of a farmer (aside from income taxes and real property taxes) will be treated like any other expenditures incurred in raising farm products.

General Explanation

The Administration proposal will delete the exception for family corporations from the requirement that corporations engaged in farming compute taxable income on an accrual method of accounting and with the capitalization of preproductive period expenses. The proposal will also extend those accounting requirements to "farming syndicates" as defined in the Tax Reform Act of 1976.

Therefore, under the Administration's proposal, the following farming operations will be required to use an accrual method of accounting and to capitalize preproductive period expenses:

(1) All farming syndicates (as defined under current law);

(2) All corporations (and partnerships with a corporate partner) engaged in farming, with the exception of (a) nurseries or other farming operations that raise or harvest trees (other than fruit and nut trees), (b) subchapter S corporations, and (c) corporations which do not have annual gross receipts exceeding $1 million.3/

As under present law, the "preproductive period expenses" required to be capitalized will not include interest or expenditures incurred on account of casualties. However, taxes, aside from income taxes and real property taxes, will no longer be excluded from the definition of "preproductive period expenses."

Analysis of Impact

Approximately 94 percent of all corporate farms have annual gross receipts under $1 million and will thereby remain eligible to use the cash receipts and disbursements method of accounting. In most instances, farming syndicates and the large corporations with receipts above $1 million already use accrual accounting for financial purposes. Therefore, it is unlikely that the Administration proposal will create any substantial recordkeeping problems for the large, family corporations and syndicates formerly exempted from the accrual method requirement.

Since the exemption for ordinary corporations will be based solely on the amount of gross receipts, equity among comparably situated taxpayers will be increased. The Administration proposal will eliminate the competitive disadvantage incurred by large farm corporations, using the accrual method, which must compete with other large corporations entitled to use the cash method because the latter happen to fall within the definition of "family corporation."

Effective Date

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

Revenue Estimate

Change In Tax Liability

($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-	40	25	10	5	7

Technical Explanation

For the purpose of the accrual rules, a "farming syndicate" will be defined as it is in the Tax Reform Act of 1976. Accordingly, a "farming syndicate" will include any enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if any offering of interests in the enterprise were required to be registered with any federal or state securities agency, or an enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or other limited entrepreneurs not actively participating in the management of the enterprise. The statutory definition of "farming syndicate" will also preserve the provisions that treat interests meeting the following requirements as interests not held by a limited partner or limited entrepreneur: (a) where an individual has an interest attributable to his active participation in the management of any trade or business of farming for a period of not less than 5 years; (b) where an interest is held in an enterprise engaged in operating a farm which serves as the principal residence of the individual who owns that interest; (c) where an individual has a participating interest in the further processing of livestock raised in a farming operation covered by the above provisions or in whose management that individual actively participates; (d) where the interest is owned by an individual whose principal business activity involves active participation in the management of a trade or business of farming; and (e) where an individual is a member of the family of a grandparent of an individual who would be excepted under any of the four situations listed above, and his interest is attributable to the active participation of such individual.

With respect to both farming corporations and syndicates, "preproductive period expenses" will refer to expenditures attributable to crops, animals or other property having a crop or yield during the period of time (a) prior to the disposition of the first marketable crop or yield of property having a useful life of more than one year, or (b) before disposition of any property having a useful life of one year or less. 4/ Exceptions from the definition will be retained for interest and expenses incurred on account of casualties, disease or drought; but taxes, aside from income taxes and real property taxes, will not be excepted. Also, in applying the definition, the use of self-produced supplies of the farm will be considered a disposition of those supplies.

Finally, any taxpayer required by this provision to change its method of accounting will treat such a change as having been made with the consent of the Secretary of the Treasury, will consider the change as not having been initiated by the taxpayer, and will generally be given a ten year period to take into account the net amount of adjustments required in the computation of taxable income. The Secretary will prescribe regulations indicating those situations in which less than a ten year period is appropriate (*e.g.*, the taxpayer was in existence for less than ten years).

Footnotes

1/ Under the cash receipts and disbursements method, gross income items are to be included for the taxable year in which actually or constructively received; and expenses are to be deducted for the taxable year in which actually paid. Under the accrual method, income is to be included for the taxable year in which all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy; deductions are permitted for the taxable year in which all the events have occurred which establish the fact of liability and the amount thereof can be determined with reasonable accuracy.

2/ Under the Tax Reduction and Simplification Act of 1977, another exemption until taxable years beginning after December 31, 1977 was granted where two families own at least 65 percent of the stock or where three families own at least 50 percent of the stock and substantially all of the remaining stock is owned by corporate employees, their families or exempt retirement trusts established for the benefit of the employees.

3/ These exceptions will not apply if the entity is a "farm syndicate."

4/ Under present law, a farming syndicate must capitalize those expenditures incurred in developing a grove, orchard or vineyard prior to the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. This special rule will be eliminated, and farming syndicates raising fruit or nuts will be subject to the general provision described above. However, all taxpayers will continue to be covered by a special Code provision for citrus and almond groves (section 278). That provision requires capitalization of the developmental expenditures of a citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. Accordingly, a farming corporation or syndicate will be required to capitalize expenditures during the first four years after planting a citrus or almond grove even though the dispostion of the first marketable crop or yield might have occurred prior to the expiration of that four-year period.

SIMPLIFICATION OF ADR DEPRECIATION

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

In 1971 Congress authorized the Secretary of the Treasury to promulgate regulations establishing the ADR system. Under the ADR system, the Treasury Department establishes useful lives for classes of assets based upon the activity in which the assets are used (e.g., mining or agriculture) or the type of asset (e.g., automobiles or office furniture). A taxpayer is permitted to compute depreciation on the basis of these lives without any showing of facts and circumstances.

Since the class lives are set so that 70 percent of all assets in a class have actual useful lives which are as long or longer than the prescribed class life, the use of class lives in itself is a benefit to the average taxpayer. Moreover, taxpayers are permitted to set useful lives within a range extending from 20 percent below to 20 percent above the established class lives.

Taxpayers who adopt the ADR system obtain other advantages in the treatment of salvage value and retirements of assets. On the other hand, the regulations require taxpayers who adopt the ADR system to comply with a number of formal accounting and reporting requirements.

Reasons for Change

The presence of many attractive features in the ADR system has led to its adoption by taxpayers holding more than half of all corporate assets. In 1974, 64 percent of all depreciable corporate assets were held by taxpayers who elected ADR. 1/ The largest corporations appreciate the advantages of the ADR system. In 1974, nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR. In contrast, little more than half of the corporate taxpayers with more than $100 million in depreciable assets elected ADR; only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. Thus, many corporations have not been sharing in the benefits of ADR to the same extent as the largest corporations. While it is not clear why these businesses have not elected ADR, it would appear that the mechanics of asset classification and the application of prescribed accounting procedures intimidate many businessmen and their accountants.

The Treasury Department has been studying ways to simplify the ADR system. It is expected that a simplified ADR system would lead to the use of ADR by additional taxpayers. However, because the Congress enacted the legislation which authorizes the existing ADR system with a particular set of regulations in mind, it is not clear that present law would authorize the Secretary of the Treasury to promulgate regulations substantially different from those contemplated when the statute was enacted.

A simplified ADR system could reflect a number of changes which experience with the existing ADR system suggests would be beneficial. For example, the current regulations set forth rules for the treatment of salvage value (section 1.167(a)-11(d)(1)). If a taxpayer does not follow "the practice of understating his estimates of gross salvage value," no change will be made to the taxpayer's estimate of salvage value unless the change would exceed 10 percent of unadjusted basis. In the case of most personal property, the taxpayer is allowed to decrease salvage value by an additional 10 percent (section 167(f) of the code). Thus, while the importance of salvage value has been significantly diluted, the Internal Revenue Service still must reexamine a taxpayer's choice of salvage values to determine whether it complies with the tests described above. A rule which eliminated this factual determination would be more consistent with the goals of ADR.

The existing regulations permit taxpayers to choose one of two conventions to determine the date from which they can begin claiming depreciation for property placed in service during the year (section 1.167(a)-11(c)(2)). Under the half-year convention, all assets placed in service during the year are deemed to have been placed in service on the first day of the second half of the taxable year (July 1 for calendar year taxpayers). Under the modified half-year convention, assets placed in service in the first half of the year are deemed to have been placed in service on the first day of the year (January 1 for calendar year taxpayers);

those placed in service in the second half of the year are deemed placed in service on the first day of the succeeding year (January 1 of the next year for calendar year taxpayers). These alternative conventions add complexity to both the operation of the ADR system and its description in the regulations. Moreover, one of the conventions--the half-year convention--offers a number of practical and theoretical advantages in the operation of the ADR system. The half-year convention does not require a taxpayer to determine exactly when the second half of his taxable year begins, a task which may not be simple if the taxpayer's taxable year has fewer than twelve months or if the taxpayer is on a 52-53 week year. The half-year convention also requires the taxpayer to create only one set of vintage accounts each year, rather than the two sets required under the modified half-year convention.

The ADR system simplifies depreciation by establishing a limited number of rules which, on the average, provide a reasonably accurate measurement of income, and which can be readily applied both by the taxpayer and by the Internal Revenue Service. It is inconsistent with that goal to allow complicated options and variations, such as the use of the double declining balance method followed by the sum of the years-digits method for the same asset. Moreover, with the sanction of Congress, the ADR system provides a favorable pattern of tax depreciation for the average taxpayer by setting the useful lives of assets below average lives and then permitting these lives to be reduced by up to 20 percent. Thus, it is unnecessary to allow taxpayers to overlay this guideline system with optional combinations of depreciation methods that further accelerate depreciation deductions.

At present, taxpayers electing ADR are subject to detailed reporting requirements (section 1.167(a)-11(f) of the regulations). The purpose of these reporting requirements is to enable the Treasury Department to determine and refine appropriate lives for different classes of assets. In practice, the reporting requirements are both ineffective and costly to taxpayers and the government. Their purpose can be more efficiently accomplished through survey techniques involving controlled sampling procedures.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue new regulations governing the ADR system. It is intended that the new regulations will be shorter and simpler than the present regulations. These regulations--which should encourage more taxpayers to adopt the ADR system--will differ from the present regulations in several respects, including the following:

1. Salvage value will be disregarded for purposes of computing depreciation.

2. All assets will be governed by the "half-year convention," under which they will be deemed to be placed in service in the middle of the taxable year.

3. Taxpayers will be restricted to the straight-line and declining balance methods of depreciation.

4. The annual reporting requirements will be eliminated. Taxpayers will be required to respond to survey requests to be used in calculating ADR standards. It is expected that no industry will be subject to the survey procedures more often than once every five years, and thus most taxpayers electing ADR will rarely be required to respond to such surveys.

The result of these changes will be a simpler system for taxpayers who elect to depreciate assets under ADR.

Effective Date

The simplified ADR system provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on or after December 31, 1979 will have sufficient time to determine whether to elect the new simplified ADR system.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

Footnote

1/ Because assets placed in service before January 1, 1971 cannot be depreciated under ADR, only 25 percent of the assets of these corporations were depreciated under the ADR system. This percentage should increase over time.