The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity

May 1985

TO THE CONGRESS OF THE UNITED STATES:

We face an historic challenge: to change our present tax system into a model of fairness, simplicity, efficiency, and compassion, to remove the obstacles to growth and unlock the door to a future of unparalleled innovation and achievement.

For too long our tax code has been a source of ridicule and resentment, violating our Nation's most fundamental principles of justice and fair play. While most Americans labor under excessively high tax rates that discourage work and cut drastically into savings, many are able to exploit the tangled mass of loopholes that has grown up around our tax code to avoid paying their fair share -- sometimes to avoid paying any taxes at all.

The American people want change and for very good reason. Our present tax code is not only unfair, it slows economic growth and job creation, and hinders technological advancement by interfering with free markets and diverting productive investment into tax shelters and tax avoidance schemes. In 1981, we made the first necessary, historic step by cutting tax rates and opening the way to vibrant economic growth and expanding opportunity for all Americans. Now is the time to build on our success, to redesign the basic structure of our tax system in order to discourage non-productive economic activity, to encourage greater compliance and to liberate incentives still further.

Accordingly, I hereby submit my proposal to overhaul our tax code based on the principles of simplicity and fairness, opening the way to a generation of growth. This is a tax proposal we can be proud of, a proposal that will help fulfill America's commitment to fairness, hope, and opportunity for all its citizens.

I urge your prompt enactment of this historic program for redesigning the tax code, and I look forward to working with you toward that end.

Ronald Reagan

THE WHITE HOUSE,

May 29, 1985.

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity

May 1985

Summary

THE PRESIDENT'S PROPOSALS FOR FAIRNESS, GROWTH, AND SIMPLICITY

SUMMARY

The President's proposals would reduce tax rates, reduce complexity, increase fairness, and increase growth. The following is a summary of the proposals and their rationale.

I. THE PROBLEM WITH THE CURRENT TAX SYSTEM

(A) The overwhelming majority of Americans are dissatisfied with the current tax system. They are concerned because:

(1) The system is unfair.

- People are troubled by stories of wealthy individuals and healthy corporations paying little or no taxes.

- They can't understand the logic or equity of people in seemingly similar situations paying dramatically different amounts of tax.

- They read or hear of one tax break after another -- from credits for investments in windmills to deductions for "educational" cruises on ocean liners -- and know that they are not getting the benefit of such breaks.

- They are skeptical of the economic justification of many tax shelter schemes -- and see them as tax dodges.

(2) The system is too complicated.

- For some, it seems a difficult -- and sometimes even ridiculous -- administrative burden. About half of all Americans seek professional tax advice; no doubt, more feel they may need it.

- And while others may not find the system so burdensome, they often resent complexity nonetheless: They sense it is unfair -- that complexity is the means by which some benefit while others do not.

(3) The current system needlessly impedes growth.

-- By encouraging investment for purposes of tax reduction rather than for independently worthy economic purposes, it prevents the market from allocating resources as efficiently and productively as it might.

-- By taxing workers' earnings at excessive rates -- or by being perceived as taxing unfairly -- it discourages work, saving, productivity, innovation, and growth.

-- Thus, it prevents workers and the economy from reaching their full potential.

(B) As dissatisfaction increases, the continued viability of the tax system is threatened -- and as it is threatened, so too is the basis of support for essential governmental services and functions.

(1) The "underground economy" and the "tax gap" (taxes owed but not paid) are large and thought to be growing. The American tradition of voluntary tax compliance is being eroded.

(2) Efforts to increase compliance within the framework of the current system seem not only to have reached the point of diminishing returns. They often seem to be counter-productive: They increase resentment and disrespect for a system that cannot long function without a firm foundation of public confidence.

(C) Americans want change.

America was born in a revolutionary context that grew out of popular resentment of an unfair tax system. Two centuries later, another revolution is quietly growing. It is a peaceful revolution -- but again it is born of popular resentment of a tax system that has gone awry.

Americans want a new system. This is not a conventional partisan matter. The tax reform movement has strong advocates within both political parties. With bipartisan effort and cooperation, Americans can have the new system they want and deserve: a system that interferes less with economic choices; that promotes growth; that is simpler; and, perhaps most importantly, that people perceive to be fair.

II. THE PRESIDENT'S PROPOSALS FOR REFORM

To increase growth, reduce complexity, and make the system more fair, the President has proposed a comprehensive set of reforms. The following are key features:

(A) PERSONAL RATE REDUCTION:

Personal income tax rates must be lowered substantially as the tax base is broadened.

(1) The President's proposals would eliminate the present system of 14 brackets of tax rates ranging from 11 to 50 percent. In its place would be a simple 3-bracket system -- with tax rates of 15, 25, and 35 percent. (For joint returns, the rates would be: 0% up to $4,000 in taxable income; 15% on the amount from $4,000 to $29,000; 25% on the amount from $29,000 to $70,000; and 35% on the amount over $70,000.)

- -- Marginal tax rates would be reduced by an average of 19 percent.
- -- Average tax rates would be reduced for all income classes.
- -- Total taxes paid by individuals would be reduced by 7 percent.

(2) The complex system of itemized deductions, exclusions, and special credits would be substantially simplified and reformed. More than 65 categories of preferential tax treatment would be eliminated or curtailed. For example:

- -- Deductions for entertainment and business meal expenses would be limited.
- -- The deductibility of state and local taxes -- which contributes to the problem of high federal tax rates, and which can be conceived as a special subsidy to high-income taxpayers in high-tax states -- would be repealed.
- -- Unemployment and disability payments (with the exception of veterans' disability payments) would be treated as income.

-- Relatively narrow tax benefits available only to a few -- like "business" deductions for educational seminars on cruise ships or for the use of sky-boxes at sporting events -- would be eliminated. Similarly, such tax abuses as those associated with income shifting to minor children or to certain trusts would be limited.

(3) Only a limited number of special deductions and exclusions would be retained -- principally those that are widely used, and generally judged to be central to American values. For example:

-- In view of America's unequivocal commitment to private home-ownership, the home mortgage interest deduction would be retained for a taxpayer's principal residence.

-- In view of America's special obligations to Social Security beneficiaries and disabled veterans, the current preferential treatment of Social Security and veterans' disability payments would be retained.

-- And in view of America's longstanding commitment to charity and voluntarism, the itemized deductions would be retained for charitable contributions.

(B) SUPPORT FOR FAMILIES:

Insofar as the tax system affects the American family, it should contribute to strengthening it rather than weakening it. Accordingly:

(1) The President's proposals would increase the personal exemption to $2,000 as of January 1, 1986 for each taxpayer and dependent -- and would index this amount to protect against inflation.

(2) The "earned income tax credit" for the working poor would be increased and indexed to protect against inflation.

(3) The incentive for private saving through Individual Retirement Accounts (IRAs) -- now available to all wage-earners -- would be expanded to afford the same benefit to spouses working in the home.

(C) FAIRNESS FOR THE POOR:

The tax system should not be an additional burden to those who are struggling to escape from poverty; insofar as possible, those below the poverty line should be freed from taxation altogether.

By raising the personal exemption, the "zero bracket amounts," and earned income tax credit, and by expanding the credit for the blind, elderly, and disabled, the President's proposals would:

(1) assure that virtually all families at or below the poverty line would be freed from taxation; and

(2) assure that virtually all older, blind, or disabled Americans at or below the poverty line would be freed from taxation.

(D) RETURN-FREE FILING:

The administrative burden on individuals should be reduced, not increased.

If the President's proposals are adopted, the number of taxpayers likely to itemize will be reduced to only 33 percent. And it will be possible to administer a "return-free" filing system that would permit more than half of all taxpayers to receive an appropriate tax bill or refund without ever having to file a return. This system would be entirely voluntary. At the taxpayer's discretion, the administrative burden would be borne by the IRS based on information already scheduled to be available to it.

(E) INCENTIVES FOR GROWTH:

The tax system should, insofar as possible, foster economic growth by encouraging work, saving, and investment; rewarding risk-taking from which there is general benefit; and allowing resources to be allocated efficiently on the basis of economic rather than tax considerations. With this in view:

(1) Changes in the tax system for individuals -- reducing rates and increasing the perception of fairness -- should increase incentives for work, saving, investment, risk-taking, and innovation. In addition, a more efficient and productive economy and faster growth would be fostered through the following, which relate primarily to business taxation.

(2) Special subsidies or preferences for specific industries or sectors should be curtailed except where there is a clear national security interest that argues to the contrary. Accordingly, the President's detailed proposals include limitations on preferences that are now available to:

-- banking;

-- insurance;

-- mining;

-- timber;

-- oil and gas; and

-- non-government beneficiaries of tax-exempt bonds.

(3) Distortions of investment patterns resulting from unjustifiable tax shelter schemes should be reduced -- as, for example, through the extension of "at risk" rules to the real estate sector.

(4) Incentives for investment in research and experimentation should be preserved through a more accurately targeted credit for such investment.

(5) Incentives for higher-risk venturing -- from which there is often greater social gain -- should be provided by excluding from taxable income 50 percent of long-term capital gains. (This would reduce the present maximum capital gains tax from 20% to 17.5%.)

(6) Tax-induced distortions among differing categories of investment should be reduced, while avoiding an overall increase in the cost-of-capital. To this end:

-- The investment tax credit should be repealed and the accelerated depreciation system should be revised and indexed for inflation to bring effective tax rates closer together for different categories of investment.

-- Firms using the "FIFO" (first-in-first-out) inventory accounting system should also be allowed to index the value of inventories for inflation (or to use "LIFO" without the conformity obligation).

-- To alleviate the double taxation of dividends, the principle of corporate dividend deductibility should be established with an initial deductible amount of 10 percent.

-- The maximum corporate tax rate should be reduced to 33 percent -- keeping it roughly in line with the maximum individual rate.

(7) Small business formation and development -- from which much of America's extraordinary job-creation comes -- should be facilitated through a graduated corporate rate structure that benefits small business and is phased out for larger ones.

NOTE RE GROWTH AND "REVENUE NEUTRALITY":

Taken together, the President's proposals are "revenue neutral" (plus-or-minus 1.5% of total revenues) -- using conventional estimating procedures, without changing macro-economic assumptions. That is, under these assumptions, the proposals would, when fully effective, raise virtually the same amount of revenue as current law.

For reasons suggested above, it is reasonable to expect improved economic performance as a result of the President's tax proposals. The Treasury Department estimates that the effect of the proposals would be to cause real GNP to be at least 1.5 percent higher by 1995 than it would be under current law. Because of the inherent uncertainty in such forecasts, however, this additional growth has not been added to Administration forecasts and is not reflected in higher revenue estimates.

(F) OVERALL FAIRNESS OF CHANGES:

In addition to the increased perception of fairness that derives from rate reduction, base-broadening, and the elimination of special preferences, it is important that the overall effect of the proposals be deemed fair when judged by such measures as the following:

(1) The number of taxpayers who "win" and who "lose": The President's proposals would produce benefits or no change in individual tax liabilities for 79 percent of families and losses for only 21 percent of families. This pattern holds across all income groups -- and is strongest in the lowest income categories. (Even those whose taxes would not change would benefit from simplification and increased fairness.)

(2) The pattern of tax reductions by income class: The President's proposals would reduce total individual income taxes by 7 percent overall. The amount of taxes paid by those in the lowest three income categories would be reduced by the largest percentages, an average of 18.3 percent.

(3) The distribution of the overall tax burden by income class: The President's proposals would result in roughly the same percentage of total revenues being contributed by each income class as is contributed under current law -- except for the poor, who would pay a much smaller percentage.

(4) The effects on those at or below the poverty line: The President's proposals would remove from income taxation altogether virtually all families, married couples, single heads of households, and older Americans at or below the poverty line.

(5) The number of economically healthy, income-earning individuals and corporations who may escape taxation altogether: The President's proposals to reform individual and corporate taxes will substantially reduce incentives and opportunities to escape all income taxation ("zero out"). As additional assurance that some contribution is made by all economically healthy, income-earning individuals and corporations, the proposals also include minimum tax requirements for both individuals and corporations.

(6) The distribution of the tax changes between corporations and individuals: This is not a particularly relevant economic measure; but it is often judged to be important as a matter of perception. When fully effective, the President's proposals would raise total corporate tax payments by an estimated 9 percent, and would lower total individual tax payments by 7 percent.

Charts that amplify these points are attached. Also attached, for summary reference purposes, is a chart that compares current law, the November 1984 Treasury Department proposals, and the President's May 1985 proposals. Detailed discussion of the President's proposals is provided in the associated volume.

# # #

Chart 1

Comparison of Marginal Tax Rates
Under Current Law and Proposal for 1986
Single Returns

Current Law 1/		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than $ 2,480	0	0	Less than $ 2,900
$ 2,480 - 3,670	11		
3,670 - 4,750	12		
4,750 - 7,010	14		
7,010 - 9,170	15		
9,170 - 11,650	16	15	$ 2,900 - 18,000
11,650 - 13,920	18		
13,920 - 16,180	20		
16,180 - 19,640	23		
19,640 - 25,360	26		
25,360 - 31,070	30	25	18,000 - 42,000
31,070 - 36,790	34		
36,790 - 44,780	38		
44,780 - 59,670	42	35	42,000 or more
59,670 - 88,260	48		
88,260 or more	50		

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1/ Estimated.

Chart 2

Comparison of Marginal Tax Rates
Under Current Law and Proposal for 1986
Joint Returns

Current Law 1/		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than $ 3,670	0	0	Less than $ 4,000
$ 3,670 – 5,930	11		
5,930 – 8,200	12		
8,200 – 12,840	14		
12,840 – 17,260	16	15	$ 4,000 – 29,000
17,260 – 21,800	18		
21,800 – 26,540	22		
26,540 – 32,260	25		
32,260 – 37,980	28		
37,980 – 49,420	33	25	29,000 – 70,000
49,420 – 64,740	38		
64,740 – 92,360	42		
92,360 – 118,040	45		
118,040 – 175,230	49	35	70,000 or more
175,230 or more	50		

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1/ Estimated.

Chart 3

Comparison of Marginal Tax Rates
Under Current Law and Proposal for 1986
Head of Household Returns

Current Law 1/		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than $ 2,480	0		
$ 2,480 - 4,750	11	0	Less than $ 3,600
4,750 - 7,010	12		
7,010 - 9,390	14		
9,390 - 12,730	17	15	$ 3,600 - 23,000
12,730 - 16,180	18		
16,180 - 19,640	20		
19,640 - 25,360	24		
25,360 - 31,070	28		
31,070 - 36,790	32	25	23,000 - 52,000
36,790 - 48,230	35		
48,230 - 65,390	42		
65,390 - 88,260	45		
88,260 - 116,850	48	35	52,000 or more
116,850 or more	50		

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1/ Estimated.

Chart 4

MARGINAL RATES OF TAX BY FAMILY ECONOMIC INCOME
Current Law and President's Proposal

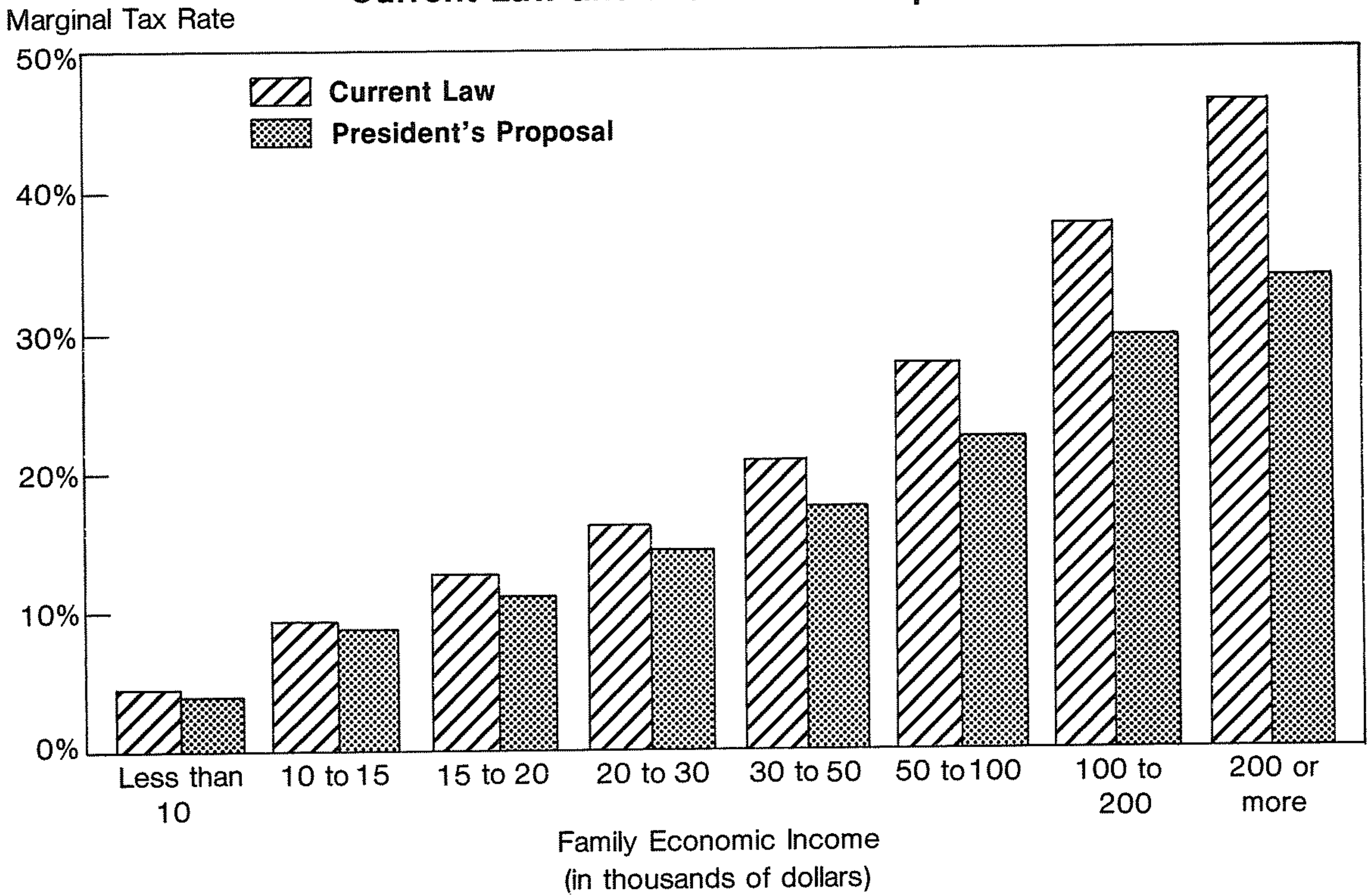

Chart 5

AVERAGE RATES OF TAX ON FAMILY ECONOMIC INCOME
Current Law and President's Proposal

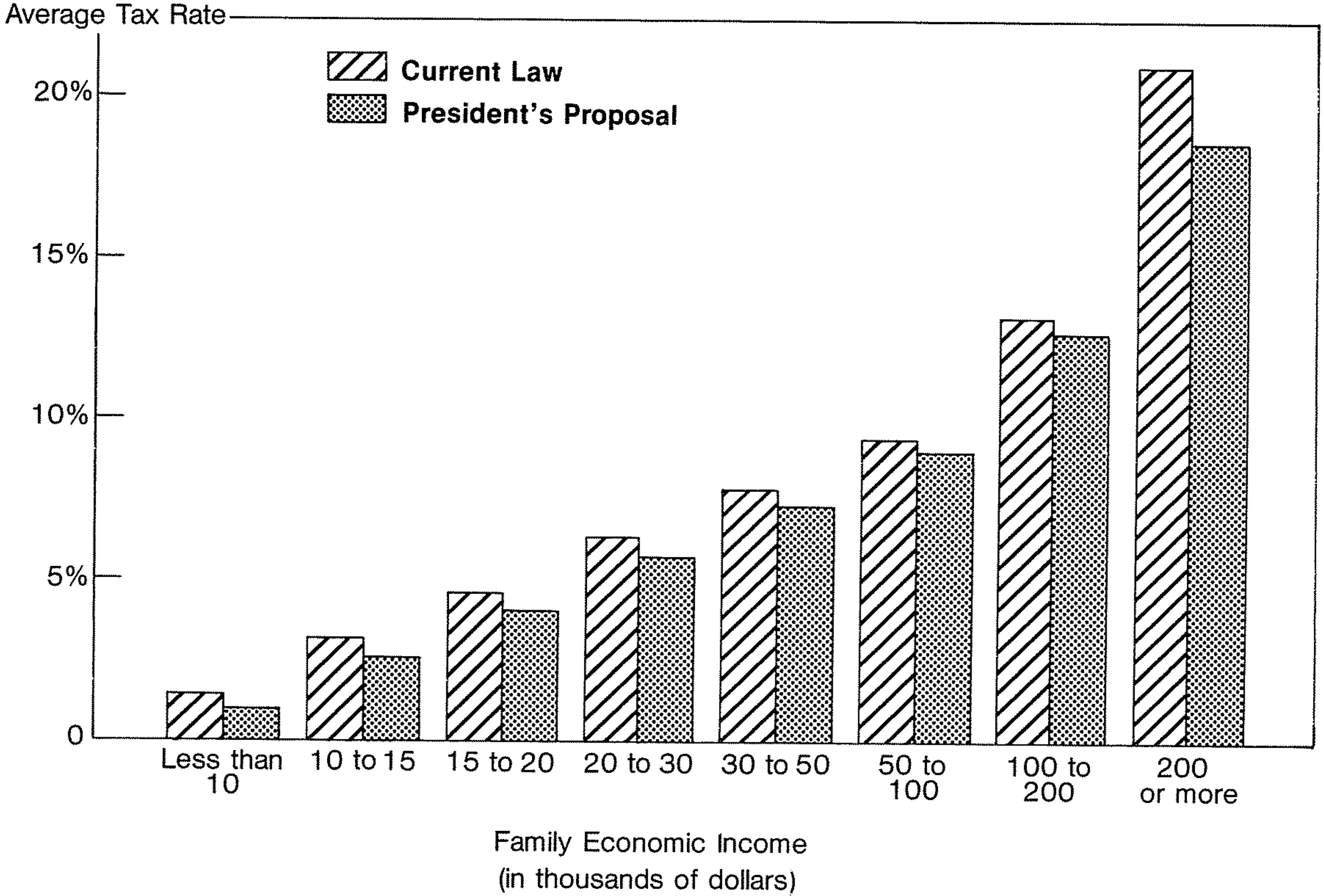

Chart 6

PERCENTAGE TAX REDUCTION
Under the President's Proposal

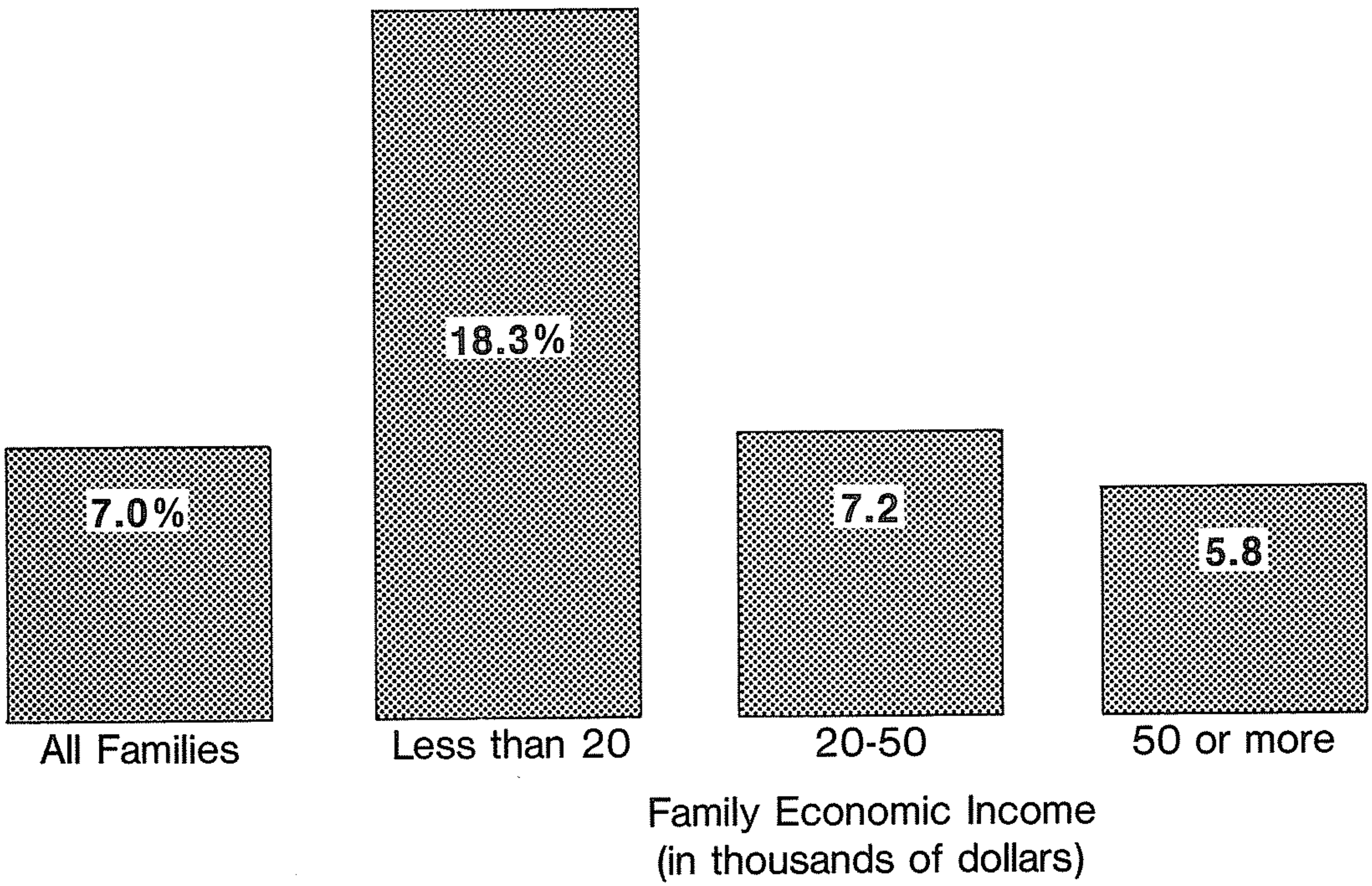

Chart 7

PERCENTAGE TAX REDUCTION BY FAMILY ECONOMIC INCOME
Under the President's Proposal

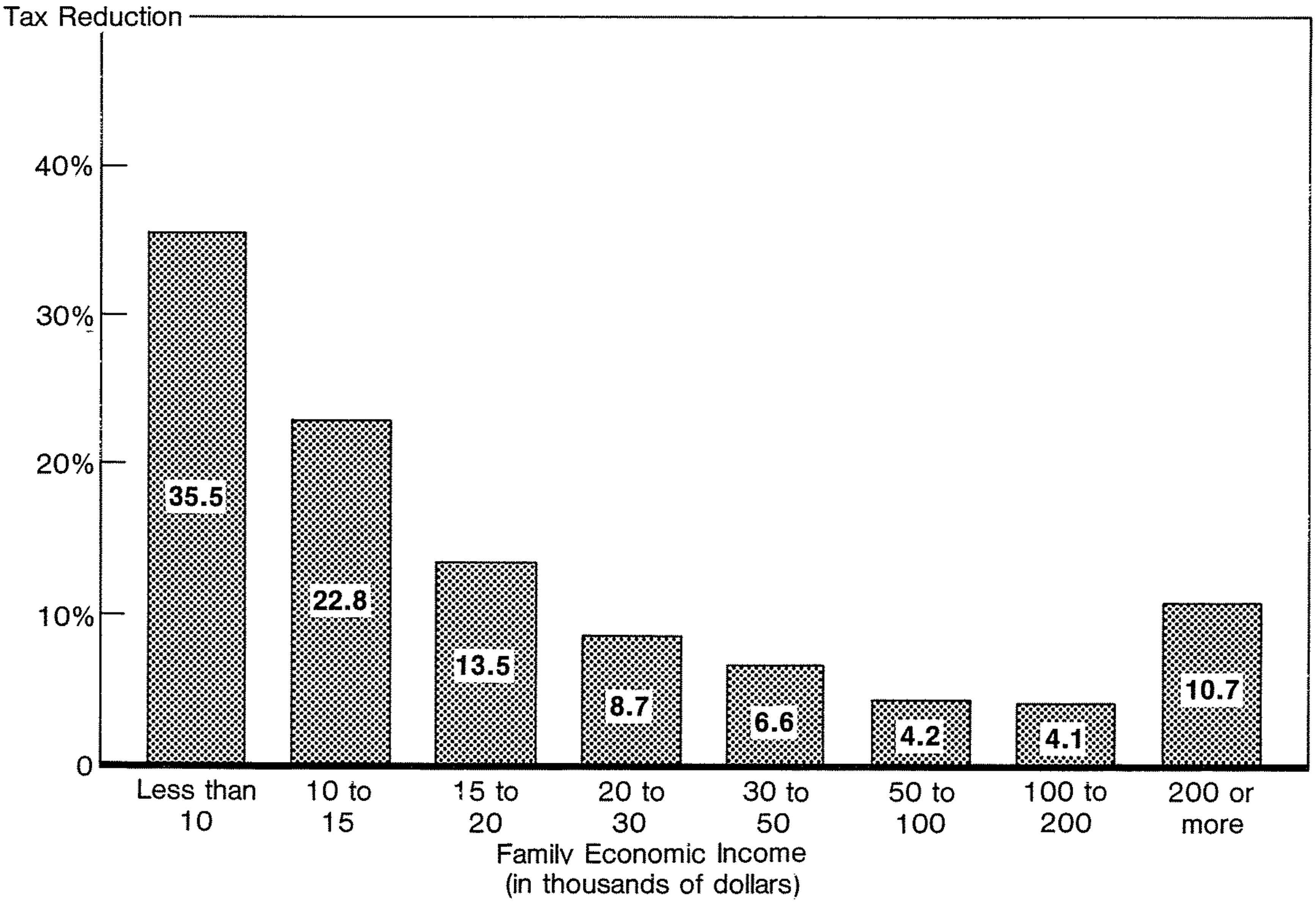

Chart 8

Average Tax Rate and Change in Taxes Paid by Income Class

Income Class	Average Tax Rate: Current Law	Average Tax Rate: President's Proposal	Change in Taxes
Less than $10,000	1.4 %	0.9 %	-35.5 %
$10,000 - $15,000	3.2	2.5	-22.8
$15,000 - $20,000	4.6	4.0	-13.5
$20,000 - $30,000	6.3	5.7	-8.7
$30,000 - $50,000	7.8	7.3	-6.6
$50,000 - $100,000	9.4	9.0	-4.2
$100,000 - $200,000	13.2	12.7	-4.1
$200,000 and Over	21.0	18.7	-10.7
Total	8.7 %	8.1 %	-7.0 %

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Chart 9

PERSONAL EXEMPTION
Current Law and President's Proposal

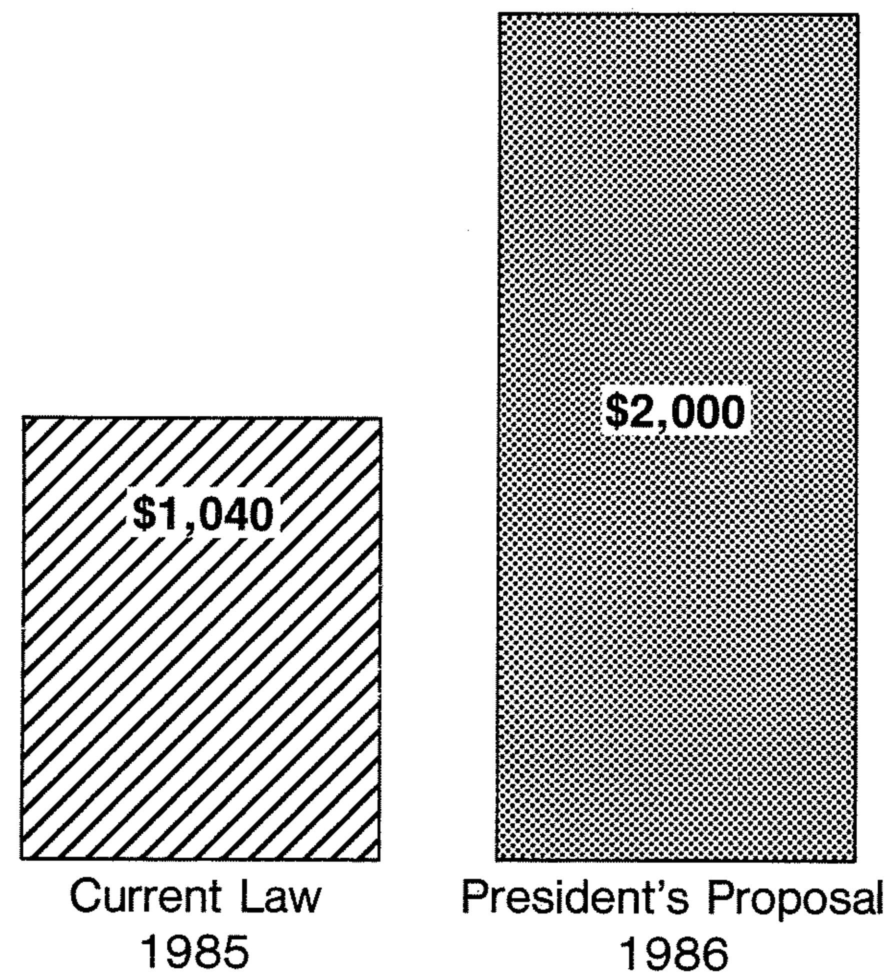

Chart 10

TAX-FREE INCOME LEVELS
Current Law and President's Proposal
(For Taxpayers under Age 65)

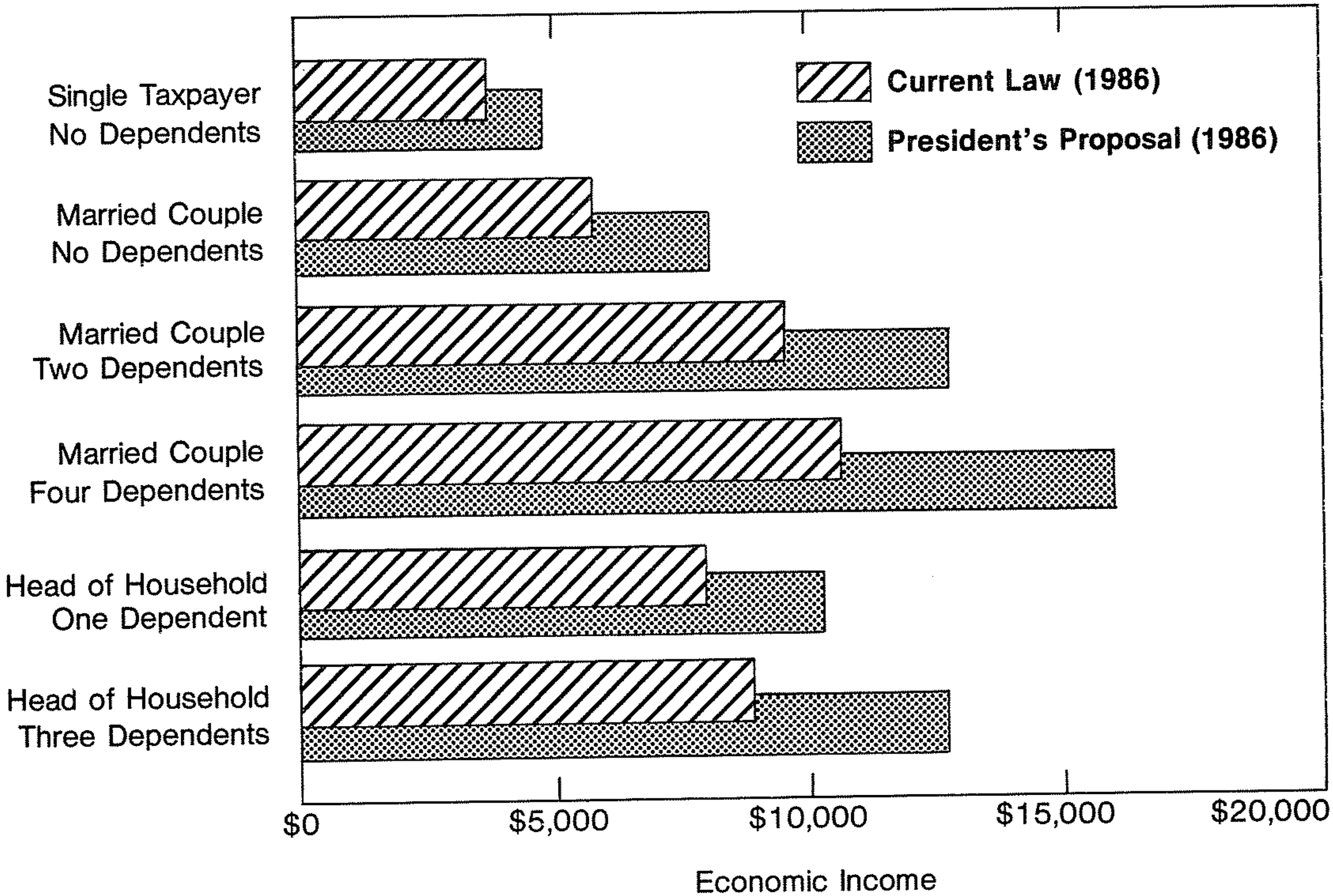

Chart 11

TAX-FREE INCOME LEVELS
Current Law and President's Proposal

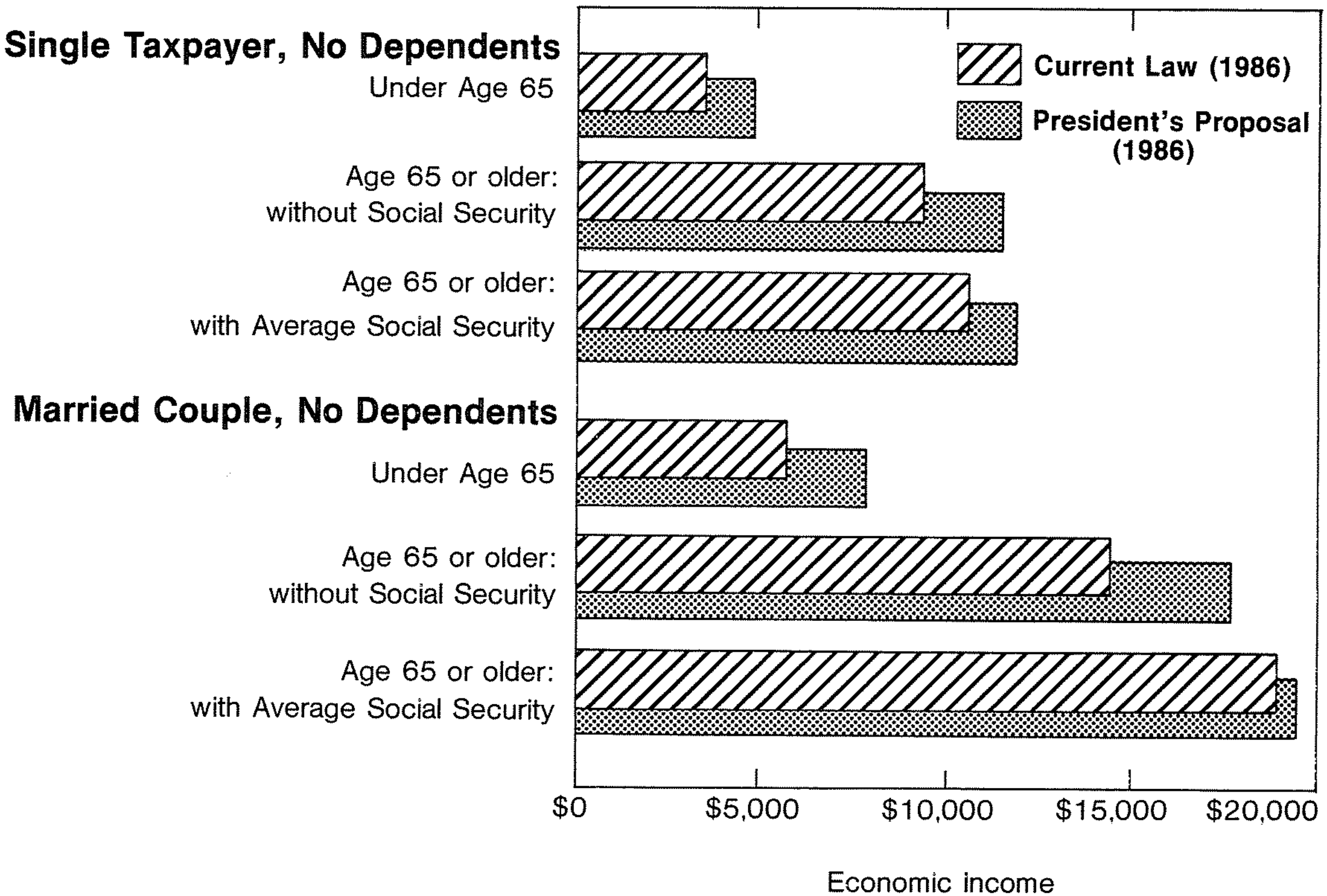

Chart 12

Comparison of the Poverty Threshold and the Tax-Free Income Level Under Current Law and the President's Proposal (1986 Levels)

Status	Poverty Threshold	Tax-Free Income Levels: Current Law 1/	Tax-Free Income Levels: Treasury Proposal
Single taxpayer, no dependents			
Under age 65	$ 5,800	$ 3,560	$ 4,900
Age 65 or older:			
No Social Security	5,400	9,383	11,600
Average Social Security	5,400	10,640	11,900
Married couples, no dependents			
Under age 65 3/	7,500	5,830	8,000
Age 65 or older:			
No Social Security	6,800	14,450	17,667
Average Social Security	6,800	18,990	19,500
Married Couples:			
Two dependents 2/ 3/	11,400	9,575	12,798
Four dependents 2/ 3/	15,000	10,598	16,000
Heads of households:			
One dependent 2/	7,700	7,945	10,158
Three dependents 2/	11,400	9,010	12,558

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1/ Includes expected indexation for inflation in 1985.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

Chart 13

FAMILIES WITH TAX CHANGE
Under the President's Proposal

(As a Percent of All Families)

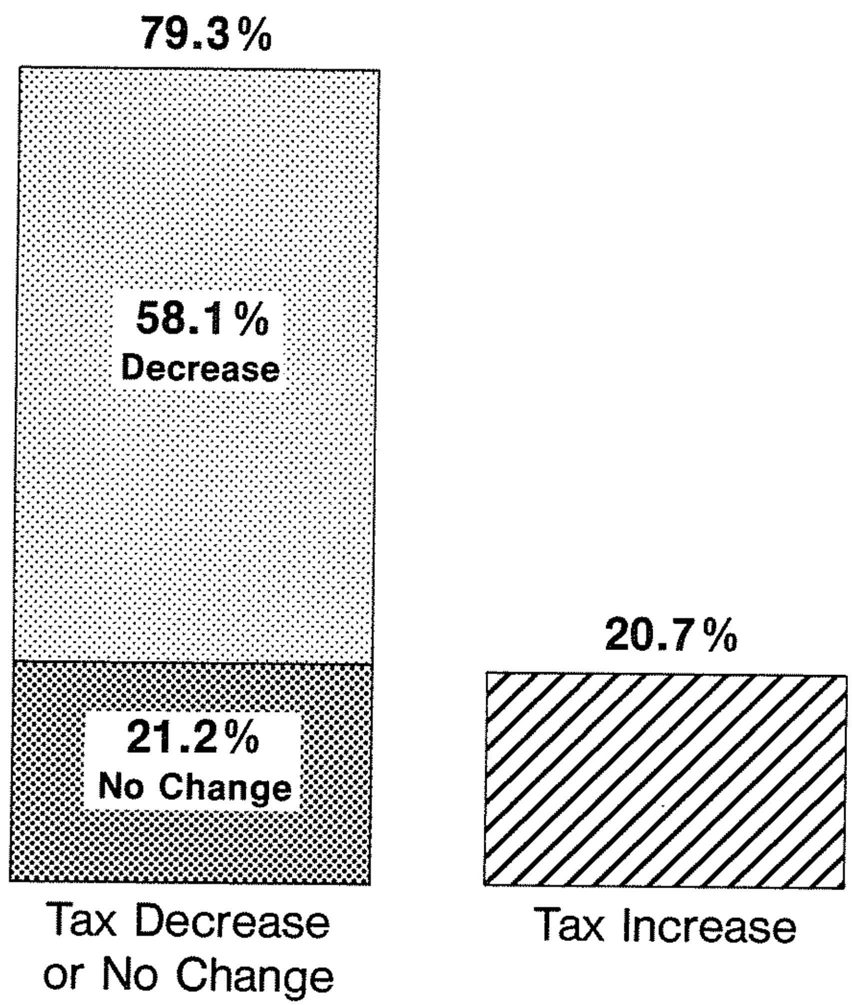

Chart 14

FAMILIES WITH TAX CHANGE BY FAMILY ECONOMIC INCOME
Under the President's Proposal
(As a Percent of All Families)

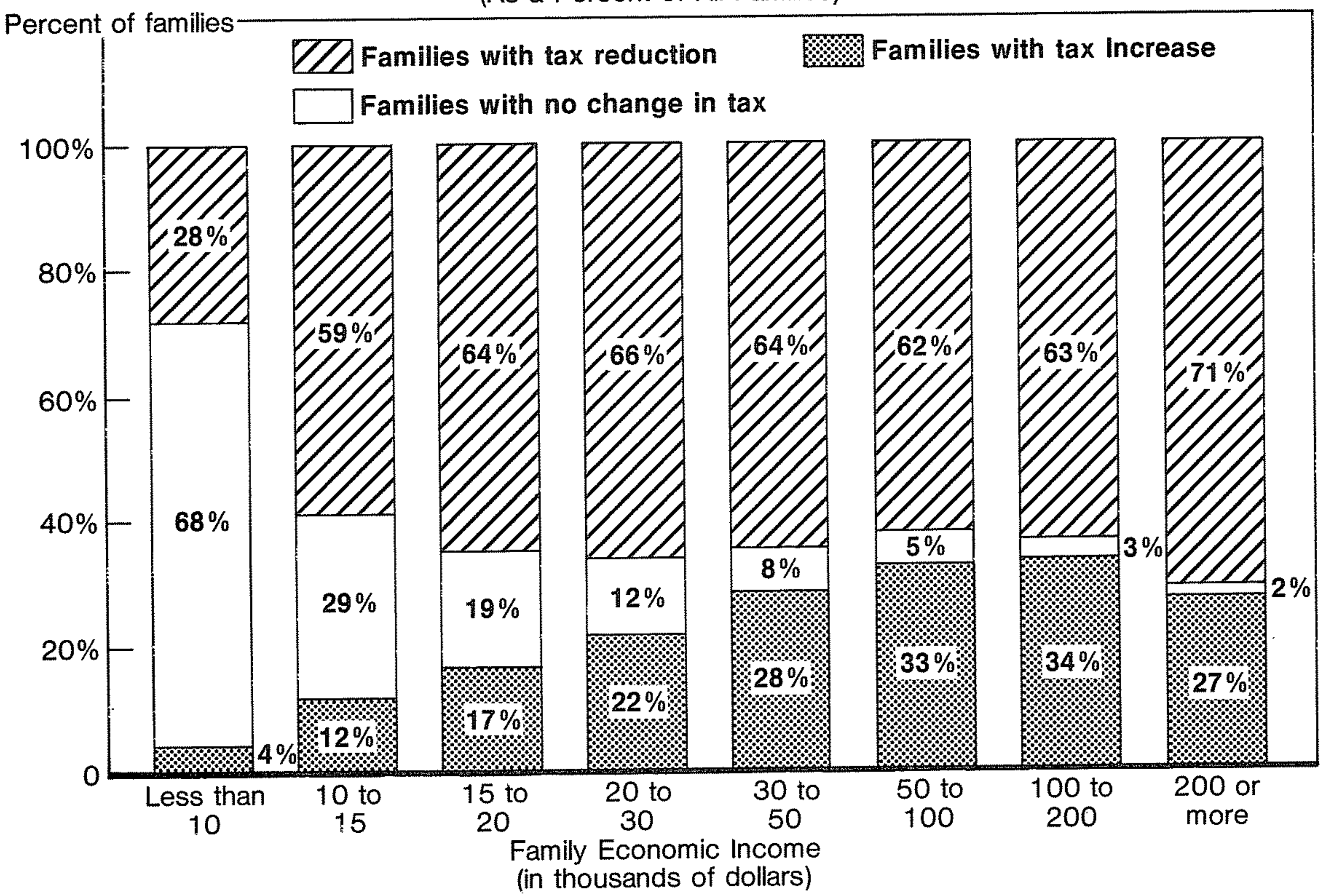

Chart 15

PERCENTAGE CHANGE IN TAXABLE INCOME
Under the President's Proposal

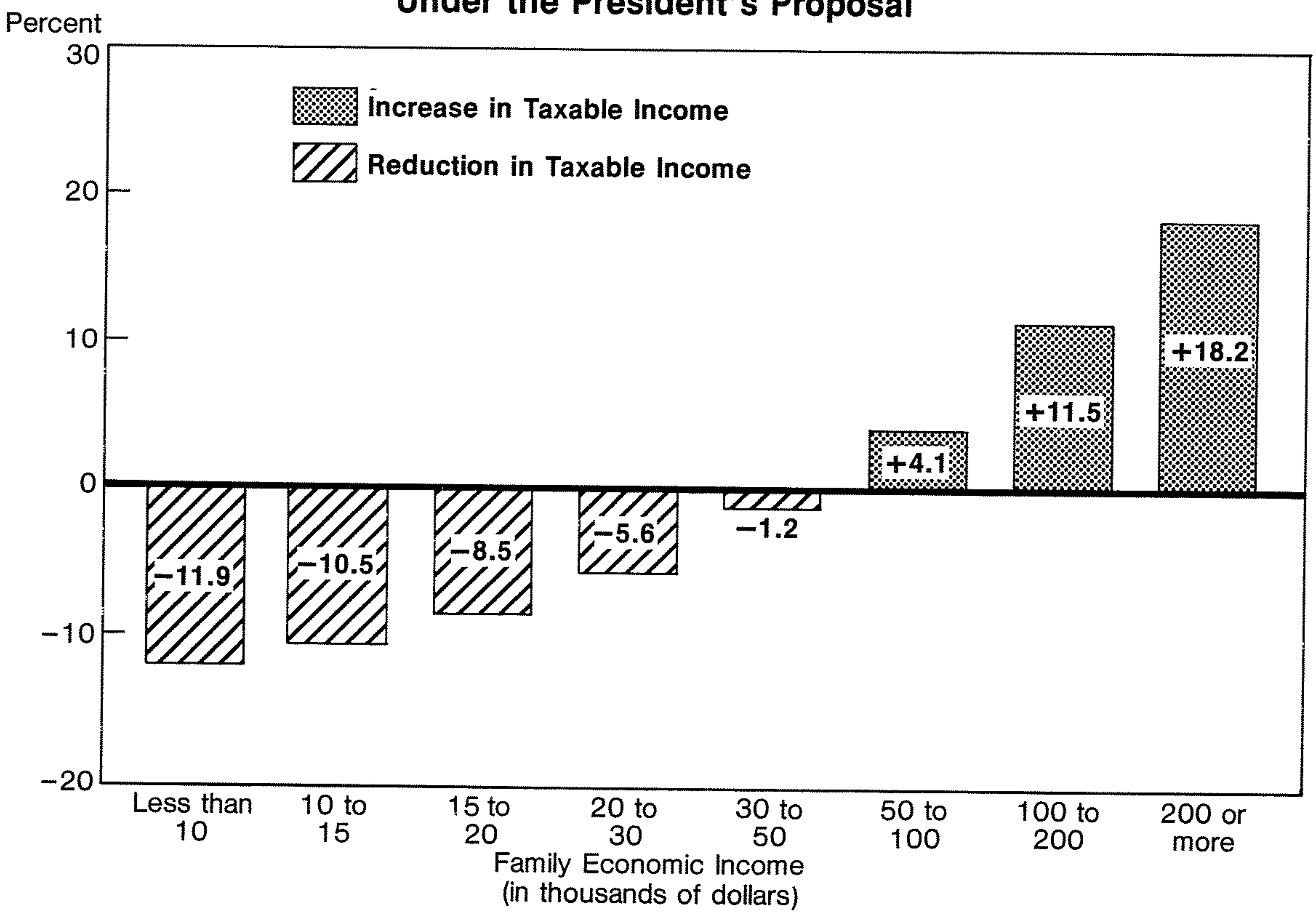

Chart 16

DISTRIBUTION OF TAXES PAID BY FAMILY ECONOMIC INCOME
Current Law and President's Proposal

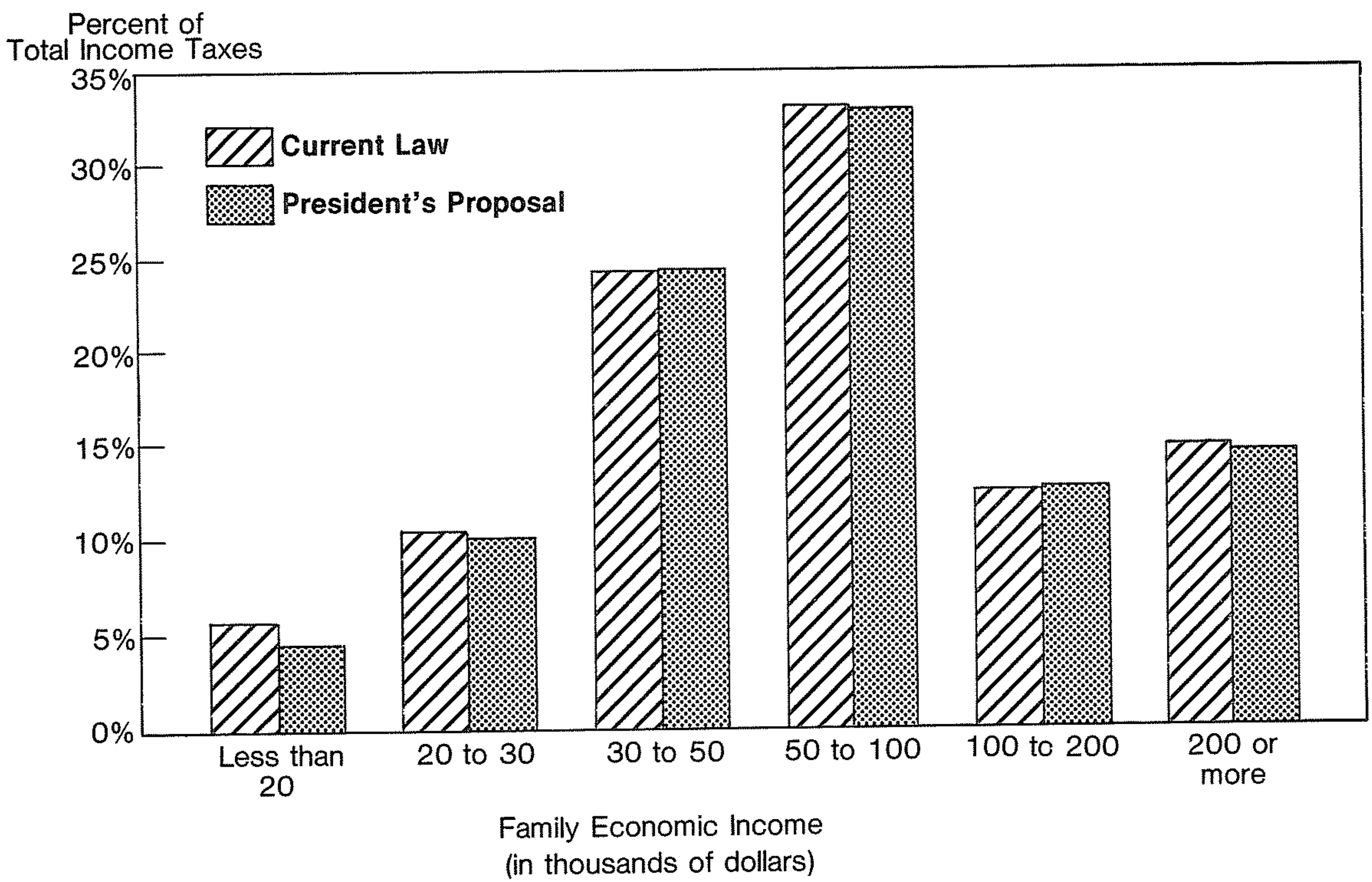

Chart 17

Distribution of Taxes Paid by Income Class

Income Class	Percent of Total Income Taxes Paid: Current Law	Percent of Total Income Taxes Paid: President's Proposal
Less than $10,000	0.5 %	0.3 %
$10,000 - $15,000	1.8	1.5
$15,000 - $20,000	3.3	3.0
$20,000 - $30,000	10.3	10.1
$30,000 - $50,000	24.3	24.4
$50,000 - $100,000	32.7	33.7
$100,000 - $200,000	12.3	12.7
$200,000 and Over	14.8	14.3
Total	100.0 %	100.0 %

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Chart 18

Comparison of Highlights of Current Law,
November 1984 Treasury Proposal, and President's Proposal

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Individual tax rates	14 rate brackets from 11 to 50%, indexed	3 rate brackets 15, 25 & 35%, indexed	3 rate brackets 15, 25 & 35%, indexed
Exemptions			
Self, spouse	$1,080, indexed	$2,000, indexed	$2,000, indexed
Dependents	$1,080, indexed	$2,000, indexed	$2,000, indexed
Zero bracket amount			
Single	$2,480, indexed	$2,800, indexed	$2,900, indexed
Joint	$3,670, indexed	$3,800, indexed	$4,000, indexed
Heads of household	$2,480, indexed	$3,500, indexed	$3,600, indexed
Two-earner deduction	Yes	No	No
Earned income credit	Yes ($550 maximum)	Yes, indexed	Increased and indexed ($726 maximum)
Child care expenses	Tax credit	Deduction	Deduction
Fringe benefits			
Health insurance	Not taxed	Taxed above a cap	Limited amount taxed
Group-term life insurance, legal services, dependent care, education assistance	Not taxed	Taxed	Not taxed

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	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Parsonage allowance	Not taxed	Taxed	Not taxed
Wage Replacement			
Unemployment compensation	Taxed if AGI over $12,000 ($18,000 if married)	Taxed	Taxed
Workers' compensation	Not taxed	Taxed, but eligible for special credit for elderly and disabled	Taxed, but eligible for expanded and indexed credit for elderly and disabled
Veterans' disability benefits	Not taxed	Taxed	Not taxed
Itemized Deductions			
State and local income tax	Deductible	Not deductible	Not deductible
Other state and local taxes	Deductible	Not deductible, unless incurred in income-producing activity	Not deductible, unless incurred in income-producing activity
Charitable contributions	Deductible by itemizers and nonitemizers	Deductible (above 2% of AGI) for itemizers, but no deduction for non-itemizers or for unrealized gains on contributed property	Deductible for itemizers, but no deduction for non-itemizers
Mortgage interest	Deductible	Deductible, for principal residences	Deductible, for principal residences

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Other personal interest	Personal interest deductible; investment interest limited to $10,000 over investment income	Limited to $5,000 over investment income for expanded definition of interest subject to limit	Limited to $5,000 over investment income for expanded definition of interest subject to limit (with phase-in)
Medical expenses	Deductible (above 5% of AGI)	Deductible (above 5% of AGI)	Deductible (above 5% of AGI)
Tax Abuses			
Entertainment expenses	Deductible	Not deductible	Not deductible
Business meals and travel expenses	Deductible	Deduction denied for meal costs above cap	Deduction denied for 50% of meal costs above cap
Income shifting to children and via trusts	Permissible	Curtailed	Curtailed, except for post-death trusts
Retirement savings			
IRA	$2,000	$2,500	$2,000
Spousal IRA	$ 250	$2,500	$2,000
Corporate pensions	Tax deferred	Tax deferred	Tax deferred
Social security	Generally not taxed	Generally not taxed	Generally not taxed
Capital and business income			
Corporate tax rates	Graduated, up to 46%	33% flat rate	Graduated, up to 33%
Limited partnerships	Losses flow through to partners	No loss flow through	Current law

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Dividend relief	$100/200 exclusion	Exclusion repealed; 50% dividend-paid deduction	Exclusion repealed; 10% dividend-paid deduction
Depreciation	ACRS	Economic depreciation, indexed	Indexed, with investment incentive
Investment tax credit	6% - 10%	No	No
Capital gains	60% excluded	Indexed, taxed as ordinary income	50% excluded (optional indexing in 1991)
Interest income/ expense	Fully taxed/ deductible	Indexed, partially excludable/nondeductible	Fully taxed/ deductible
Inventory accounting			
LIFO conformity required	Yes	No	No
FIFO	Not Indexed	Indexed	Indexed
Uniform production cost rules	No uniform rules	Uniform rules	Uniform rules
Installment sales	Deferral	No deferral if receivables pledged	Generally no deferral if receivables pledged
Bad debt reserve deduction	Yes	No	No
Oil industry			
Percentage depletion	Yes	No; Indexed cost depletion	Phased out with stripper exception
Expensing of intangible drilling costs	Yes	No	Yes

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Windfall profits tax	Will phase out in 1991	Phase-out accelerated	Will phase out in in 1991
Financial institutions			
Special bad debt deduction	Yes	No	No
Deduction for interest to carry tax-exempts	Yes	No	No
Exemption of credit unions	Yes	No	No, except for small credit unions
Deferral for life insurance income and annuity income	Yes	No	No, except for existing policies
Exemption of certain insurance companies including fraternal organizations	Yes	No	Yes
Municipal bonds			
Public purpose	Tax-exempt	Tax-exempt	Tax-exempt
Private purpose	Tax-exempt	Taxable	Taxable
Rehabilitation and energy credits	Yes	No	No
Minimum tax on individuals and corporations	Yes	Not necessary	Retain and tighten

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity

May 1985

General Explanation

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I. INDIVIDUAL INCOME TAXES

CHAPTER 1

REDUCE MARGINAL TAX RATES

REDUCE MARGINAL TAX RATES

General Explanation

Chapter 1.01

Current Law

The amount of tax imposed on taxable income in excess of the zero bracket amount of individuals varies from a minimum rate of 11 percent to a maximum rate of 50 percent. There are different rate schedules for four classes of taxpayers: (1) married individuals filing jointly and certain surviving spouses (14 tax rates); (2) heads of households (14 tax rates); (3) single individuals (15 tax rates); and (4) married individuals filing separately (14 tax rates). The progression of the rates for each class of taxpayers is adjusted annually for inflation as measured by the Consumer Price Index for all-urban consumers (CPIU).

Reasons for Change

The accumulation of tax exclusions and deductions over the years has substantially eroded the tax base, forcing higher rates of tax on income that is subject to tax. High marginal tax rates create disincentives for saving, investing, and working. These in turn constrict economic growth and productivity.

The Administration proposals would expand the base of income by eliminating many current deductions and exclusions unrelated to the proper measurement of taxable income. This expanded base permits a significant reduction in marginal tax rates without impairing Federal income tax revenues.

Proposal

The current 14 tax rates (15 for single taxpayers) would be replaced by three rates -- 15, 25, and 35 percent as shown on Table 1. The applicable tax rate brackets would be indexed as under current law.

Effective Date

The proposed individual tax rates would be effective July 1, 1986. Thus, the rate schedule for taxable years beginning on or after January 1, 1986, would reflect blended rates based on the new rates effective on July 1. Withholding to reflect the rate reduction would change on July 1, 1986.

Analysis

The proposal would reduce individual tax liabilities an average of 7 percent; marginal tax rates on economic income would be approximately 19 percent lower than under current law. The percentage reduction in taxes is greater at the bottom of the income scale than for middle-income families, due to the increase in the tax threshold. Tax liabilities of families with incomes below $10,000 would fall by an average of 35.5 percent, and the reduction in taxes for families with incomes below $20,000 would be 18.3 percent.

Table 1.01-1

1986 Current Law Tax Rate Schedules

Single Returns		Head of Household Returns		Joint Returns	
Taxable Income	Marginal Tax Rate (percent)	Taxable Income	Marginal Tax Rate (percent)	Taxable Income	Marginal Tax Rate (percent)
Less than $ 2,480	0	Less than $ 2,480	0	Less than $ 3,670	0
2,480 - 3,670	11	2,480 - 4,750	11	3,670 - 5,930	11
3,670 - 4,750	12	4,750 - 7,010	12	5,930 - 8,200	12
4,750 - 7,010	14	7,010 - 9,390	14	8,200 - 12,840	14
7,010 - 9,170	15	9,390 - 12,730	17	12,840 - 17,260	16
9,170 - 11,650	16	12,730 - 16,180	18	17,260 - 21,800	18
11,650 - 13,920	18	16,180 - 19,640	20	21,800 - 26,540	22
13,920 - 16,180	20	19,640 - 25,360	24	26,540 - 32,260	25
16,180 - 19,640	23	25,360 - 31,070	28	32,260 - 37,920	28
19,640 - 25,360	26	31,070 - 36,790	32	37,980 - 49,420	33
25,360 - 31,070	30	36,790 - 48,230	35	49,420 - 64,740	38
31,070 - 36,790	34	48,230 - 65,390	42	64,740 - 92,360	42
36,790 - 44,780	38	65,390 - 88,260	45	92,360 - 118,040	45
44,780 - 59,670	42	88,260 - 116,850	48	118,040 - 175,230	49
59,670 - 88,260	48	116,850 or more	50	175,230 or more	50
88,260 or more	50				

1986 Proposed Tax Rate Schedules

Single Returns		Head of Household Returns		Joint Returns	
Taxable Income	Marginal Tax Rate (percent)	Taxable Income	Marginal Tax Rate (percent)	Taxable Income	Marginal Tax Rate (percent)
Less than $ 2,900	0	Less than $ 3,600	0	Less than $ 4,000	0
2,900 to 18,000	15	3,600 to 23,000	15	4,000 to 29,000	15
18,000 to 42,000	25	23,000 to 52,000	25	29,000 to 70,000	25
42,000 or more	35	52,000 or more	35	70,000 or more	35

Office of the Secretary of the Treasury

May 28, 1985

CHAPTER 2

INCREASE FAIRNESS FOR FAMILIES

Fair and simple taxation of the family unit is a vital component of the Administration proposals. The proposals would accomplish these goals by redefining the tax threshold and by simplifying and rationalizing the provisions affected by the composition of the family unit.

Families with income at or below the poverty level should not be subject to income tax. Thus, the level of income at which tax is first paid would be raised so that for most taxpayers it approximates the poverty level. This would be accomplished by raising the zero bracket amounts, relatively more in the case of heads of households, and doubling the personal exemption compared with its 1984 level. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The working poor also would be protected by increasing the earned income credit and indexing it for inflation.

Special relief for the blind, elderly, and disabled would be consolidated in a single tax credit, and the existing child care credit would be replaced with a more appropriate deduction. In light of the flatter rate schedule, which increases work incentives for taxpayers generally, the two-earner deduction would be repealed.

INCREASE ZBA AND PERSONAL EXEMPTIONS

General Explanation

Chapter 2.01

Current Law

Individual income tax rates begin at 11 percent and progress to a top marginal rate of 50 percent. For nonitemizing taxpayers, no tax is imposed on taxable income up to the "zero bracket amount" (ZBA, also known as the "standard deduction"), which is $2,390 for unmarried individuals and heads of households, $3,540 for married couples filing joint returns and certain surviving spouses, and $1,770 for married individuals filing separately. Generally, a taxpayer may elect to itemize deductions only if the total amount of deductions exceeds the applicable ZBA.

In computing taxable income, each taxpayer is entitled to a personal exemption of $1,040 and to a dependency exemption of $1,040 for each of the taxpayer's dependents. If the taxpayer is blind or 65 years of age or older, an additional personal exemption of $1,040 is provided. On a joint return, each spouse is entitled to claim the applicable number of personal exemptions.

The ZBA and the amount deducted from income for each personal and dependency exemption are adjusted for inflation. The percentage increase in each amount equals the percentage increase in prices during the previous fiscal year, as measured by the consumer price index for all urban consumers.

Reasons for Change

The sum of personal and dependency exemptions plus the ZBA establishes a tax threshold below which a taxpayer's income is exempt from taxation. The current levels of the ZBA and the personal and dependency exemptions do not exempt from tax an amount necessary to maintain a minimum standard of living. Moreover, as family size increases, the cost of maintaining a minimum living standard increases more rapidly than the amount of income exempt from tax. For example, in 1986 a family of four generally would start paying tax when its income exceeds $9,575, which is approximately $1,825 below the poverty threshold for such families. By burdening poor families, the tax system makes their transition to prosperity more difficult. The tax system thus discourages family creation and weakens and limits those that are formed.

Because the current tax thresholds have not kept up with increases in incomes, the number of persons required to file returns has grown, along with the percentage of taxpayers forced to itemize deductions. The increase in the number of returns and of itemizers has placed additional recordkeeping burdens on taxpayers and also has drained the resources of the Internal Revenue Service. These increased costs are frequently out of proportion to the amounts of tax involved.

The additional personal exemptions provided to the blind and the elderly provide the greatest tax benefit to those elderly and blind taxpayers with the highest incomes. Thus, they are not the most effective way of reducing the tax burden for the blind and elderly who are in need.

Proposal

The ZBA would be increased to $2,900 for single returns, $4,000 for joint and certain surviving spouse returns, $2,000 for returns for married persons filing separately, and $3,600 for head of household returns. The amount deductible for each personal and dependency exemption would be increased to $2,000 for taxable years beginning on or after January 1, 1986, and would be indexed for inflation thereafter.

The additional exemptions for the blind and the elderly would be repealed, but special tax treatment for the elderly, blind, and disabled would be combined into a single tax credit. See Ch. 2.02.

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986.

Analysis

Table 1 compares the proposed personal exemptions and ZBA amounts to those under current law for 1986. The personal exemption for tax-payers, spouses, and dependents for 1986 would be increased to $2,000, compared to $1,080 under current law (after indexing for inflation expected to occur in 1985). The zero bracket amounts for single returns, head of household returns, and joint returns also would increase, as shown on Table 1.

Although the additional exemptions for the blind and the elderly would be repealed, low-income elderly and blind persons would be eligible for the expanded credit for the elderly, blind, and disabled. When the proposed increase in the personal exemption is combined with the expanded credit, the tax-free income level for elderly and blind persons would increase. The expanded tax credit would ensure that the income of low-income elderly and blind individuals would be exempt from tax.

Table 2 compares tax-free income levels for 1986 under current law and the Administration proposals with poverty thresholds for households of different sizes and compositions. Under the Administration proposals, the tax-free income levels would be increased for single persons and families of all sizes. For example, for 1986 the tax-free income level for a one-earner married couple with no dependents would increase from $5,830 to $8,000. A one-earner married couple with two children would pay no income tax unless its income exceeded $12,798, assuming full use of the earned income credit. Under current law, the same family would pay tax on income above $9,575.

Table 2 shows that the proposed increase in the personal exemption and zero bracket amounts would exempt from tax families in poverty. Although the gap between the tax-free income level and poverty threshold would be narrowed for single persons without dependents, the tax-free income level for such taxpayers would still be $900 less than the poverty level in 1986. If the tax-free income level for single persons were raised further to close the gap, however, single persons who decided to marry would experience a tax increase or "marriage penalty." Moreover, since single persons frequently live with relatives or unrelated persons, comparison of the tax-free income level with the poverty threshold for such persons often is misleading. When the tax-free income level for single persons is combined with the tax-free income levels of parents or other household members, the combined tax-free income level may exceed the poverty level.

Table 2.01-1

Comparison of Personal Exemption and ZBA for 1986
Under Current Law and the President's Proposal

	Current Law 1/	Proposed Law
Personal exemption		
For taxpayers, spouses, and dependents (each)	$1,080	$2,000
For the blind and the elderly (each)	1,080	2/
Zero-bracket amount		
Single persons	2,480	2,900
Heads of households	2,480	3,600
Married couples	3,670	4,000

Office of the Secretary of the Treasury May 28, 1985

1/ Includes indexation for expected inflation.

2/ Replaced with expanded credit.

Table 2.01-2

Comparison of the Poverty Threshold and the Tax-Free Income Level for 1986 Under Current Law and the President's Proposal

Status	Poverty Threshold	Tax-Free Income Levels: Current Law 1/	Tax-Free Income Levels: Proposed Law
Single persons without dependents	$ 5,800	$ 3,560	$ 4,900
Heads of households with one dependent 2/	7,700	7,945	10,158
Married couples 3/	7,500	5,830	8,000
Married couples with two dependents 2/ 3/	11,400	9,575	12,798

Office of the Secretary of the Treasury May 28, 1985

1/ Includes expected indexation for inflation.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

COMBINE TAX BENEFITS FOR ELDERLY, BLIND AND DISABLED INTO EXPANDED CREDIT

General Explanation

Chapter 2.02

Current Law

Individuals aged 65 or over and certain disabled persons are eligible for a nonrefundable credit equal to 15 percent of a defined "base amount." The base amount for the credit is computed by reference to the individual's "initial base amount." For those aged 65 or over, the initial base amount is $5,000 for a single person (or for a married couple filing jointly if only one spouse is aged 65 or over). If both spouses are 65 or older, the initial base amount is $7,500 if they file a joint return and $3,750 if they file a separate return and live apart at all times during the year.

The actual base amount for the credit is equal to an individual's initial base amount reduced by (i) the amount of nontaxable pension and annuity income (principally social security benefits) and most nontaxable disability payments, or (ii) one-half of the taxpayer's adjusted gross income in excess of $7,500 (for single taxpayers), $10,000 (for married couples filing joint returns), or $5,000 (for married individuals filing separate returns). When applied to the elderly, the credit provides a compensating tax benefit to those individuals who receive little or no social security benefits and hence derive little or no advantage from the exemption of such benefits from tax.

Individuals under age 65 also may qualify for the credit if (i) they receive employer-provided disability income or other taxable disability income and (ii) they are (or are expected to be) totally disabled for at least one full year. For these individuals, the initial base amount is the lesser of such disability income or the initial base amount that would apply if they were elderly. In these cases, the credit provides individuals receiving taxable disability payments with treatment comparable to that provided for recipients of tax-free workers' compensation and veterans' disability payments.

Elderly, blind, and disabled taxpayers also receive preferential treatment in other sections of the Internal Revenue Code. A taxpayer is allowed an additional personal exemption upon attaining age 65, and an additional exemption if he or she is blind. Each exemption reduces taxable income by $1,080 for 1986. In addition, most disability income is untaxed, including workers' compensation, black lung payments, veterans' disability payments, and personal injury awards. Finally, social security benefits (including social security disability income) are excluded from income unless the taxpayer's adjusted gross income (with certain modifications) exceeds $25,000 ($32,000 in the case of a joint return); in no event are more than one-half of such benefits included in income.

Reasons for Change

The preferential treatment applicable to elderly, blind, and disabled taxpayers recognizes the special hardships and costs such individuals encounter. Certain of the preferences available to such taxpayers under current law, however, provide the greatest benefit to those least in need. Thus, the additional personal exemptions for the elderly and blind provide the greatest benefit to those of the elderly and blind with the highest incomes. A $1,080 exemption is worth $540 to an individual in the 50 percent tax bracket, but only $216 to an individual in the 20 percent tax bracket. There is no justification for this disparity.

In contrast, the current credit for the elderly targets its assistance to those with the greatest need. Because of the dollar-for-dollar offset for social security benefits, the credit provides no benefit to those who receive the average level of social security benefits. Moreover, because the credit is phased out as income increases, it provides the greatest benefit to low-income taxpayers. The credit for taxable disability payments operates in the same manner, and thus similarly targets its benefits to low-income taxpayers.

Finally, the current credit for employer-provided disability income encourages the recharacterization of retirement income as disability income (for those retiring before age 65), since the latter is eligible for the credit.

Proposal

The current special tax benefits for the elderly, blind, and disabled would be combined in a single credit, similar to the current credit for the elderly and disabled. All newly taxable disability income (workers' compensation and black lung) would be made eligible for the credit. To restrict recharacterization of normal retirement income as disability income, employer-provided disability income would be eligible for the credit only if provided under a qualified plan.

The amount of the credit would be calculated in the same manner as under current law. The initial base amount for the blind and those over 65 would be $7,000 (in the case of single taxpayers or taxpayers filing joint returns that include only one blind or elderly taxpayer), $11,500 (in the case of joint returns where both spouses are blind or over 65), $8,750 (in the case of heads of households who are either blind or over 65), or $5,750 (in the case of a married individual filing a separate return who is either blind or over 65 and has lived apart from his or her spouse for the entire year). Limits on the amount of employer-provided disability income eligible for the credit would be increased to identical levels.

The income level at which the credit begins to phase out would be increased to $11,000 (for single taxpayers), $14,000 (for joint returns), $12,500 (for heads of household), or $7,000 (for married individuals filing separate returns).

Both the initial base amounts and the income levels at which the credit begins to phase out would be indexed for inflation, beginning in 1987.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986. Only taxable disability income would be eligible for the credit. The Administration proposals would require taxation of most workers' compensation and black lung payments received on or after January 1, 1987. Thus, with respect to such payments, the proposal generally would be effective on or after January 1, 1987.

Analysis

Table 1 compares the tax-exempt thresholds for the elderly and blind under current law and the Administration proposal. When combined with the proposed increase in their personal exemptions (to $2,000 in 1986), the expansion of the credit for the elderly, blind, and disabled would increase their tax-exempt thresholds, despite the elimination of their additional exemptions. The tax-exempt levels shown in the table are far in excess of those for taxpayers generally.

The proposal would provide more equitable treatment for the elderly and blind and would also reduce artificial distinctions between sources of disability income. The effect of extending the credit to other forms of disability income is discussed more fully in Ch. 3.07, relating to proposed changes in the taxation of workers' compensation and black lung benefits.

Table 2.02-1

1986 Tax-Free Levels of Income for the Elderly and Blind (And Those With Employer-Provided Disability Income)

	Single		Joint (Couple)	
	Current Law	Proposed Law	Current Law	Proposed Law
Ordinary Taxpayer	$ 3,560	$ 4,900	$ 5,830	$ 8,000
Age 65 or More 1/				
No Social Security	9,383	11,600	14,450	17,667
Average Social Security 2/	10,640	11,900	18,990	19,500
Blind 1/				
No Social Security	4,640	11,600	7,990	17,667
Average Social Security 2/	10,640	11,900	18,990	19,500
Under Age 65, with Employer-Provided Disability Income ($6,000 single/$9,000 joint)	9,383	10,400	14,450	15,333

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1/ For joint returns, assumes both are elderly/blind.

2/ Benefits of $6,000 (single) or $11,000 (joint).

REPEAL TWO-EARNER DEDUCTION

General Explanation

Chapter 2.03

Current Law

The progressive tax rate structure of current law often results in higher tax rates for couples whose incomes are combined as a consequence of marriage. This result contributes to the so-called "marriage penalty," i.e., the increase in a couple's aggregate tax liability that may occur due to their marriage. The marriage penalty is ameliorated in part by the joint return rate schedule, under which married couples are taxed at lower rates than a single person with the same amount of taxable income. Because of the joint return rate schedule, marriage can result in a reduction of tax liability for some couples. Whether marriage actually results in a tax penalty or "bonus" depends principally on the total amount of a couple's taxable income and the percentage of such income attributable to each spouse.

To limit the marriage penalty, current law provides a special deduction for married couples in which both spouses earn personal service income. Thus, two-earner married couples who file joint returns may deduct from gross income the lesser of $3,000 or ten percent of the qualified earned income of the spouse with the lower qualified earned income for the taxable year.

Reasons for Change

The current deduction for two-earner married couples is poorly designed to offset the increased tax liabilities that some couples face as a result of marriage. The deduction does not eliminate the marriage penalty for many couples, and for some it provides a benefit that exceeds any increase in tax liability caused by marriage. For still others, the deduction merely increases an existing marriage bonus. Moreover, because the deduction applies only to earned income, it has no effect when the marriage penalty arises from investment income.

The marriage penalty under current law is attributable primarily to the progressive rate structure and to the joint return concept, under which a married couple's income is aggregated for tax purposes. Abandonment of the joint return system would eliminate the marriage penalty, but would reintroduce a host of questions concerning how a couple's income and deductions are to be allocated between spouses. Moreover, taxing a married couple on the same basis as two single persons with equivalent combined income ignores that married couples frequently pool their incomes and may benefit from shared living expenses. An equally direct but better conceived response to the marriage penalty is to reduce marginal tax rates, which at current high levels may discourage labor force participation or reduce the number of hours worked by second earners (typically married women).

Proposal

The deduction for two-earner married couples would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The Administration proposals include flatter tax rate schedules and lower marginal tax rates. In general, these changes would reduce the significance of tax consequences in individual decisions and improve incentives for taxpayers to work and invest. Since the tax structure would retain a degree of progressivity, as well as joint return treatment for married couples, the Administration proposals would not eliminate the possibility of a marriage penalty, nor, for that matter, of a marriage bonus. They represent, however, a more direct and consistent attempt to minimize the impact of marriage on tax liabilities than the current two-earner deduction.

Repeal of the two-earner deduction would eliminate Schedule W and one line from Form 1040 and seven lines from Form 1040A.

INCREASE AND INDEX EARNED INCOME TAX CREDIT

General Explanation

Chapter 2.04

Current Law

An eligible individual is allowed a refundable credit against income tax equal to 11 percent of the first $5,000 of earned income. The maximum credit of $550 is reduced by an amount equal to 12 2/9 percent of the excess of adjusted gross income ("AGI") or earned income (whichever is greater) over $6,500. Thus, the credit is eliminated when AGI or earned income reaches $11,000. Earned income eligible for the credit includes wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment.

An individual is eligible for the earned income credit only if the individual lives in the United States and (1) is married, files a joint return, and is entitled to a dependency exemption for a child living with the taxpayer, (2) is a surviving spouse, or (3) is the head of a household and entitled to a dependency exemption for a child living with the individual for more than one-half of the taxable year.

The maximum credit amount and the AGI or earned income limits are not indexed for inflation.

Reasons for Change

The earned income credit serves as an offset to social security and income taxes and provides work incentives for many low-income families with dependents. However, inflation has reduced the value of the credit. Moreover, increases in income attributable to inflation have reduced the number of families eligible for the credit and the amount of the credit for many of those who remain eligible.

The Tax Reform Act of 1984 reduced the inflation-caused decrease in the value of the credit and in the credit's availability by increasing the credit percentage, maximum credit, and income limit for the credit. The new amounts, however, are not indexed and will remain fixed until changed by legislation.

In order to provide some compensation for the effect of inflation on the value of credit and on the number of families eligible for the credit, the credit percentage should be increased, and the credit should phase out at a higher income level. To eliminate the need for periodic legislative adjustments in the credit, the maximum earned income credit amount and the AGI or earned income limit should be indexed to the rate of inflation.

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Proposal

The earned income credit would be increased to 14 percent of the first $5,000 of earned income. The maximum credit of $700 would be reduced by 10 percent of the excess of AGI or earned income (whichever is greater) over $6,500. Thus, the credit would be eliminated when AGI or earned income reaches $13,500. Beginning in 1986, the maximum earned income credit and the AGI or earned income limit would be adjusted for inflation. The amount of the adjustment in a given calendar year would depend on the percentage increase in consumer prices for the previous fiscal year, as measured by the consumer price index for all-urban consumers ("CPIU").

Effective Date

The proposal would apply for taxable years beginning on or after January 1, 1986. Adjustments in inflation for 1986 would be based on changes in the CPIU for the 1985 fiscal year.

Analysis

In 1983, earned income tax credits totalling $1.8 billion were claimed on individual income tax returns. The increase in the credit percentage and extension of the credit would provide an additional offset for social security and income taxes and a work incentive for many low-income families with dependents. Indexation of the earned income credit would ensure that inflation-induced increases in incomes would not reduce the credit for some low-income families and exclude other low-income families from eligibility. For example, assume that an eligible taxpayer earning $6,500 in 1985 receives a four percent increase in income in 1986 and that inflation also equals four percent during the same period. Although the taxpayer's nominal income has increased, his or her "real" income (i.e., income adjusted for inflation) has stayed the same. Under current law, however, the taxpayer's earned income credit would fall from $550 in 1985 to $518 in 1986, because nominal income has increased. The real value of the credit, in 1985 dollars, would be only $497. Under the proposal, the credit percentage would be increased to 14 percent and, assuming that inflation was four percent during fiscal year 1985, the earned income limit and maximum credit would be increased by four percent for 1986. Thus, the taxpayer would be eligible for a credit of $728, the inflation-adjusted value of the maximum credit.

REPLACE CHILD AND DEPENDENT CARE CREDIT WITH DEDUCTION

General Explanation

Chapter 2.05

Current Law

A nonrefundable credit is allowed to an individual who pays employment-related child and dependent care expenses provided the individual maintains a household for one or more "qualifying individuals." In general, a qualifying individual is (1) a dependent of the taxpayer who is under the age of 15 and for whom the taxpayer can claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of taking care of himself or herself, or (3) a spouse of the taxpayer if the spouse is physically or mentally incapable of taking care of himself or herself.

Dependent care expenses are considered to be employment-related only if they are incurred to enable the taxpayer to work and are paid for household services and the care of one or more qualifying individuals. Expenses for household services include the performance of ordinary and usual maintenance in the household, provided the expenses are attributable in part to the care of a qualifying individual. Thus, amounts paid for the services of a maid or cook qualify for the credit if part of the services performed are provided for a qualifying individual.

The amount of employment-related expenses that is eligible for the credit is subject to both a dollar limit and an earned income limit. Employment-related expenses are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. Further, employment-related expenses generally cannot exceed the earned income of the taxpayer, if single, or, for married couples, the earned income of the spouse with the lower earnings. Married couples must file a joint return to claim the credit.

Taxpayers with adjusted gross incomes of $10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with adjusted gross incomes of $10,000 to $28,000, the credit is reduced by one percentage point for each $2,000 or fraction thereof above $10,000. The credit is limited to 20 percent of employment-related child and dependent care expenses for taxpayers with adjusted gross incomes above $28,000.

Reasons for Change

Child and dependent care expenses incurred in order to obtain or maintain employment affect a taxpayer's ability to pay tax in much the same manner as other ordinary business expenses. A family with

$30,000 of income and $2,000 of employment-related child care expenses does not have greater ability to pay tax than one with $28,000 of income and no such expenses.

There is, of course, a personal element in dependent care expenses incurred for household services and the care of one or more qualifying individuals. No practical standards exist, however, for allocating child and dependent care expenses based upon the personal and business benefits derived. Moreover, the cost of dependent care is frequently substantially higher than other mixed business/personal expenses for which no deduction is allowed, such as the cost of commuting and of most business clothing. Disallowance of all dependent care costs in the computation of taxable income thus could generate a significant work disincentive.

Allowance of a deduction rather than a credit is the appropriate treatment of costs incurred in producing income. The current credit for dependent care expenses is targeted for the benefit of low-income taxpayers, although these expenses reduce the ability to pay tax at all income levels. Tax relief for low-income taxpayers is provided best through adjustments in tax rates or in the threshold level of income for imposition of tax. Such changes benefit all similarly situated taxpayers.

Computation of the limits on the dependent care credit, which vary with the taxpayer's adjusted gross income, also adds to the complexity of the tax law.

Proposal

A deduction from gross income would be provided for qualifying child and dependent care expenses up to a maximum of $2,400 per year for taxpayers with one dependent, and $4,800 per year for taxpayers with two or more dependents. Qualifying expenses would continue to be limited by the taxpayer's earned income, if single, or, in the case of married couples, by the earned income of the spouse with the lower earnings.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposal recognizes that child and dependent care expenses constitute legitimate costs of earning income. The extent to which such expenses also provide a personal benefit, however, varies in each situation. As with certain other expenditures that provide mixed business and personal benefits to taxpayers, such as business meal expenses, the proposal sets a dollar limitation on the amount allowed as a deduction.

Under the proposal, approximately six million families (6.5 percent of all families) would claim deductions for dependent care expenses totalling approximately $8 billion. Approximately 60 percent of these deductions would be claimed by families with economic incomes under $50,000. The deduction, however, is relatively less favorable to low-income families than is the current credit. The choice of the deduction reflects the view that progressivity should be provided directly through the personal exemptions and the rate structure.

CHAPTER 3

MAKE THE SYSTEM MORE NEUTRAL AND FAIR

Part A. Excluded Sources of Income--Fringe Benefits

An employee is generally required to include in gross income all compensation received during the year from his or her employer, regardless of whether the compensation is paid in cash or in property or other in-kind benefits. Current law, however, exempts from taxation certain employer-provided in-kind benefits, such as the cost of group-term life insurance (up to $50,000), educational assistance, accident and health insurance, group legal services, and dependent care assistance. These and certain other fringe benefits are expressly excluded from an employee's taxable income if provided under qualified employer-sponsored plans.

Compensation paid in the form of in-kind benefits is not different in principle from compensation paid directly in cash. The employee who receives fringe benefits is not in a different pre-tax economic position than the employee who receives cash compensation and uses it to purchase the same benefits. The exclusion of certain fringe benefits from income under current law is thus unrelated to the proper measurement of income. It is intended instead to reduce the after-tax cost of certain goods or services and thereby to subsidize consumption of such items by eligible taxpayers.

The exclusion of fringe benefits from income has economic and social costs that have not always been reflected in political debate over fringe benefit tax policy or in individuals' expressed judgments about the desirability of maintaining existing tax preferences for fringe benefits. The incentive for consumption of fringe benefits created by their exemption from tax may overstimulate demand, producing losses in efficiency and artificially high prices. Nontaxation of fringe benefits also raises significant fairness concerns, since nontaxable benefits are not available to all taxpayers and are of greater value to high-bracket taxpayers. Finally, and most importantly, the exclusion of fringe benefits from income loses significant tax revenue, thus causing tax rates to be higher than they would be if fringe benefits were taxable.

The costs entailed in excluding fringe benefits from the tax base may be justified to the extent employer provision of fringe benefits serves significant social policy objectives that might otherwise fall to government and government-funded programs. This rationale for the nontaxation of fringe benefits requires, however, that the availability of an income exclusion be conditioned on the provision of fringe benefits on a broad, nondiscriminatory basis. It suggests as well that fringe benefits be excluded from income only where they directly and significantly enhance employee health and security.

INCLUDE IN INCOME A LIMITED AMOUNT OF EMPLOYER-PROVIDED HEALTH INSURANCE

General Explanation

Chapter 3.01

Current Law

All employer contributions to health insurance plans on behalf of an employee are excluded from the employee's gross income, regardless of the cost or extent of the coverage. The same rule generally applies to amounts paid by an employer to or on behalf of an employee under a self-insured medical plan.

Although medical expense reimbursements under a self-insured plan must be provided on a nondiscriminatory basis to be excludable, similar benefits provided through an outside insurer are not subject to nondiscrimination rules.

Reasons for Change

The exclusion of employer-provided health insurance from income subsidizes the cost of such insurance for eligible taxpayers. Although this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services, in its present form, the exclusion contributes substantially to horizontal inequity and to higher than necessary marginal tax rates.

The exclusion from income of employer-provided health insurance is unfair to individuals who are not covered by employer plans and who must therefore pay for their health care with after-tax dollars. Table 1 illustrates the impact of the exclusion on two employees each of whose compensation costs his respective employer $35,000. Individual A receives $2,400 of his compensation in the form of employer-provided health insurance; Individual B receives all of his compensation in cash. As shown in the table, A's after-tax income is $809 higher than B's simply because some of his compensation is in the form of health insurance. B must pay for any medical expenses or privately purchased insurance out of his lower after-tax earnings.

The exclusion for employer-provided health care has also contributed to the erosion of the tax base and to consequent high marginal tax rates, especially as employer-provided health care has become increasingly widespread. Imposing a limited tax on employer-provided health care would help broaden the base of taxable income and thus reduce marginal tax rates without jeopardizing the national policy of encouraging essential health care services.

Table 3.01-1

Tax Benefits Arising from the Exclusion of Employer-Provided Health Insurance 1/

	Individual A	Individual B
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	2,400	---
Employer Social Security Tax	2,147	2,305
Cash Wages	30,453	32,695
Employee Income Tax	2,996	3,489
Employee Social Security Tax	2,147	2,305
After-Tax Income Plus Value of Health Insurance	**27,710**	**26,901**
Cost of $2,400 of Health Insurance	1,591	2,400

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1/ 1985 tax rates for a family of four with no other income and with itemized deductions equal to 23 percent of adjusted gross income.

In addition, the tax benefits provided for employee health care should not be available on a basis that permits discrimination in favor of owners and high-paid employees. Thus, nondiscrimination rules should apply to employer-provided health benefits regardless of whether such benefits are self-insured or provided through third-party coverage.

Proposal

Employer contributions to a health plan would be included in the employee's gross income up to $10 per month ($120 per year) for individual coverage of an employee, or $25 per month ($300 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee).

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

In most cases, determination of the precise cost of coverage would be unnecessary, because the floor amounts would clearly be exceeded. In those cases where the floor amounts would not necessarily be exceeded, the following method of determining cost would be used.

The annual cost of providing coverage under an insured plan (or any insured part of a plan) would be based on the net premium charged by the insurer for such coverage. The annual cost of providing coverage under a noninsured plan (or any noninsured part of a plan) would be based on the costs incurred with respect to the plan, including administrative costs. In lieu of using actual administrative costs, an employer could treat seven percent of the plan's incurred liability for benefit payments as the administrative costs of the plan. A plan would be a noninsured plan to the extent the risk under the plan is not shifted from the employer to an unrelated third party.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs in a significant manner from the coverage of another group of employees.

The proposal would require that the cost of coverage under the plan be determined in advance of the payroll period. The cost would be redetermined at least once every 12 months, and whenever there are significant changes in the plan's coverage or in the composition of the group of covered employees.

If the actual cost of coverage cannot be determined in advance, reasonable estimates of the cost of coverage would be used. If an estimated cost were determined not to be reasonable, the employer would be liable for the income taxes (at the maximum rate applicable to individuals) and the employment taxes (both the employer's and the employee's share) that would have been paid if the actual cost of coverage had been used. Where an employer makes contributions to a multiemployer plan, the multiemployer plan would be treated as the employer for purposes of determining the cost of coverage and the liability for errors in estimates.

If the cost of coverage fluctuates each year depending on the experience of the employer under the plan, an average annual cost of coverage could be used, based, in appropriate circumstances, on the average cost for the past three years (adjusted to reflect increases in health insurance costs).

Appropriate nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties. See Ch. 3.04 for a description of the proposed nondiscrimination rule.

Effective Date

The proposal would apply to employer contributions received in taxable years beginning on or after January 1, 1986.

Analysis

The proposal would reduce the unfair distinction between those with employer-provided health insurance and those who must pay for health insurance with after-tax dollars. In the case illustrated in Table 1, under current law the employee with $2,400 of employer-provided health insurance paid $809 less in taxes than a similar family that purchased $2,400 of health insurance with after-tax dollars. Under the Administration proposal, the difference would fall from $809 to $611. The cost of $2,400 of employer-provided health insurance would rise from $1,591 to $1,789, due partly to the inclusion of $300 of employer contributions in income and partly to the reduction in the marginal tax rate for this family (from 22% to 15%).

The higher amount included in income for family coverage reflects the fact that such coverage is approximately two-and-one-half times as costly as individual coverage.

The proposal would be administratively simple, since almost all those with employer contributions will have such contributions in excess of the proposed includable amounts. Only in those rare cases where the employer's contribution is less than $10 (individual) or $25 (family coverage) per month would estimates of the average cost of health plan coverage be necessary. Moreover, the proposal's implementation need not be delayed, since it should have no major impact on the nature of negotiated contracts.

The distributional impact of this proposal is summarized in Table 2. Less than 20 percent of all employer contributions would be included in income, resulting in additions to taxable income for approximately half of all families. Families with incomes above $30,000 would pay three-quarters of the taxes imposed on employer contributions. Less than 5 percent of the additional tax liability would fall on those with under $15,000 of income. The additional tax liability is concentrated among higher income taxpayers for two reasons. First, as illustrated in the first two columns of Table 2, employer contributions for health insurance are much more common (and larger) for higher income families. Less than 15 percent of families with incomes below $15,000 receive such contributions, compared to over 80 percent of families with incomes over $50,000. Second, the tax rate on the included portion of employer contributions is higher for those with higher incomes. Given the proposed increases in the personal exemption and zero bracket amounts, no families with incomes below the poverty line would pay tax on employer contributions.

Table 3.01-2

Distribution of Employer Contributions for Health Insurance (1983), and Estimated Impact of the Proposal

Family Economic Income	Percent of Families Receiving Employer Contribution	Average Employer Contribution	Percent of Contributions Included in Income Under the Proposal	Distribution of Additional Tax Liability
$ 0 to 9,999	14 %	$ 60	19 %	* %
10,000 to 14,999	34	80	19	4
15,000 to 19,999	46	90	18	6
20,000 to 29,999	60	100	18	16
30,000 to 49,999	76	130	18	34
50,000 to 99,999	86	170	16	34
100,000 to 199,999	81	190	15	6
200,000 or more	76	200	14	*
All Families	56 %	$125	17 %	100 %

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* Less than 0.5 percent.

REPEAL $5,000 EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

General Explanation

Chapter 3.02

Current Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee are excluded from the recipient's income. The maximum amount that may be excluded from income with respect to any employee is $5,000. Accordingly, an allocation of this exclusion is required if multiple beneficiaries receive, in the aggregate, more than $5,000. Except with respect to certain distributions from or under qualified plans, the exclusion does not apply to self-employed individuals.

In addition to the statutory exclusion, some courts have permitted taxpayers to exclude from income payments from a decedent's employer in excess of $5,000. The rationale of these cases is that the employer's payment to the decedent's estate or beneficiary constitutes a gift rather than compensation. Such "gifts" are excludable without regard to the $5,000 limitation.

Reasons for Change

The exclusion of certain death benefits from income creates an artificial preference for what is, in effect, an alternative form of employee compensation. The exclusion of such benefits from the tax base causes the tax rates on other compensation to increase. Moreover, the exclusion is unfair because it is not available to all taxpayers (such as self-employed individuals).

Death benefits are similar to group-term life insurance, the exclusion for which is retained. The exclusion for group-term life insurance premiums, however, is conditioned on satisfaction of certain requirements, including a nondiscrimination test. Because of the nature of death benefits, it would be very difficult administratively to place the same conditions on their availability (or on imputed premiums for death benefits, which are also excluded). In the absence of such restrictions, death benefits may become more of a vehicle to provide tax-free compensation for highly paid employees, than a means to enhance the security of employees generally.

Finally, confusion exists under present law as to whether a payment by an employer to a deceased employee's family constitutes a death benefit subject to the $5,000 limitation or a fully excludable gift. Treatment of such a payment as a gift often is contrary to economic reality and leads to different tax treatment on similar facts.

Proposal

The proposal would repeal the $5,000 exclusion for employer-provided death benefits. Any amount paid by or on behalf of an employer by reason of the death of an employee to the estate or a family member or other beneficiary of the decedent would be characterized as a taxable death benefit rather than as an excludable gift.

Effective Date

The repeal would be effective for benefits paid due to deaths occurring on or after January 1, 1986. The exclusion would continue, however, for amounts paid under a collective bargaining agreement entered into before January 1, 1986, until the earlier of January 1, 1989, or the date such agreement terminates.

Analysis

Approximately $400 million of employer-provided death benefits are excluded from income under current law. As with all exclusions, the tax benefit per dollar of the death benefit exclusion increases with the recipient's tax bracket. Thus, the exclusion provides the greatest assistance to high-income taxpayers, who are also more likely to receive such benefits than low-income taxpayers.

Finally, a specific provision that payments from an employer to a deceased employee's estate or family do not constitute gifts would simplify current law and also reduce the unfairness created by current law where similar facts may lead to different tax results.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED COMMUTING SERVICES

General Explanation

Chapter 3.03

Current Law

The value of employer-provided commuting transportation is excluded from the income of employees if the transportation services are provided under a nondiscriminatory plan using vehicles that meet size and usage requirements (generally vans). The exclusion is not available to self-employed individuals and is scheduled to expire for taxable years beginning after December 31, 1985.

Reasons for Change

The exclusion of qualified transportation services from employee income is poorly designed to promote its intended purpose of energy conservation. The exclusion targets only one form of group transportation, employer-provided van pools. This may cause taxpayers to reject possibly more efficient but non-subsidized transportation alternatives. Moreover, the qualified transportation exclusion is not aimed at ensuring security for individual employees, but rather at achieving the general goal of energy conservation. This goal can be achieved more effectively and equitably through non-tax measures.

Proposal

The exclusion from gross income of the value of employer-provided commuting transportation would be allowed to expire.

Effective Date

Taxpayers have had notice of the scheduled expiration of the van-pooling exclusion for taxable years beginning after December 31, 1985. It would be allowed to expire as scheduled.

Analysis

Expiration of the van-pooling exclusion will eliminate an unnecessary distortion in employee and employer choices over cost-effective transportation.

ESTABLISH A UNIFORM NONDISCRIMINATION RULE

General Explanation

Chapter 3.04

Current Law

Overview. A variety of fringe benefits are excluded from the income of employees if provided by employers under certain statutorily prescribed conditions. Among those conditions is the general requirement that fringe benefits be provided on a nondiscriminatory basis. Thus, with the exception of the exclusion for employer-provided health insurance, each fringe benefit exclusion is subject to nondiscrimination rules that require that the benefit not be provided on a basis that favors certain categories of employees (the prohibited group members). Failure to satisfy the applicable nondiscrimination test results in a denial of the tax exclusion, and thus inclusion of the benefit in income, either for all employees receiving the benefit or only for prohibited group members.

Separate nondiscrimination rules apply with respect to each benefit. Thus, a prohibited group member for one benefit may or may not be a prohibited group member for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Group-Term Life Insurance Plans. If a group-term life insurance plan is determined to be discriminatory, the $50,000 exclusion of the cost of insurance does not apply with respect to key employees. A discriminatory plan is one which favors key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. For purposes of these rules, related employers are treated as a single employer.

With respect to eligibility, a group-term life insurance plan must satisfy one of the following tests: (1) the plan benefits at least 70 percent of all employees; (2) at least 85 percent of all participants are not key employees; (3) the class of employees receiving benefits is not discriminatory in favor of key employees; or (4) in the case of a plan which is part of a cafeteria plan, the cafeteria plan requirements are met. In determining whether a plan satisfies this eligibility test, employees who have not completed three years of service, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens who receive no U.S. earned income may be disregarded.

For purposes of determining whether the type or amount of benefits under the plan discriminates in favor of key employees, all benefits available to key employees must be available to all other employees, and benefits proportionate to compensation are considered nondiscriminatory.

The term "key employee" is generally defined as it is under the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners receiving at least $150,000 in annual compensation. Employees are key employees with respect to a year if they fall within one of the above categories at any time during the five preceding years.

Health Benefits Plans. The exclusion of health benefits provided by an employer through an insurance company, and the exclusion of medical benefits and reimbursements provided under such insurance, are not conditioned on the satisfaction of a nondiscrimination test. However, if an employer provides its employees with health benefits under a self-insured plan, the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent the reimbursement is not an "excess reimbursement," which generally is a reimbursement provided to a highly compensated individual under a discriminatory plan.

A self-insured health plan is discriminatory if it favors highly compensated individuals as to eligibility to participate or as to benefits. For purposes of this nondiscrimination rule, related employers are treated as a single employer.

Under the eligiblity test, a health plan must benefit (1) at least 70 percent of all employees, (2) at least 80 percent of all eligible employees, but only if at least 70 percent are eligible, or (3) a class of employees that does not discriminate in favor of highly compensated individuals. In determining whether a plan satisfies any of these tests, employees who have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

The benefits provided under a self-insured health plan will be treated as discriminatory unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

For purposes of these rules, highly compensated individuals are (1) the five highest paid officers, (2) shareholders owning more than ten percent of the stock of the employer, and (3) employees who are among the highest paid 25 percent of employees (excluding non-participants who may be disregarded for purposes of the eligibility test).

Group Legal Services Plans. The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a plan benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, the availability of the exclusion is subject to a concentration test under which no more than 25 percent of the amounts contributed during a year may be provided for five percent owners (or their spouses or dependents).

Educational Assistance Programs. The exclusion for amounts paid or expenses incurred by the employer for educational assistance to an employee under an educational assistance program is not available if the program benefits a class of employees that is discriminatory in favor or employees who are officers, owners, or highly compensated (or their dependents). Under this test, employees covered by a collective bargaining agreement may be disregarded. Also, the exclusion is subject to a concentration test under which no more than five percent of the amounts paid or incurred by the employer for educational assistance may be provided for five percent owners (or their spouses or dependents).

Dependent Care Assistance Programs. The exclusion for amounts paid or incurred by the employer for dependent care assistance under a dependent care assistance program is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a program benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance is provided for five percent owners (or their spouses or dependents).

Cafeteria Plans. The cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. For purposes of these rules, related employers are treated as a single employer.

A cafeteria plan does not discriminate as to eligibility to participate if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) there is a uniform year of service requirement of no more than three years.

A cafeteria plan will not be considered to discriminate as to contributions and benefits if statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants. If a cafeteria plan provides health benefits, the plan will not be treated as discriminatory if the following tests are met: (1) contributions on behalf of each participant include either 100 percent of the cost of health benefit coverage of the majority of highly compensated participants who are similarly situated or 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage under the plan; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation. If a cafeteria plan is maintained pursuant to a collective bargaining agreement, the plan is deemed to be nondiscriminatory.

A participant or individual is considered highly compensated for purposes of the cafeteria plan rules if he or she is an officer, a five percent shareholder, highly compensated, or a spouse or dependent of any of the above.

In addition, the availability of the cafeteria plan treatment for to key employees is subject to a concentration test, which provides that no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees. Related employers are treated as a single employer for purposes of this rule. The term "key employee" has the meaning given to such term for purposes of the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners with at least $150,000 in compensation.

Certain Fringe Benefits (Sec. 132). The exclusion of a no-additional-cost service or a qualified employee discount applies to a fringe benefit provided to an officer, owner, or highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a class of employees which does not discriminate in favor of such owners, officers or highly compensated employees. Meals provided at a company cafeteria that covers its direct operating costs are generally excluded from income, except that this general exclusion does not apply to employees who are officers, owners, or highly compensated if access to the cafeteria is provided on a basis which discriminates in favor of such employees. For purposes of these rules, related employers are treated as a single employer.

Qualified Tuition Reductions. The exclusion of a qualified tuition reduction applies to an officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated.

Welfare Benefit Funds. A voluntary employees' beneficiary association or a group legal services fund which is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules. Under these rules, no class of benefits may be provided to a class of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefit test merely because benefits are proportional to compensation. For purposes of these rules, related employers are treated as a single employer.

For purposes of the above rules, the following employees may be disregarded: (1) employees with less than three years of service; (2) employees who have not attained age 21; (3) seasonal or less than half-time employees; (4) employees covered by a collective bargaining agreement; and (5) nonresident aliens with no U.S. earned income. Under a special rule, if a benefit, such as group legal services, is covered by a separate nondiscrimination rule, that separate rule will apply in lieu of the rules described above.

The term "highly compensated individual" includes any individual who is one of the five highest paid officers, a ten percent shareholder, or among the highest paid ten percent of all employees. For purposes of determining the highest paid ten percent of all employees, employees that have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

These nondiscrimination rules also apply for certain other purposes. For example, they must be satisfied in order for an employer to be able to deduct contributions to a welfare benefit fund to provide post-retirement life insurance or health benefits. Also, post-retirement life insurance or a post-retirement health benefit provided through a welfare benefit fund will be subject to a 100 percent excise tax if the plan of which the fund is a part does not satisfy these nondiscrimination rules.

Reasons for Change

Nondiscrimination requirements are an integral part of the current provisions under which certain employer-provided fringe benefits are excluded from the income of employees. The tax-favored treatment of such fringe benefits significantly reduces the Federal income tax base and thus forces significantly higher marginal tax rates on wages, dividends, rents, and all other income not exempt from tax. These costs may be justified only if employer-provided fringe benefits fulfill important social policy objectives, and in this respect meet responsibilities that would otherwise fall to government and government-funded programs. Strict nondiscrimination rules are a necessary adjunct to this public policy rationale since they require that fringe benefits be nontaxable only where provided to a broad cross-section of employees. Nontaxable fringe benefits that favor key or highly compensated employees do not serve public policy objectives, but are instead a form of tax-preferred compensation for a limited class of employees.

The nondiscrimination rules that currently apply to fringe benefits are marred by inconsistency and by their failure to establish clear and administrable standards. The separate nondiscrimination rules applicable to each fringe benefit employ different definitions of the prohibited group members and establish different standards for nondiscriminatory coverage. These differences have no policy justification, and thus create unnecessary complexity for taxpayers and for the Internal Revenue Service. In addition, although employer-provided health insurance is among the most significant fringe benefits both in terms of its importance to employees and its revenue cost, it is not subject to nondiscrimination rules. As with other fringe benefits, the exclusion of such insurance from employees' income should be conditioned on its nondiscriminatory provision to a broad cross-section of employees.

The current nondiscrimination rules also provide inadequate guidance to taxpayers and to the Internal Revenue Service. Thus, the definition of prohibited group members is generally vague, leaving unclear, for example, who qualifies as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members.

The uncertainty with respect to the current nondiscrimination requirements has resulted in significantly different patterns of coverage for different employee groups. Cautious employers may adopt conservative plans, covering a broad cross-section of their employees. Other employers, however, may conclude that uncertainty in the law permits an agressive approach, and set up plans that focus benefits on management or highly compensated employees. The Internal Revenue Service's ability to monitor employer practice is limited under current law, since the facts and circumstances approach of the existing standards requires that compliance be tested through detailed examination of individual cases.

The uncertainty and gaps in coverage that are attributable to the current nondiscrimination rules outweigh the arguable benefits of those rules. A facts and circumstances approach does offer flexibility to employers, but similar benefits can be achieved without wholly abandoning workable, objective standards. Objective nondiscrimination tests, if combined with a procedure under which plans involving special circumstances could be reviewed by the Internal Revenue Service, would provide workable guidelines while retaining appropriate employer flexibility.

Proposals

Scope. The nondiscrimination rules described in the following paragraph would apply to employer-maintained group-term life insurance plans, health benefit plans (whether self-insured or through an insurance company), qualified group legal services plans (whether self-insured or through an insurance company), educational assistance programs, dependent care assistance programs, cafeteria plans, certain fringe benefits (sec. 132), qualified tuition reduction arrangements, and welfare benefit funds.

Prohibited Group Members. A uniform definition of prohibited group members would apply to the nondiscrimination test for each fringe benefit. Thus, in determining whether a fringe benefit is provided on a nondiscriminatory basis in a particular year, the prohibited group members would be defined to include any employee who, at any time during the three-year period ending on the last day of the plan year, met any one of the following descriptions: (1) an owner of one percent or more of the employer (under appropriate attribution rules); (2) an employee receiving at least $50,000 in annual compensation; (3) an employee who is among the top ten percent of employees by compensation or is among the highest three employees (this number would be adjusted for small employers) by compensation, but not if he or she receives less than $20,000 in annual compensation (former employees would be disregarded for this purpose); and (4) a family member of another prohibited group member for the year. The $50,000 and $20,000 figures would be indexed for inflation.

The appropriateness of the top ten percent and highest three employees portions of the prohibited group definition in identifying the prohibited group members will depend, in part, on an employer's salary structure. Thus, a mechanical rule would be provided to identify those situations where the ten percent and high three classes of employees are inappropriate and to expand or contract these classes accordingly. Also, adjustments to the three year lookback rule may be appropriate where the number of employees employed by the employer changes significantly during that three year period.

In the case of a benefit plan that covers former employees, an employee who was a prohibited group member for either the plan year in which he separated from service or the previous plan year would continue to be treated as a prohibited group member. Thus, if an employee falls within one of the descriptions set forth above at any time within the year of separation or any of the preceding three years, he or she would continue to be a prohibited group member in the year of separation from service and thereafter. Appropriate rules would be designed to address the situation where an employee returns to service after separation.

Nondiscriminatory Coverage. The exclusion from income of each employer-provided benefit would be subject to a nondiscriminatory coverage test requiring that the percentage of prohibited group members actually benefiting under a benefit plan not exceed 125 percent of the percentage of the other employees actually benefiting under the plan. In applying this test to contributory plans, only employees making the required contribution would be treated as actually benefiting under the plan.

In certain very limited situations, where compelling business reasons indicate that application of the 125 percent test would not be appropriate, such test would not be applied if a timely ruling is obtained from the Internal Revenue Service. For example, an employer may acquire another company during a plan year. The acquired company may not have provided its employees with a health plan or it may have provided a plan substantially different from that provided by the acquiring employer. It may thus be appropriate to treat both the acquiring employer's health plan and the acquired company's health plan, if they each satisfied the coverage test prior to the acquisition, as satisfying the coverage test for a limited period after the acquisition, in order to permit the post-acquisition employer to redesign the plans to satisfy the test. Of course, during the limited period, the acquiring company's plan would be required to satisfy any reasonable conditions that the Internal Revenue Service may impose as part of the timely ruling, such as that the plan satisfy the nondiscriminatory coverage test by reference to the entire post-acquisition company with a more liberal percentage (e.g., 150 percent) substituted for 125 percent. Relief from the 125 percent test may also be appropriate where a substantial number of an employer's employees do not elect health coverage under the employer's plan because they are receiving health benefits through, for example, their spouses' employers. The Internal Revenue Service would apply reasonable conditions on the continued validity of such rulings.

In addition, any classification of employees used by a plan for participation purposes would be required to be nondiscriminatory on its face. Thus, for example, if a plan provided that the bottom 20 percent of the non-prohibited group members by compensation were ineligible, the plan would not pass the coverage test even if the plan otherwise satisfied the 125 percent coverage test. A contributory plan or a plan that excludes a class of employees based on a bona fide job category would not be discriminatory on its face under this provision.

In addition, the coverage test is not satisfied if a requirement for benefiting under the plan is discriminatory. For example, even if the 125 percent test is satisfied, the nondiscrimination coverage test is not satisfied if any non-prohibited group participant was required, as a condition of plan participation, to have completed a longer period of service than the prohibited group participant with the shortest required service period. Another example would be where any non-prohibited group participant had to make a larger employee contribution than the prohibited group participant with the smallest required contribution.

Certain classes of employees would be disregarded in applying the 125 percent coverage test to an employer's benefit plan so long as the plan did not benefit any employee in such class. The classes of excludable employees would be as follows: (1) employees with less than one year of service (except in the case of an employer's health plan); (2) part-time and seasonal employees; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens who receive no U.S. earned income. Part-time employees would generally be defined as employees who in a week work less than the lesser of (i) 20 hours or (ii) one-half of the customary hours worked by full-time employees. Seasonal employees would generally be defined as employees who in a year work less than the lesser of (i) 1,000 hours or (ii) one-half of the customary hours worked by full-time employees. In the case of an employer-maintained health plan, in lieu of the one year of service rule, employees with less than 30 days of service would be disregarded. However, employees with less than 90 days of service would be disregarded in applying the 125 percent test to a health plan if the plan also provided the option of post-separation health coverage of at least 90 days under the same terms available to other plan participants.

Nondiscriminatory Availability. All types and levels of benefits available to any prohibited group participant in a plan must also be available to all non-prohibited group participants. Similarly, if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants. For example, if a non-prohibited group participant was required to spend $1,000 on dependent care before the participant was eligible to receive reimbursements for dependent care expenses and not every prohibited group participant was subject to the same condition, the plan would discriminate in availability.

Nondiscriminatory Benefits: Insurance-Type Benefits. Group-term life insurance, health benefits, and group legal benefits provided under employer-maintained plans would each be subject to a nondiscriminatory benefits test. Health benefits and group legal benefits would both be treated as insurance-type benefits, regardless of whether they are provided under an arrangement with an insurance company or on a self-insured basis. The definition of an employer-maintained plan would be modified to require a permanent, enforceable plan to qualify for a benefit exclusion.

For group-term life insurance, benefits would be treated as nondiscriminatory if the amount of insurance coverage provided to participants varies uniformly by compensation. Thus, no prohibited group participant would be permitted to receive coverage which is a higher multiple of compensation than the lowest such multiple for any non-prohibited group participant. Appropriate rules would establish how former employees would be treated under this test.

For employer-maintained health benefit plans, including self-insured reimbursement plans, benefits would be treated as nondiscriminatory if, in all respects, the health benefit coverage provided to any prohibited group participant is also provided to all non-prohibited group participants. For this purpose, two employees actually receiving different types of health benefit coverage would be considered to have received the same type of health benefit coverage if each had the choice of electing, without charge, either type of coverage or if each had the choice of electing either type of coverage for the same charge (or for a charge which is proportional to compensation or more than proportional to compensation). Also, if two employees receive the same type of individual health coverage and only one receives family health coverage in addition, the two employees will be deemed to receive the same health coverage if the family coverage was available to both employees without charge.

In the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits requirement. This rule would have special application to health plans offering both individual coverage and family coverage. These two types of coverage could be considered separate benefits and thus could be tested separately under the nondiscriminatory coverage and the nondiscriminatory benefits test. However, in determining whether a separate "family coverage health plan" is nondiscriminatory under the coverage test, only employees with spouses or dependents would be considered.

Appropriate integration rules would be applied where benefits provided under Medicare or other Federal, State, or foreign law, are properly taken into account under the employer's health benefit plan. In addition, health benefits provided under a plan to an employee may be coordinated with those provided under a plan maintained by the employer of an employee's spouse.

Disability coverage would be tested under the same nondiscriminatory benefit rules applicable to other health benefit coverage, except that the amount of the coverage would be permitted to vary with compensation in accordance with the rules applicable to group-term life insurance. Also, appropriate rules would be applied for disability plans that integrate with disability benefits provided under Social Security or other Federal, State, or foreign law. If a disability plan is integrated with disability benefits under Social Security or any other law, appropriate adjustments would also be required to the extent a qualified plan maintained by the same employer may be integrated with Social Security or such other law.

An employer's group legal plan would generally have to meet the nondiscriminatory benefits test applicable to health benefit plans. Thus, a group legal plan could not discriminate with respect to legal services coverage. However, family coverage and individual coverage may not be considered the same coverage as under the health plan rules. In addition, in determining whether a separate "family coverage plan" is nondiscriminatory under the coverage test, all nonexcludable employees would be considered, regardless of family status. As with health plans, the nondiscriminatory benefits test would be applied on a per capita basis. Also, if the legal services plan provides different types or levels of legal services coverage, each type or level of benefits must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits test.

As noted above, a plan would not qualify for an exclusion unless it is permanent. This means that an employer must establish the plan with the intention of maintaining it for an indefinite period of time. An early termination without a bona fide and unforeseeable business reason may indicate that the plan was not intended to be permanent, especially if the duration of certain life, health, or legal coverage coincides with the period during which one or more prohibited group participants have a need for such coverage.

Nondiscriminatory Benefits: Noninsurance-Type Benefits. An educational assistance program and a dependent care assistance program, as well as certain other fringe benefits (sec. 132) and qualified tuition reductions, would each be required to satisfy a nondiscriminatory benefits test under which the average amount provided for a prohibited group participant under the program may not exceed 125 percent of the average amount expended for a non-prohibited group participant.

In the case of educational assistance, only educational assistance expenditures for degree programs, whether they be post-graduate, college, high school, or a lower level, would be considered under the usage test. With respect to no-additional-cost services, qualified employee discounts, and qualified tuition reductions, a similar 125 percent test would be applied under which use of a service, discount, or reduction would be valued under appropriate rules.

Concentration Test. The current law concentration tests for group legal services, cafeteria plans, educational assistance, and dependent care would be retained with certain modifications. Instead of prohibiting concentration in favor of five percent owners or key employees, the rule would apply to the top twenty prohibited group members by compensation. (Appropriate rules would be provided for determining the top twenty prohibited group members by compensation.) Also, the contributions provided for prohibited group participants with respect to each of these benefits may not exceed 25 percent of the total contributions provided with respect to such benefit. In addition, the concentration test would apply to each fringe benefit excluded from income. Finally, as applied to educational assistance, the rule would be modified to apply only to education leading to a degree.

Former Employees. The nondiscriminatory coverage and benefit requirements and the concentration test would apply to former employees. However, former employees must be treated separately for purposes of these requirements. For example, if an employer provides health insurance to active and retired employees, the discrimination rules must be applied separately to the two groups.

Less Than Full-Time Employees. If an employee covered under a benefit plan works in a plan year less than the lesser of (i) 1,500 hours or (ii) 75 percent of the hours considered full-time, appropriate adjustments may be made in applying the nondiscriminatory availability and benefits tests. For example, if an employer maintains a contributory health plan, it may not be inappropriate to treat as nondiscriminatory under the availability and benefits tests a requirement that employees working less than 1,500 hours contribute a higher amount than the full-time employees.

Aggregation of Plans. For purposes of the nondiscriminatory availability and the nondiscriminatory benefits tests, employer plans covering a common prohibited group participant shall be treated as one plan unless each of the plans would satisfy the nondiscriminatory coverage test if 100 percent were substituted for 125 percent. Also, at the election of the employer, two or more plans of such employer may be treated as one plan.

Effect of a Finding of Discrimination. If a plan is discriminatory in coverage or benefits, or fails to satisfy the concentration test, the exclusion would not apply to prohibited group participants. In the case of group-term life insurance, health benefits, and group legal services, the exclusion of the value of the coverage under the plan would not apply. If the coverage under the plan were taxable to the prohibited group participants, however, any reimbursement of expenses under the plan would remain nontaxable. A finding of discrimination would not affect the exclusion of the coverage for non-prohibited group participants.

In the case where a prohibited group member participates in a discriminatory health benefit plan and a nondiscriminatory health benefit plan, the amounts taxable under the discriminatory plan would not reduce the amounts taxable under the nondiscriminatory plan. See Ch. 3.01 for a discussion of the amounts taxable under a nondiscriminatory plan.

Cafeteria Plans. The nondiscrimination tests applicable to a particular benefit, as described above, would continue to apply to such benefit even if it is offered under a cafeteria plan.

In addition, the cafeteria plan must satisfy the nondiscriminatory coverage test treating each employee eligible to make elections under the plan as benefiting under the plan. Also, the nondiscriminatory availability test would apply to a cafeteria plan. Thus, all types and levels of benefits available to any prohibited group participant must also be available to all non-prohibited group participants, and if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants.

In applying the nondiscriminatory coverage and benefits tests to each separate benefit offered under a cafeteria plan, a special rule would apply to reimbursements of medical, legal, or dependent care expenses under a reimbursement account. A reimbursement account for either medical, legal, or dependent care expenses would be deemed to satisfy the nondiscriminatory coverage and benefits tests if the average reimbursement for prohibited group participants in the cafeteria plan does not exceed 125 percent of the average reimbursement for non-prohibited group participants in the cafeteria plan. In applying this test, reimbursements for medical, legal, and dependent care expenses would be aggregated. A reimbursement account would generally be defined as an arrangement maintained by the employer which is funded in whole out of elective contributions by participants. Reimbursements of insurance premiums would not be permitted under reimbursement accounts. The current law rules otherwise applicable to reimbursement accounts (e.g., forfeitability) would continue to apply.

For purposes of testing each individual benefit under the nondiscriminatory coverage and benefits tests, each level or type of benefit elected under the cafeteria plan would be treated as a separate plan.

Welfare Benefit Funds. The nondiscrimination rules applicable to welfare benefit funds would be modified to conform to the proposed nondiscrimination rules. Thus, for example, a voluntary employees' beneficiary association would be precluded from discriminating in favor of those employees who are prohibited group members under the proposed definition. In addition, the 125 percent coverage test would apply.

Aggregation of Employers. The rules treating related employers as a single employer for purposes of the rules described in this proposal would be extended to each fringe benefit. Also, the leasing rules currently applicable to qualified plans would apply without regard to the safe harbor plan provisions of such rules.

Effective Date

The proposal would generally apply to fringe benefit plan years beginning on or after January 1, 1986. However, this general effective date would be January 1, 1987 with respect to employer-provided health care coverage. In addition, an exception would be made for fringe benefit plans maintained pursuant to a collective bargaining agreement entered into prior to January 1, 1986, until the first plan year beginning on or after the earlier of January 1, 1989 or the date such agreement terminates.

Analysis

The extension and strengthening of the nondiscrimination rules would help direct more of the benefits to those for whom the exclusions were designed. The coverage test, for instance, would assure that in most situations, non-prohibited group members would be covered in proportions close to that of the prohibited group members. For example, assume an employer has 20 prohibited group members and 80 non-prohibited group members and none of these employees may be excluded from the nondiscriminatory coverage test. Assume further that all of the prohibited group members are covered. In order to satisfy the 125 percent coverage test, at least 80 percent of the non-prohibited group members, i.e., 64 of the non-prohibited group members, must be covered.

REPEAL EXCLUSION FOR EMPLOYEE AWARDS

General Explanation

Chapter 3.05

Current Law

Gifts are excluded from the gross income of the donee. Whether an employer's award to an employee constitutes taxable compensation or a gift excludable from gross income depends upon the facts and circumstances surrounding the award.

If an employee award is excludable from income as a gift, the amount that can be deducted by the employer is limited by statute. In general, the cost of a gift of an item of tangible personal property awarded to an employee by reason of length of service, productivity or safety achievement may not be deducted by the employer to the extent that it exceeds $400. In the case of an award made under a permanent, written plan which does not discriminate in favor of officers, shareholders, or highly compensated employees, gifts of items with a cost up to $1,600 may be deducted, provided that the average cost of all items awarded under all such plans of the employer does not exceed $400.

The fact that an award does not exceed the dollar limitations on deductions has no bearing on whether the award constitutes taxable compensation to the employee; in all cases that issue depends on the facts and circumstances surrounding the award. Nevertheless, many taxpayers take the position that if the dollar limitations are not exceeded, the award automatically constitutes a gift and is excludable from the employee's income.

Reasons for Change

A gift for tax purposes is a transfer of property or money attributable to detached and disinterested generosity, motivated by affection, respect, admiration, or charity. The on-going business relationship between an employer and employee is generally inconsistent with the disinterest necessary to establish a gift for tax purposes. Moreover, in the unusual circumstances where an employee award truly has no business motivation, it should not be deductible as an ordinary and necessary expense of the employer's business.

Current law not only allows employee awards to be characterized as gifts but provides a tax incentive for such characterization. The amount of an employee award treated as a gift is excluded from the income of the employee, but the employer may nevertheless deduct the award to the extent it does not exceed certain dollar limits. Even to the extent an award exceeds those limits, gift characterization produces a net tax advantage if the employee's marginal tax rate exceeds that of the employer.

Current law also generates substantial administrative costs and complexity by requiring the characterization of employee awards to turn on the facts and circumstances of each particular case. The dedication of Internal Revenue Service and taxpayer resources to this issue is inappropriate, since relatively few employee awards represent true gifts and since the amounts involved are frequently not substantial.

Proposal

Gift treatment would generally be denied for all employee awards. Such awards would ordinarily be treated as taxable compensation, but in appropriate circumstances would also be subject to dividend or other non-gift characterization. De minimis awards of tangible personal property would be excludable by the employee under rules of current law concerning de minimis fringe benefits.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Available data concerning employee awards of tangible personal property is incomplete. Surveys indicate that businesses made gifts to employees totalling approximately $400 million in 1983. It is unclear what portion of these gifts were in the form of tangible personal property; however, the majority of these gifts were less than $25 in value. Less than ten percent of all employees are covered by an employer plan for such benefits. Thus, the proposal would affect few employees and would promote horizontal equity.

Part B. Excluded Sources of Income--Wage Replacement Payments

REPEAL EXCLUSION FOR UNEMPLOYMENT AND DISABILITY PAYMENTS

General Explanation

Chapter 3.06

Current Law

In general, any cash wage or salary compensation received by an employee is fully includable in the employee's income. Under current law, however, payments under a variety of programs designed to replace wages lost due to unemployment or disability are fully or partially exempt from tax.

Unemployment Compensation. If the sum of a taxpayer's adjusted gross income (determined without regard to certain social security and railroad retirement benefits and the deduction for two-earner married couples) and his unemployment compensation is less than a "base amount" ($12,000 for single returns and $18,000 for joint returns), unemployment compensation is totally excluded from gross income. If such sum exceeds the base amount, then the taxpayer's gross income includes the lesser of (i) one-half of such excess, or (ii) all of the taxpayer's unemployment compensation.

Thus, for example, if a married couple filing a joint return receives $8,000 in unemployment compensation and has no other income, the unemployment compensation will be totally excluded from gross income. On the other hand, if the couple has $18,000 of other income, one-half of the unemployment compensation will be included in their gross income. As income other than unemployment compensation increases, a greater percentage of unemployment compensation will be included (up to 100 percent if their other income equals or exceeds $26,000).

Disability Compensation. Workers' compensation payments as well as black lung benefits to disabled coal miners are fully excluded from income.

Reasons for Change

Net Replacement Rates. Most wage replacement programs pay benefits equal to a flat percentage of gross earnings, subject to minimum and maximum dollar limits. Although this percentage is generally stated as a gross replacement rate, the effect of a wage replacement program can be determined only by analyzing its "net replacement rates" -- the fraction of a worker's lost after-tax wages that the program replaces. Exclusion of wage replacement payments

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from income causes a program's net replacement rate to exceed its gross replacement rate. Assume, for example, that Individual A would have earned $25,000 last year and would have paid taxes of $5,000, leaving after-tax income of $20,000. If A is disabled and receives one-half of his gross earnings ($12,500) in tax-free wage replacement payments, the 50 percent gross replacement rate results in a 62.5 percent net replacement rate, since $12,500 is 62.5 percent of $20,000.

<u>Fairness</u>. The fairness of a wage replacement system must be examined in terms of net rather than gross wage replacement rates, since it is the net replacement rate that indicates what percentage of the individual's true loss in wage income has been restored. The current exclusion of wage replacement benefits from income typically causes net replacement rates to exceed gross replacement rates. Moreover, this excess increases with the tax rate of the recipient's family.

Assume, for example, that individuals A and B have identical jobs and that each earns $160 per week. Due to disability or unemployment, both suffer a loss of all wages, and each receives tax-free payments of $80 per week. Although each has a gross replacement rate of 50 percent, their net replacement rates may differ greatly. If A has several dependents and no other source of income, he would have paid no income tax on his $160 per week; thus his net replacement rate equals his gross replacement rate of 50 percent. On the other hand, if B's spouse has substantial earnings so that the family is in the 30 percent tax bracket, B's net replacement rate will exceed 70 percent because his $80 tax-free payment has replaced after-tax income of $112.

As illustrated by a comparison of net replacement rates, the exclusion of wage replacement payments from income under current law provides the greatest benefit to single taxpayers with no dependents and to taxpayers with other sources of income. Correspondingly, current law provides the least benefit to taxpayers with several dependents and no other source of income. Moreover, the exclusion generally results in higher net replacement rates for those unemployed or disabled for short periods than for those suffering from long-term unemployment or disability.

The current disparity in net replacement rates could be redressed by redesigning wage replacement programs to take total family income into account. This solution, however, would add greatly to administrative complexity. A more efficient approach would be to tax wage replacement payments, recognizing that payment schedules could also be adjusted to maintain average net replacement rates. This would ensure comparable net replacement rates for individuals receiving benefits under the same programs.

<u>Work Incentives</u>. Any wage replacement program will reduce work incentives by reducing the net gain from returning to work. This effect is greatest when such payments are nontaxable, since net wage

replacement rates then increase with family income. For example, if a 66 percent net replacement rate is desired for families with income below the tax-free threshold, it will be necessary to provide a 66 percent gross replacement rate for low-wage workers. Unless benefit payments are based on need, however, a 66 percent gross replacement rate will result in net replacement rates in excess of 100 percent for low-wage workers from high-income families. Such high replacement rates are clearly undesirable. However, as long as payments are nontaxable and are not based on need, adequate net replacement rates for low-income families will create extremely high net replacement rates for low-wage workers from wealthier families.

With respect to unemployment compensation, taxing an increasing percentage of unemployment compensation as the recipient's income increases above his "base amount" creates peculiar work disincentives. For example, if a married individual receives $5,000 in unemployment compensation, each additional dollar that the individual or his or her spouse earns between $13,000 and $23,000 will require inclusion in their gross income of another $0.50 of the unemployment compensation. In effect, each additional dollar of earned income within that range increases their taxable income by $1.50, and thereby multiplies their marginal tax rate by 1.5 for each dollar of earned income within that range. Such perverse results are inevitable if such a phased-out threshold is used.

The conflict between minimum replacement rates and work incentives is greatly reduced if benefits are taxed, even if the average net replacement rate is maintained through higher payments.

Neutrality. Wage replacement payments are presumably reduced in recognition that they are nontaxable, thereby reducing the cost of funding such programs. If the programs are paid for by employers (either through insurance or taxes), exclusion provides an indirect subsidy to industries with high injury or layoff rates, and indirectly raises tax rates on other income. Since the cost of job-related injuries and anticipated layoffs is a real cost of production, this subsidy distorts market prices and resource allocation. Although neutrality could also be achieved by treating wage replacement programs as insurance and taxing employees on the "premiums" paid by employers, this would be administratively difficult and would do nothing to reduce the problems of fairness or work disincentives discussed above.

The exclusion from taxation may also hide the true cost of government-mandated programs from the policymakers who determine their scope and size. Taxing wage replacement payments would enable policymakers to make more informed decisions.

Proposal

All unemployment compensation would be included in income.

In addition, all cash payments for disability from workers' compensation and black lung would be included in income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, and payments for burial expenses. Includable payments would all be eligible for an expanded credit for the elderly, blind, and disabled. See Ch. 2.02. In order to protect low- and moderate-income disabled taxpayers, the proposal would make taxable disability payments eligible for a 15 percent tax credit. The amount eligible for the credit would be reduced by any Title II social security benefits and tier 1 railroad retirement benefits and by one-half of the excess of adjusted gross income over $11,000 ($14,000 for joint returns).

Effective Dates

The proposal would apply to all unemployment compensation received in taxable years beginning on or after January 1, 1987.

With respect to workers' compensation payments, the proposal would apply to all payments received by employees or their survivors for disabilities occurring on or after January 1, 1987. Payments received for a disability occurring before such date would remain nontaxable.

The proposal would apply to all black lung disability payments received in taxable years beginning on or after January 1, 1987, regardless of the date on which the disability occurred.

Analysis

In General. Taxing wage replacement payments would eliminate the disparities in net replacement rates under current law. It would thus be possible to replace a given percentage of lost wages for workers in low-income families without providing net replacement rates far above that rate for workers from families with substantial income from other sources. This would enable wage replacement programs to target the benefits to those who need them most.

Unemployment Compensation. Most unemployment compensation is now excluded from gross income. In 1982, only one-third of such payments were taxed. Of $20.6 billion in payments, only $7 billion were included in gross income. Over $3.8 billion was received by taxpayers with adjusted gross incomes between $18,000 and $30,000, more than 30 percent of which was excluded from gross income.

Most unemployment compensation is received by families with other sources of income. Unemployment compensation provided less than half of family income for more than 67 percent of those receiving benefits in 1983. Most unemployed individuals remain unemployed for less than

15 weeks, so their unemployment compensation supplements income from employment during the rest of the year. Under such circumstances, the exclusion of unemployment compensation from income provides an unnecessary and unfair tax advantage. For example, someone earning $15,000 during the year and receiving $3,000 in unemployment compensation now pays substantially less tax than another person who works all year and earns $18,000.

Any unemployment compensation program will necessarily create some work disincentives. The proposal, however, would eliminate the peculiar disincentives created by the threshold for taxing such benefits under the current system.

States may wish to adjust their unemployment compensation programs if all such compensation is included in gross income. A State that pays benefits equal to 50 percent of gross wages will provide net replacement rates of less than 50 percent to most unemployed workers. The Administration proposals include increased personal exemptions and zero bracket amounts, along with lower tax rates. As a consequence, most workers who are unemployed for a long time and have little access to other sources of income would pay little or no tax on their benefits. The proposed effective date would provide time, however, for States to adjust benefits to protect even more workers.

Disability Payments. By combining most of the special treatment for the disabled in a single tax credit, the proposal would ensure that preferential treatment for the disabled is provided in a fair and consistent manner. Workers receiving workers' compensation and black lung disability payments would be treated similarly to persons who are disabled and receive disability pay from their employer.

Workers' compensation rarely provides the primary source of income for a family. Most of those receiving workers' compensation are off work for less than three weeks, and less than one percent are permanently and totally disabled. Families receiving more than half of their income from workers' compensation are rare (less than 7 percent of all cases), and the majority of recipient families obtain less than 10 percent of their income from workers' compensation. Very few families (approximately 4 percent) received more than $7,000 in benefits in 1983.

Table 1 compares the 1987 tax-free levels of income under current law and the Administration proposals for selected families receiving workers' compensation. Due to the preferential treatment for disability income, their tax-free levels of income would continue to exceed those for non-disabled taxpayers, which are shown in the first row of the table. As a result of the increased personal exemptions and zero bracket amounts, combined with the expanded tax credit for disability income, the tax-exempt level of income would increase for the vast majority of those disabled for less than the full year. Moreover, workers disabled all year with no other source of income would pay no tax unless their benefits exceeded $21,176 (single),

Table 3.06-1

1987 Tax-Free Levels of Income for Those with Workers' Compensation and Black Lung Disability Payments

	Single		Joint (Couple)		Joint (Family of 4) 1/	
	Current Law	Proposal	Current Law	Proposal	Current Law	Proposal
Nondisabled Taxpayer	$ 3,700	$ 5,100	$ 6,060	$ 8,320	$ 9,721	$13,316
Workers' Compensation 2/						
Totally disabled one month						
$30,000 worker	5,367	6,767	7,727	9,987	11,388	14,316
$10,000 worker	4,256	5,656	6,616	8,876	10,277	13,649
Totally disabled six months						
$30,000 worker	13,700	13,883	16,060	17,070	19,721	19,843
$10,000 worker	7,033	8,433	9,393	11,653	13,054	15,399
Totally disabled all year						
Worker with no other income	3/	21,176	3/	31,211	3/	38,947
Black Lung 4/	7,914	9,314	12,381	14,617	18,149	18,795

Office of the Secretary of the Treasury May 28, 1985

1/ Assumes full use of earned income tax credit. For current law, assumes one earner.

2/ Assumes benefits equal two-thirds of lost wages.

3/ Unlimited amounts are now exempt from tax, but maximum benefits in most states will be less than $17,000 in 1989 (estimated by adjusting 1984 levels by the expected increase in wages).

4/ Benefits estimated to be $4,214 (single), $6,321 (couple), and $8,428 (family of four) in 1987.

$31,211 (couple), or $38,947 (family of 4). The maximum benefit payable in 1987 (estimated by adjusting 1984 benefits for expected increases in wages) would be less than these amounts in all but 5, 2, and 1 State respectively.

The tax-exempt level of income would also increase for those receiving black lung disability payments (who are all permanently disabled), as shown in Table 1.

As illustrated in Table 2, workers' compensation benefits are received primarily by middle- and high-income taxpayers. This is largely attributable to the fact that most of those receiving workers' compensation are off work for less than three weeks (with less than one percent permanently and totally disabled), and that such benefits are related to wage levels. Moreover, since each dollar of excluded income is worth more to those in higher tax brackets, the tax benefits from current law are concentrated among higher income families.

Table 3.06-2

Distribution of Workers' Compensation Payments by Economic Income

Family Economic Income	Percentage of All Families (Total Population)	Percentage of Cash Payments from Workers' Compensation
$ 0 - 9,999	15.0 %	4.1 %
10,000 - 14,999	12.7	7.4
15,000 - 19,999	11.7	8.3
20,000 - 29,999	19.3	22.2
30,000 - 49,999	23.3	33.7
50,000 - 99,999	15.4	22.4
100,000 - 199,999	2.1	1.3
200,000 or more	0.5	0.4
Total	100.0 %	100.0 %

Office of the Secretary of The Treasury May 28, 1985

Despite the extensive protection the proposal provides for the low- and moderate-income disabled, the taxation of these forms of disability income generates substantial revenue which can be used to reduce tax rates on other income. Moreover, the higher personal exemption and zero bracket amount would ensure that no families below the poverty line are taxed on income from any source.

The repeal of the exclusion is delayed until 1987 to allow the State and the Federal governments to make any desired compensatory changes in their benefit schedules. Moreover, in the case of workers' compensation, the repeal would apply only to those receiving workers' compensation for disabilities occurring on or after January 1, 1987.

Since most workers' compensation payments are made by private insurance companies, payments for past injuries are funded from premiums paid in the past. As a result, there is no easy way to adjust such payments for the change in tax status. No such grandfathering is proposed for the Federal black lung program because those payments can be adjusted, if desired, for all beneficiaries.

Part C. Excluded Sources of Income--Other

LIMIT SCHOLARSHIP AND FELLOWSHIP EXCLUSION

General Explanation

Chapter 3.07

Current Law

Current law provides an exclusion from income for the amount of certain scholarships or fellowship grants. In the case of candidates for a degree at an educational organization with a regular faculty, curriculum and enrolled body of students, any scholarship or fellowship grant is excludable unless it represents compensation for services. If teaching, research, or other services are required of all such degree candidates, a scholarship or fellowship grant is not regarded as compensation for such services.

Nondegree candidates may exclude scholarships or fellowship grants only if the grantor is a charitable organization, a foreign government or an international organization, or an agency of the United States or a State. The amount that may be excluded is limited to $300 per month, with a lifetime maximum of 36 months. This limit does not apply, however, to amounts received to cover expenses for travel, research, clerical help, or equipment, which are incident to the scholarship or the fellowship grant ("incidental expenses").

Compensation for past, present, or future services is generally not treated as a scholarship or as a fellowship grant. However, in addition to the special rule for degree candidates, there is an exception for certain amounts received under a Federal program. These amounts are treated as scholarships even though the recipient must agree to perform future services as a Federal employee as a condition of obtaining the scholarship.

Reasons for Change

Scholarships and fellowship grants confer a benefit on the recipient that should be taxed as income. The full exclusion of these benefits from income under current law is unfair to the ordinary taxpayer who must pay for education with earnings that are subject to tax.

In theory, it might be appropriate to include the full amount of any scholarship in income. In practice, this would create real hardships for many scholarship recipients. Scholarship awards are often made on the basis of need, and if students were taxed on such amounts, they would often not have the resources to pay the tax. Moreover, unlike most cases in which in-kind benefits are subject to tax, a scholarship is typically not provided in lieu of a cash amount and is not otherwise convertible to cash. The definition of income for tax purposes is appropriately limited by considerations of ability to pay. Accordingly, income from a scholarship for tax purposes should, in general, be limited to amounts that represent out-of-pocket savings for regular living expenses.

An exception for incidental expenses of nondegree candidates is also appropriate. Such expenses would typically be deductible as ordinary and necessary business expenses, and thus in most cases an exclusion simply provides an equivalent tax result.

Proposal

Scholarships and fellowship grants generally would be includable in gross income. In the case of degree candidates, scholarships would be excludable to the extent that they were required to be, and in fact were, spent on tuition and equipment required for courses of instruction, but not for room and board or other personal living expenses. In the case of nondegree candidates, reimbursements for incidental expenses (as defined in current law) would be excludable.

The special rules concerning performance of future services as a Federal employee and compensation for services required of all degree candidates would be repealed. Thus, the amount of any scholarship or fellowship grant representing compensation for services would be included in income, regardless of the employer for whom the services were performed or whether other degree candidates were required to perform similar services.

Effective Date

The proposal generally would be effective with respect to scholarships and fellowships received in taxable years beginning on or after January 1, 1986. However, if a binding commitment to grant a scholarship in the case of a degree candidate was made before January 1, 1986, amounts received pursuant to such commitment would be excludable under the current-law rules through the end of 1990.

Analysis

Degree candidates receiving scholarships that were used for tuition and fees would not be liable for tax by reason of the award. Moreover, even students receiving scholarships for expenses other than tuition and fees would not pay tax as a result of the award unless the student's total income exceeded the sum of the zero bracket amount and the personal exemption ($4,900 if single, and $8,000 for a married couple filing jointly, at 1986 levels).

REPEAL EXCLUSION FOR PRIZES AND AWARDS

General Explanation

Chapter 3.08

Current Law

In general, the amount of a prize or award is includable in income on the same basis as other receipts of cash or valuable property. Current law provides an exception to this general rule, however, for prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for this exclusion, the recipient of the prize or award must be selected without any action on his or her part to enter the contest or proceeding, and must not be required to render substantial future services as a condition of receiving the prize or award.

Reasons for Change

Prizes or awards increase an individual's ability to pay tax the same as any other receipt that adds to an individual's economic wealth. In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of the tax the individual would otherwise owe.

Proposal

The amount of any prize or award received by a taxpayer would be fully includable in income, regardless of whether for religious, charitable, scientific, educational, artistic, literary, or civic achievement. The rule of current law excluding certain prizes and awards from income would continue to apply, however, to the extent that the individual recipient of a prize or award designates that such prize or award go to a tax-exempt charitable organization.

Effective Date

The proposal would be effective for prizes and awards received in taxable years beginning on or after January 1, 1986.

Analysis

Repeal of the exclusion for certain prizes and awards would affect the tax liability of only a few taxpayers, but it would increase the perceived and actual fairness of the tax system by subjecting these persons to tax on the same basis as others.

Part D. Preferred Uses of Income

The Administration proposals would curtail itemized deductions for certain personal expenditures, in order to broaden the tax base, simplify compliance and administration, and allow rates to be reduced. The deduction for State and local taxes would be repealed, and the charitable contribution deduction would be eliminated for nonitemizers. The itemized deductions for charitable contributions, medical expenses, casualty losses, and principal-residence mortgage interest would be left unchanged. Changes to the itemized deduction for interest expense are described in Chapter 13.01 (limit on interest deduction). The deduction for miscellaneous expenses would be replaced with an adjustment to income. (See Chapter 4.01).

REPEAL DEDUCTION OF STATE AND LOCAL TAXES

General Explanation

Chapter 3.09

Current Law

Individuals who itemize deductions are permitted to deduct certain State and local taxes without regard to whether they were incurred in carrying on a trade or business or an income-producing activity. The following such taxes are deductible:

- State and local real property taxes.
- State and local personal property taxes. (In some States, payments for registration and licensing of an automobile are wholly or partially deductible as a personal property tax.)
- State and local income taxes.
- State and local general sales taxes.

Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-producing activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes. Taxes incurred in carrying on a trade or business or which are attributable to property held for the production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-producing activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

Reasons for Change

Fairness. The current deduction for State and local taxes disproportionately benefits high-income taxpayers residing in high-tax States. The two-thirds of taxpayers who do not itemize deductions are not entitled to deduct State and local taxes, and even itemizing taxpayers receive relatively little benefit from the deduction unless they reside in high-tax States. Although the deduction for State and local taxes thus benefits a small minority of U.S. taxpayers, the cost of the deduction is borne by all taxpayers in the form of significantly higher marginal tax rates.

The unfair distribution of benefits from the deduction for State and local taxes is illustrated by recent tax return data. For example, in 1982 itemizing taxpayers in New York received an average tax savings of $1292 from the deduction, whereas itemizers in Wyoming on average saved only $257. In effect, the deduction requires taxpayers in certain communities to subsidize taxpayers in other communities. Moreover, the deduction effectively skews the burden of State and local taxes within particular communities. Consider the variation in effective sales tax rates for three persons facing a 6 percent State sales tax: a nonitemizer, an itemizer in the 50 percent tax bracket, and an itemizer in the 20 percent bracket. The nonitemizer pays the full 6 percent sales tax rate, whereas the two itemizers pay effective rates of 3 and 4.8 percent, respectively. The deduction thus causes effective sales tax rates to vary with a taxpayer's marginal income tax rate and with whether a taxpayer itemizes, and produces the lowest effective rate for high-bracket/high income taxpayers.

Erosion of the Tax Base. The deduction for State and local taxes is one of the most serious omissions from the Federal income tax base. Repeal of the deduction is projected to generate $33.8 billion in revenues for 1988. Recovery of those revenues will permit a substantial reduction in marginal tax rates. Indeed, unless those revenues are recovered, tax rates will almost certainly remain at the current unnecessarily high levels.

The Fallacy of the "Tax on a Tax" Argument. Some argue that the deductibility of State and local taxes is appropriate because individuals should not be "taxed on a tax." The argument is deficient for a number of reasons. First, it ignores the effect of State and local tax deductibility on the Federal income tax base. Deductibility not only reduces aggregate Federal income tax revenues, it shifts the burden of collecting those revenues from high-tax to low-tax States. High-tax States effectively shield a disproportionate share of their income from Federal taxation, leaving a relatively greater share of revenues to be collected from low-tax States. Absent the ability to impose Federal income tax on amounts paid in State and local taxes, the Federal government loses the ability to control its own tax base and to insist that the burden of Federal income taxes be distributed evenly among the States.

Second, the "tax on a tax" argument suggests that amounts paid in State or local taxes should be exempt from Federal taxation because they are involuntary and State or local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies. Moreover, State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services and municipal garbage removal. In this respect, the determination by State and local taxpayers of their levels of taxation and public service benefits is analogous to their individual decisions over how much to spend for the purchase of private goods.

It is, of course, true that not all benefits provided by State and local governments are directly analogous to privately purchased goods or services. Examples include police and fire protection, judicial and administrative services and public welfare. These services nevertheless provide substantial personal benefits to State and local taxpayers, whether directly or by enhancing the general quality of life in State and local communities.

Finally, the "tax on a tax" argument is contradicted by the practice of most States with respect to their own tax systems, including many of those with high tax rates. Federal income taxes are allowable as a deduction from State individual income taxes in only 16 States and from State corporate income taxes in only seven States. New York and California, States with very high tax rates, are among the States that deny a deduction for Federal income taxes.

Inefficient Subsidy. The deduction for State and local taxes may also be regarded as providing a subsidy to State and local governments, which are likely to find it somewhat easier to raise revenue because of the deduction. A general subsidy for spending by State and local governments can be justified only if the services which State and local governments provide have important spillover benefits to individuals in other communities. The existence of such benefits has not been documented.

Even if a subsidy for State and local government spending were desired, provision of the subsidy through a deduction for State and local taxes is neither cost effective nor fair. On average, State and local governments gain less than fifty cents for every dollar of Federal revenue lost because of the deduction. Moreover, a deduction for State and local taxes provides a greater level of subsidy to high-income States and communities than to low-income States and communities. In addition, a deduction for taxes does not distinguish between categories of State and local spending on the basis of their spillover effects, but is as much a subsidy for spending on recreational facilities as for public welfare spending. Finally, the deduction distorts the revenue mix of State and local governments by creating a bias against the imposition of user charges in favor of more general taxes.

Proposal

The itemized deduction for State and local income taxes and for other State and local taxes that are not incurred in carrying on a trade or business or income-producing activity would be repealed. State and local taxes (other than income taxes) which currently are deductible only by itemizers, but which are incurred in carrying on an income-producing activity, would be aggregated with employee business expenses and other miscellaneous deductions and would be deductible subject to a threshold. See Ch. 4.01.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

While only one-third of all families itemized deductions in 1983, this group included most high-income families (more than 95 percent of families with income over $100,000 itemized tax deductions) and very few low-income families (2 percent of families with income of $10,000 or less itemized tax deductions). (Table 1.) Two-thirds of the total deductions for State and local tax payments were claimed by families with economic income of $50,000 or more. The benefits are even further skewed toward high-income families because deductions are worth more to families which face higher marginal tax rates.

The tax savings from deductibility vary widely among the States and, as shown in Table 2, provide the greatest benefits to individuals in high-income States. Because this tax expenditure requires tax rates for all individuals to be higher than they otherwise would be, those in the 15 States with above-average tax savings per capita currently gain at the expense of taxpayers in the other 35 States. Even within the high-tax States, less than one-half of all taxpayers itemize deductions.

Recent estimates indicate that the effect of tax deductibility on the level of State and local government spending is not large. A National League of Cities study found that total State and local spending is about 2% higher because of the existence of tax deductibility. This estimated effect is low in part because less than one-third of total State and local spending is financed by taxes potentially deductible from the Federal individual income tax. Because State and local spending has been growing by about 7% per year since 1980, the elimination of tax deductibility would not reduce the absolute level of State and local spending, but only reduce its rate of growth. However, because the proportion of taxpayers who itemize varies a great deal among the States as well as among local governments within a State, the effect on spending for a particular State or local government would be larger than 2 percent for a high-income community and may not affect spending at all in low-income communities where few residents itemize deductions.

The three most important sources of State and local tax revenue in the U.S. are general sales, personal income and property taxes. Some argue that itemized deductions should be eliminated for some of these taxes, but retained for others. As Table 3 shows, however, elimination of any one tax deduction would have an uneven effect on taxpayers among the States. In addition, since State and local governments would be likely to increase reliance on the remaining deductible taxes, disallowing deductions for particular taxes is likely to lead to sizeable distortions in State and local revenue mixes. For example, disallowing only the sales tax deduction might force a State, like Washington, that relies heavily on a general sales tax but does not have an individual income tax, to adopt one.

Table 3.09-1

Distribution of Deductions for Taxes Paid by Economic Income - 1983

Family Economic Income	Number of Families (thousands)	Percentage with State and Local Deduction	State and Local Taxes Deducted 1/ (millions)	Average Amount Deducted 2/
$ 0 - 9,999	337	2 %	$ 233	$ 691
10,000 - 14,999	516	4	465	901
15,000 - 19,999	1,009	9	1,009	1,089
20,000 - 29,999	3,894	22	5,307	1,363
30,000 - 49,999	10,820	51	22,012	2,034
50,000 - 99,999	11,298	80	36,408	3,223
100,000 - 199,999	1,793	95	12,150	6,776
200,000 or more	426	97	9,090	21,338
All Families	30,093	33	86,762	2,883

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1/ Net of income tax refunds.

2/ For families that itemize deductions.

Table 3.09-2

States Ranked by Per Capita Tax Savings from Tax Deductibility Under Current Law, 1982

State	Tax Savings Per Capita	Income Per Capita	Rank of Income Per Capita
New York	$233	$12,314	7
District of Columbia	198	14,550	2
Maryland	185	12,238	9
New Jersey	167	13,089	4
Delaware	162	11,731	14
California	155	12,567	5
Massachusetts	155	12,088	11
Minnesota	150	11,175	19
Michigan	144	10,956	22
Wisconsin	137	10,774	26
Connecticut	135	13,748	3
Oregon	117	10,335	31
Hawaii	116	11,652	15
Rhode Island	116	10,723	28
Virginia	113	11,095	20
Colorado	110	12,302	8
U.S. Average	106	11,107	-
Illinois	101	12,100	10
Utah	91	8,875	46
Georgia	87	9,583	37
Nebraska	87	10,683	29
Oklahoma	89	11,370	18
Pennsylvania	83	10,955	23
Ohio	82	10,677	30
Kansas	80	11,765	13
North Carolina	77	10,044	41
Arizona	76	10,173	32
Iowa	75	10,791	25
Vermont	75	9,507	39
South Carolina	73	8,502	49
Maine	70	9,042	42
Missouri	70	10,170	34
New Hampshire	68	10,729	27
Kentucky	65	8,934	44
Idaho	64	9,029	43
Washington	63	11,560	16
Nevada	57	11,981	12
Indiana	51	10,021	35
Florida	50	10,978	21
Alabama	49	8,649	48
Arkansas	49	8,479	50
Alaska	45	16,257	1
Texas	43	11,419	17
North Dakota	42	10,872	24
Montana	41	9,580	38
Mississippi	39	7,778	51
New Mexico	38	9,190	40
West Virginia	34	8,769	47
Tennessee	33	8,906	45
Wyoming	33	12,372	6
Louisiana	31	10,231	32
South Dakota	20	9,666	36

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Source: Advisory Commission on Intergovernmental Relations.

Table 3.09-3

Percentage Reliance on Different Deductible Taxes by States in 1982 1/

State	Property Taxes	General Sales Taxes	Individual Income Taxes
Alabama	19.8 %	50.7 %	29.5 %
Alaska	89.1	10.9	0
Arizona	38.7	42.4	18.9
Arkansas	31.6	37.4	31.0
California	33.1	37.3	29.6
Colorado	43.0	37.3	19.7
Connecticut	60.6	34.7	4.7
D.C.	34.0	24.8	41.2
Delaware	26.8	0	73.2
Florida	53.1	46.9	0
Georgia	35.3	34.6	30.1
Hawaii	22.8	51.8	25.5
Idaho	37.9	24.7	37.4
Illinois	47.2	31.1	21.7
Indiana	42.7	37.9	19.5
Iowa	50.5	20.8	28.7
Kansas	51.0	25.7	23.2
Kentucky	27.0	33.5	39.5
Louisiana	22.4	68.9	8.7
Maine	48.6	27.9	23.5
Maryland	33.9	18.9	47.2
Massachusetts	47.4	14.8	37.8
Michigan	53.1	20.2	26.7
Minnesota	36.5	23.0	40.5
Mississippi	30.5	57.1	12.4
Missouri	35.7	36.2	28.1
Montana	76.1	0	23.9
Nebraska	55.6	26.5	17.8
Nevada	33.0	67.0	0
New Hampshire	97.3	0	2.7
New Jersey	61.8	19.7	18.6
New Mexico	25.4	72.8	1.7
New York	40.2	23.3	36.5
North Carolina	33.0	27.4	39.6
North Dakota	52.2	38.5	9.3
Ohio	45.7	26.0	28.3
Oklahoma	26.2	42.0	31.8
Oregon	56.8	0	43.2
Pennsylvania	39.0	25.1	35.9
Rhode Island	54.0	22.1	23.9
South Carolina	32.6	33.8	33.6
South Dakota	56.8	32.2	0
Tennessee	37.2	60.8	1.9
Texas	55.7	44.3	0
Utah	33.5	39.2	27.3
Vermont	59.0	12.2	28.7
Virginia	40.6	22.7	36.7
Washington	40.8	59.2	0
West Virginia	22.2	55.8	22.0
Wisconsin	43.9	20.4	35.7
Wyoming	60.4	39.6	0
U.S. Average	42.5%	31.4%	26.2%

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1/ These figures include some general sales and property taxes with an initial impact on business rather than individuals. Certain other taxes can also be itemized deductions. Property, general sales, and individual income taxes accounted for 94 percent of total taxes itemized in 1982.

Source: Advisory Commission on Intergovernmental Relations.

ACCELERATE EXPIRATION OF CHARITABLE CONTRIBUTION DEDUCTION FOR NONITEMIZERS

General Explanation

Chapter 3.10

Current Law

Contributions to or for the benefit of religious, charitable, educational, and certain other tax-exempt organizations are deductible, subject to certain limitations. Prior to 1981 individuals who did not itemize their deductions could not deduct their charitable contributions. The Economic Recovery Tax Act of 1981 (ERTA) extended the charitable contribution deduction to nonitemizing taxpayers, phased in over a five-year period. For contributions made in the 1984 tax year, individuals who did not itemize deductions were permitted to deduct 25 percent of the first $300 of contributions made. For 1985 and 1986, the $300 limitation is removed, and the percentage of contributions deductible by nonitemizers is increased to 50 percent and 100 percent, respectively. Thus, under current law, the charitable contribution deduction will be allowed in full to nonitemizers in 1986. The charitable deduction for nonitemizers is scheduled to expire after 1986, however, so that after that time the deduction will again be unavailable to individuals who do not itemize their deductions.

Reasons for Change

Taxpayers are not subject to tax on their incomes up to the zero bracket amount (ZBA). This exemption generally is regarded as an allowance for certain personal expenses that ought not to be included in income and that all taxpayers are deemed to incur. In lieu of the ZBA, a taxpayer may itemize deductible personal expenses, such as certain medical expenses, interest expenses, and, prior to the ERTA changes, charitable contributions. Allowing a deduction for charitable contributions by nonitemizers in effect creates a double deduction for such contributions -- first through the ZBA, which is available only to nonitemizers, and second through the charitable contribution deduction.

In addition, the allowance of a charitable contribution deduction for nonitemizers is administratively burdensome for the Internal Revenue Service and complicated for taxpayers. In particular, it is extremely difficult for the Internal Revenue Service to monitor deductions claimed for countless small donations to eligible charities; the expense of verification is out of proportion to the amounts of tax involved. Dishonest taxpayers are thus encouraged to believe that they can misrepresent their charitable contributions with impunity. Moreover, taxpayers who claim charitable contribution deductions are required to maintain records substantiating those contributions. In the case of smaller gifts, the effort required to comply with the necessary substantiation requirements may be out of proportion to the amounts involved.

Finally, allowance of the deduction for nonitemizers would make it much more difficult to implement the proposed return-free system described in Ch. 5.01 for large numbers of taxpayers.

Proposal

The scheduled expiration date of the charitable contribution deduction for nonitemizers would be accelerated.

Effective Date

Expiration of the charitable contribution deduction for nonitemizers would be effective for contributions made in taxable years beginning on or after January 1, 1986.

Analysis

There is little data indicating whether the charitable contribution deduction for nonitemizers has significantly increased the level of charitable giving. Because nonitemizers generally have lower incomes and thus lower marginal tax rates than itemizers, their contributions generally are not affected significantly by tax considerations. Rather, contributions made by nonitemizers are influenced far more by non-tax considerations such as general donative intent. Therefore, any adverse effect of the proposal on charitable giving is not expected to be significant, particularly in relation to the proposal's effect on tax revenues. The repeal of the charitable contribution deduction for nonitemizers is estimated to increase revenues in fiscal years 1986 and 1987 by $419 million and $2,687 million, respectively.

The proposal would simplify both the regular tax form (1040) and the short-form (1040A). The current deduction requires that a "worksheet" be included in the tax form instructions, on which the taxpayer makes calculations, the results of which are subsequently transferred onto Form 1040 or 1040A. The proposal would eliminate these computations and would relieve nonitemizers of recordkeeping burdens.

Part E. Tax Abuses--Mixed Business/Personal Use

Many expenses that involve significant personal consumption currently are being deducted as business expenses. This is unfair to taxpayers who do not have access to business perquisites and also distorts consumption choices. The proposals would limit deductions for entertainment, business meals, and travel expenses.

LIMIT DEDUCTION FOR ENTERTAINMENT AND BUSINESS MEAL EXPENSES

General Explanation

Chapter 3.11

Current Law

Ordinary and necessary expenses paid or incurred during a taxable year generally are deductible if the expenses bear a reasonable and proximate relation to the taxpayer's trade or business or to activities engaged in for profit. Although ordinary and necessary business expenses may include entertainment expenses, business entertainment expenses are deductible only if they satisfy certain additional requirements.

Business meals are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during, or after the meal. Expenses for other entertainment activities are deductible only if they are "directly related to" or "associated with" the taxpayer's trade or business. Entertainment activities are considered "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The taxpayer need not show that income actually resulted from the entertainment. In general, entertainment expenses satisfy the "associated with" standard if they are directly preceded or followed by a substantial and bona fide business discussion. A business discussion may be considered substantial and bona fide even if it consumes less time than the associated entertainment and does not occur on the same day as the entertainment activity.

Deductions for entertainment facilities, such as yachts, hunting lodges, or country clubs, used to entertain clients or customers also are subject to certain restrictions. A deduction is allowed for the portion of the cost of club memberships that are "directly related" to the taxpayer's business if the facilities are used primarily for business purposes. No deduction is allowed for other types of entertainment facilities. Tickets to sporting and theatrical events, and the costs of skyboxes, lounges, boxes or other similar arrangements that provide the taxpayer a specific viewing area to a sporting or theatrical event, however, are not considered to be expenses related to an entertainment facility. Thus, such expenses are fully deductible if they meet the "directly related to" or "associated with" tests for entertainment activities.

Business entertainment expenses also are subject to separate substantiation requirements. Deductions for entertainment expenses must be supported by records showing the amount of the expense, time and place of entertainment, business purpose of the expense, and business relationship to the taxpayer of any persons entertained.

Reasons for Change

<u>In General</u>. The subject of business entertainment expenses has received repeated legislative attention since 1962, when Congress first applied special restrictions to the deduction of such expenses. The continuing concern in this area reflects the difficulty of identifying the business component of expenses that have obvious personal benefits and are commonly incurred in nonbusiness contexts.

Although there are special restrictions on the deduction of business entertainment expenses, current law has largely maintained a facts and circumstances approach in determining whether entertainment expenses were incurred for business rather than personal purposes. The existing "directly related to" or "associated with" tests require investigation of a taxpayer's expectations and intentions. It frequently is possible under those tests to demonstrate an actual business purpose or connection for an entertainment expense that nevertheless has a strong, if not predominant, element of personal consumption. Thus, under present law, the costs of country club memberships, football and theater tickets, parties, and lunches and dinners at expensive restaurants are all deductible where a reasonable business connection can be demonstrated. Indeed, such deductions may be allowed even in cases where less time is devoted to business than to entertainment, no business is discussed, or the taxpayer is not even present at the entertainment activity.

The liberality of the law in this area is in sharp contrast to the treatment of other kinds of expenses that provide both business and personal benefits. In some cases, such as work-related clothing, the presence of any personal benefit is deemed sufficient reason to disallow any deduction. In other cases, taxpayers are allowed to deduct only the portion of expenses allocated to business. In contrast, present law often allows full deductibility of entertainment expenses that entail substantial personal consumption.

<u>Fairness</u>. The current treatment of business entertainment expenses encourages taxpayers to indulge personal entertainment desires while at work or in the company of business associates. The majority of taxpayers, however, do not benefit from this incentive. Most hold jobs that do not permit business entertainment, and many others are scrupulous in claiming business deductions for personal entertainment.

Current law thus creates a preference for the limited class of taxpayers willing and able to satisfy personal entertainment desires in a setting with at least some business trappings. Lunches are deductible for a business person who eats with clients at an elegant restaurant, but not for a plumber who eats with other workers at the construction site. The cost of tickets to a sporting event for friends of a business person is deductible if they are business associates, but the cost of tickets for friends of a secretary, sales clerk, or nurse must be paid for with after-tax dollars.

Extreme abuses of these deductions are commonly cited by those who assail the tax system as unfair. Such abuses may be limited to a relatively small number of taxpayers, but they nevertheless undermine the public trust that is essential in a tax system based on self-assessment. Taxpayers are not only aware of the abuses, they perceive an inability under current law to police them. Absent public confidence that the rules apply on the same basis to all, disrespect for the system and greater noncompliance are inevitable. The adoption of workable limitations on the deductibility of entertainment expenses would be an important step to preserve that confidence.

Efficiency. The treatment of "business related" entertainment under current law also encourages excessive spending on entertainment. The business person in the 40 percent marginal tax bracket considering whether to spend $20 or $50 on a "business meal" knows that the $30 extra cost of the more expensive meal is reduced to $18 because of the available deduction. The taxpayer's choice of meals is more likely to be based on personal rather than business considerations, but the deductibility of the expense makes selection of the expensive meal more likely than in a nonbusiness context. Similarly, a business person in the 50 percent marginal tax bracket may conclude that it costs nothing extra to take a business associate to the theater even if it serves little or no business purpose. The attendance of the business associate permits a claim that the cost of both tickets is deductible, and thus the extra ticket may cost nothing on an after-tax basis.

Present law has no effective response to these practices because it characterizes an entertainment expense as business or personal on the basis of the taxpayer's intentions and purposes. Once a business purpose or connection is established, it ordinarily permits the entire expense to be deducted, even though the total amount spent reflects what is in essence a choice about the level of personal consumption.

Proposals

1. No deduction would be allowed for entertainment activity expenses. Entertainment activity expenses, however, would be exempted from the general disallowance rule if they: are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; constitute recreational expenses for employees (e.g., Christmas parties and summer outings); are expenses for goods, services, and facilities made available to the general public (e.g., samples and promotional activities); or are expenses includable in income of persons who are not employees.

2. A deduction would be allowed for the cost of ordinary and necessary business meals furnished in a clear business setting (as defined in Treasury regulations). To the extent the total cost of a

business meal exceeds $25 times the number of persons participating in such meal, 50 percent of such excess would be nondeductible. The meal cost limitation would include gratuities and tax with respect to the meal. However, expenses for food and beverage furnished on the business premises of the taxpayer primarily for employees of the taxpayer would not be subject to the limitation.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

Business Meal Limitations. Business meals provide a mixture of business and personal benefits. The extent to which a meal provides a personal benefit will vary, and it is not possible to develop rules that would specify the precise percentage of personal benefit in individual cases. The proposal, therefore, establishes a relatively mechanical limitation on the deductibility of business meals, targeted at meal expenses that are most likely to provide a significant level of personal consumption. The $25 allowance is intentionally quite generous and is intended to provide a full deduction for the vast majority of business meals. The deduction will be disallowed only for 50 percent of the portion of the cost of a business meal that is in excess of $25.

Representatives of the restaurant industry in testimony before Congress have provided several estimates of the average cost of restaurant meals. If adjusted for inflation, those estimates would range between $7.50 and $11.50 for 1986. In addition, Census data shows that only about 2.5 percent of all restaurant meals in 1977 were in restaurants where the average bill exceeded $10.00. Adjusted for inflation, this suggests that only about 2.5 percent of all meals were in restaurants with average bills over $19.00 in 1986. Recent surveys suggest that less than 15 percent of all business meals would be affected by the proposal in 1986.

While the proposal will reduce the number of expensive business meals, it is expected that the limitations will not have a significant impact on more than five percent of restaurants. Moreover, since some high-cost meals will be replaced by moderate-cost meals, the effect on total employment in the restaurant industry is expected to be modest.

Businesses currently are required to keep detailed records for all deductible meals. Therefore, the additional recordkeeping costs should be minimal.

Placing a limit on the deductibility of business meals would eliminate the extreme cases of abuse -- those that offend the average taxpayer the most. Despite its small revenue effect, the proposal would be of significant assistance in restoring trust in the tax system.

The Elimination of Other Entertainment Deductions. The proposal would completely eliminate deductions for entertainment expenses such as tickets to professional sporting events, tickets to the theater, the costs of fishing trips, and country club dues. Because all such entertainment has a large personal component, the proper tax treatment, on both efficiency and equity grounds, is to disallow a deduction.

Approximately one-third of all baseball tickets and over one-half of all hockey tickets are purchased by businesses. The net effect is often to raise the cost of tickets for those who are not subsidized through the tax system for their purchases. Some performing arts organizations also sell large proportions of their tickets to businesses. Some tickets bought by businesses would remain deductible if the tickets are made available to the general public as a promotion under current law standards.

LIMIT DEDUCTION FOR TRAVEL EXPENSES

General Explanation

Chapter 3.12

Current Law

Travel expenses incurred by a taxpayer while "away from home" are deductible if such expenses are reasonable and necessary in the taxpayer's business and are directly attributable to the taxpayer's business. Travel expenses may include the cost of travel to and from the destination and the cost of meals, lodging, and other incidental travel costs (e.g., laundry, taxi fares) incurred while at the business destination. A taxpayer's "home" for purposes of the deduction is generally his or her business headquarters. A taxpayer is considered to be "away" from his or her business headquarters only if the travel involves a "temporary" rather than an "indefinite" assignment at another location. If a taxpayer accepts a job at a distant location for an indefinite period, the new job location becomes the taxpayer's tax home. Temporary employment generally is expected to last for a short or foreseeable period of time, but whether employment is temporary or indefinite is essentially a factual question.

The costs of attending a convention or other meeting (including the costs of meals and lodging) in the North American area are deductible if the taxpayer is able to show that attendance at the convention is directly related to his or her trade or business and that such attendance is advancing the interests of the taxpayer's trade or business. The North American area includes the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada, Mexico, and certain Caribbean countries that have entered into exchange of tax information agreements with the United States. A stricter rule applies for conventions held outside the North American area. In order to claim a deduction for the costs of attending such a convention, a taxpayer also must show that it was "as reasonable" for the meeting to be held outside the North American area as within it.

Deductions for conventions, seminars, or other meetings held on cruise ships are subject to additional limitations. No deduction is allowed unless the cruise ship is registered in the United States and stops only at ports of call in the United States or in possessions of the United States. In any event, a taxpayer may deduct no more than $2,000 for such meetings per year.

Professional education expenses, including travel as a form of education, are deductible if the education maintains or improves existing employment skills or is required by an employer, or applicable law or regulation. To be deductible, the travel must be directly related to the duties of the taxpayer in his or her employment or other trade or business. The deductible educational travel may occur while the taxpayer is on sabbatical leave.

Reasons for Change

The present limitations on deductions for business travel fail to distinguish adequately between costs incurred for business purposes and costs reflecting personal consumption. The deduction for expenses for meals and lodging incurred "away from home" is premised on the assumption that the business traveler incurs additional costs while away from home. Restaurant meals are likely to be more expensive than the cost to the taxpayer of eating at home, and hotel accomodations are a duplicative expense for the taxpayer who maintains regular living quarters elsewhere. These excess costs incurred by a taxpayer away from home may reasonably be treated as legitimate business expenses.

Extended travel status, however, generally permits economies not available on shorter trips. The temporary residence of a taxpayer expecting to be away from home for a year or more typically will have kitchen, laundry, and other facilities that permit the taxpayer to avoid excess expenses. Moreover, extended travel may permit the taxpayer to abate fixed costs associated with his permanent residence, such as by renting or subletting his house or apartment.

In addition, the current tax treatment of travel that has both business and personal elements creates opportunities for abuse that threaten public confidence in the system. Current law largely retains a facts and circumstances approach to the characterization of such mixed motive expenses, and thus requires investigation of the taxpayer's particular intentions and expectations. The fact that a plausible business purpose frequently can be established for travel that has a strong personal component encourages taxpayers, in a system of self-assessment, to take aggressive reporting positions. The great majority of taxpayers are honest, and apply current law standards in good faith. It is not reasonable, however, to expect that taxpayers deny themselves the benefit of the doubt when applying rules that are broad and open to interpretation.

The issues identified above are characteristic of a system that emphasizes fairness of individual results, and thus avoids the rougher justice achieved by mechanical, bright-line rules. Without challenging these priorities in any fundamental way, it is still appropriate to recognize that the integrity of the system ultimately depends on rules that taxpayers respect and perceive that others respect. This is especially so with regard to deductions for expenses, such as travel, that most taxpayers undertake strictly for personal purposes and that have obvious personal consumption benefits. Accordingly, strict limitations on deductions for travel expenses are appropriate where the component of personal consumption is manifest or where business and personal motivations are so intertwined as to be inseparable.

Proposals

1. For purposes of determining whether a taxpayer is away from home, travel assignments which extend for more than one year in one city would be considered indefinite, and no travel deductions would be allowed.

2. No deduction would be allowed for business travel by ocean liner, cruise ship, or other form of luxury water transportation in excess of the cost of otherwise available business transportation, unless the taxpayer provides proof of existing medical reasons for utilizing such transportation.

3. No deduction would be allowed for expenses paid with respect to conventions, seminars, or other meetings held aboard cruise ships.

4. No deduction would be allowed for travel as a form of education.

5. The limitations set forth in 2. through 4. above would not apply in cases where the expenses in question are paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement); are treated as compensation by an employer and taken into account as wages by an employee; or are expenses includable in income of persons who are not employees.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposed limitations on certain travel expense deductions are designed to restrict deductions for travel expenses where personal consumption benefits are most evident without unduly restricting deductions for legitimate business expenses.

The one-year rule for defining temporary employment would eliminate a significant source of dispute between taxpayers and the Internal Revenue Service, and would provide a reasonable division between temporary and indefinite assignments. One year's stay at a single location is sufficient to indicate that regular living patterns will be established at the new location and, thus, that food and lodging expenses need not be duplicative of or more expensive than comparable costs at the original job site.

The disallowance of a deduction for the cost of travel by cruise ships, ocean liner, or other form of luxury water transportation in excess of the cost of otherwise available business transportation is intended to deny a deduction for the portion of the travel cost most likely to constitute personal rather than business benefit.

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Part F. Tax Abuses--Income Shifting

Although the proposed rate schedule for individuals is flatter than under current law, there would remain a substantial difference between the top and bottom rates. Thus, as under current law, taxpayers subject to the top rate would have an incentive to shift income to their children or other family members subject to tax at lower rates. Current law limits income shifting through various rules, including the assignment-of-income doctrine and the interest-free loan provisions. This Part discusses proposed rules that would buttress current limits on income-shifting by preventing taxpayers from reducing the tax on unearned income by transferring income to minor children or establishing trusts.

ADJUST TAX RATE ON UNEARNED INCOME OF MINOR CHILDREN

General Explanation

Chapter 3.13

Current Law

Minor children generally are subject to the same Federal income tax rules as adults. If a child is claimed as a dependent on another taxpayer's return, however, the child's zero bracket amount is limited to the amount of the child's earned income. Accordingly, the child must pay tax on any unearned income in excess of the personal exemption ($1,040 in 1985).

Under current law, when parents or other persons transfer investment assets to a child, the income from such assets generally is taxed thereafter to the child, even if the transferor retains significant control over the assets. For example, under the Uniform Gifts to Minors Act ("UGMA"), a person may give stock, a security (such as a bond), a life insurance policy, an annuity contract, or money to a custodian, who generally may be the donor, for the child. As a result of the gift, legal title to the property is vested in the child. During the child's minority, however, the custodian has the power to sell and reinvest the property; to pay over amounts for the support, maintenance, and benefit of the minor; or to accumulate income. Results similar to those achieved by a transfer under the UGMA may be obtained by transferring property to a trust or to a court-appointed guardian.

Parents also may shift income-producing assets to a child, without relinquishing control over the assets, by contributing such assets to a partnership or S corporation and giving the child an interest in the partnership or corporation.

Reasons for Change

Under current law, a family may reduce its aggregate tax liability by shifting income-producing assets among family members. Such "income shifting" is a common tax-planning technique, typically accomplished by the parents transferring assets to their children so that a portion of the family income will be taxed at the child's lower marginal tax rate.

Income shifting undermines the progressive rate structure, and results in unequal treatment of taxpayers with the same ability to pay tax. A family whose income consists largely of wages earned by one or both parents pays tax on that income at the marginal rate of the parents. Even though such wage income is used in part for the living expenses of the children, parents may not allocate any portion of their salary to their children in order that it be taxed at the children's lower tax rates. Families with investment income, however, may be financially able to transfer some of it to the children, thereby shifting the income to lower tax brackets. Typically, this ability is most prevalent among wealthy taxpayers. Moreover, use of a trust or a gift under the UGMA allows the parents to achieve this result without relinquishing control over the property until the children come of age.

The opportunity for income shifting also complicates the financial affairs of persons who take advantage of it, and causes some persons to make transfers they would not make absent tax considerations. Disputes with the Internal Revenue Service are created in the case of transfers that arguably are ineffective in shifting the incidence of taxation to the transferee, such as when a parent nominally transfers property to children but in reality retains the power to revoke the transfer.

Proposal

Unearned income of children under 14 years of age that is attributable to property received from their parents would be taxed at the marginal tax rate of their parents. This rule would apply only to the extent that the child's unearned income exceeded the personal exemption ($2,000 under the Administration proposals). The child's tax liability on such unearned income would be equal to the additional tax that his or her parents would owe if such income were added to the parents' taxable income and reported on their return. If the parents report a net loss on their return, the proposed rule would not apply, and the child's unearned income would be taxed along with his or her earned income. If more than one child has unearned income which is taxable at the parents' rate, such income would be aggregated and added to the parents' taxable income. Each child would then be liable for a proportionate part of the incremental tax.

All unearned income of a child would be treated as attributable to property received from a parent, unless the income is derived from a qualified segregated account. A child who receives money or property from someone other than a parent, such as another relative, or who earns income, could place such property or earnings into a qualified segregated account. Property received by reason of the death of a parent could also be placed into the account. However, other amounts otherwise received directly or indirectly from a parent could not be placed into the account.

For purposes of this provision, an adopted child's parents would be the adoptive parent or parents. In the case of a foster child, the parents would be either the natural parents or the foster parents, at the child's election. If the parents are married and file a joint return, the child's tax would be computed with reference to the parents' joint income. If the parents live together as of the close of the taxable year, but do not file a joint return (i.e., if they are married and file separate returns or if they file as single individuals), then the child's tax would be computed with reference to the income of the parent with the higher taxable income. If the parents do not file a joint return and are not living together as of the close of the taxable year, the child's tax would be computed with reference to the income of the parent having custody of the child for the greater portion of the taxable year.

Expenses that are properly attributable to the child's unearned income would be allowed as deductions against such income. Itemized deductions and the personal exemption generally would be allocated between earned and unearned income in any manner chosen by the taxpayer. Interest expense, however, would be deductible against unearned income that is taxable at the parents' tax rate only if it is attributable to debt that was assumed by the child in connection with a transfer of property from the parents, or to debt that encumbered such property at the time of the transfer.

Earned income and income from a qualified segregated account would be taxable (after subtracting the portion of the child's itemized deductions and personal exemption allocated to such income) under the rate schedule applicable to single individuals, starting at the lowest rate. Moreover, unlike current law, the zero bracket amount could be used against both the child's earned income and unearned income from a segregated account, although it could not be used to offset other unearned income.

The proposed taxation of income of children under 14 years of age may be illustrated by the following example.

Suppose Sarah, aged 13, earns $500 from a paper route in 1984. She has $4,000 in a bank account, attributable to savings from her earned income and gifts from her grandparents. She earns $360 in interest from the account. She also earns $1,000 from an account set up by her parents under the Uniform Gifts to Minors Act. Under current law, Sarah's unused zero bracket amount is $2,300 less $500, or $1,800. This amount must be added to her income. Thus, Sarah's income is:

$ 500
360
1,000
1,800
$3,660, less $1,000 personal exemption = $2,660.

In 1984, the tax on taxable income of $2,660 is $39.60. Sarah must file a return and pay this tax.

Under the proposal (assuming 1984 levels of the zero bracket amount and personal exemption), Sarah would not have to file a return, because her income taxable at her parents' rate ($1,000) is not in excess of her personal exemption, and her other income ($860) is not in excess of the zero bracket amount. If her parents placed more money in her name she would have to file a return. Even then, however, only one rate would apply to her income, namely that of her parents.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would help to ensure the integrity of the progressive tax rate structure, which is designed to impose tax burdens in accordance with each taxpayer's ability to pay. Families would be taxed at the rate applicable to the total earned and unearned income of the parents, including income from property that the parents have transferred to the children's names. The current Federal income tax incentive for transferring substantial amounts of investment property to minor children would be eliminated.

Under the proposal, the unearned income of a minor child under 14 years of age would be taxed at his or her parents' rate. This is the age at which children may work in certain employment under the Fair Labor Standards Act. Because most children under 14 have little or no earned income, maintenance of segregated accounts and preparation of their returns under the proposal should not be complex.

In most cases the income tax return of a child under 14 years of age is prepared by or on behalf of the parent and signed by the parent as guardian of the child. In such cases, the requirement that a child's income be aggregated with that of his or her parents would not create a problem of confidentiality with respect to the parents' return information, since there would be no need to divulge this information to the child. Although the return generally would be filed by a parent on behalf of a child, liability for the tax would rest, as under current law, on the child.

Only children required to file a return under current law would be required to do so under the proposal. In 1981, only 612,000 persons who filed returns reporting unearned income were claimed as dependents on another taxpayer's return. This represents less than one percent of the number of children claimed as dependents in that year. Moreover, in many instances the proposal would eliminate tax liability for children who currently must file a return because they cannot use the zero bracket amount to offset unearned income that is not attributable to property received from their parents.

REVISE GRANTOR AND NON-GRANTOR TRUST TAXATION

General Explanation

Chapter 3.14

Current Law

In General

The manner in which the income from property held in trust is taxed depends upon the extent to which the grantor has retained an interest in the trust. A so-called "grantor trust," a trust in which the grantor has retained a statutorily defined interest, is treated as owned by the grantor and the trust's income is taxable directly to the grantor. Non-grantor trusts, including "Clifford trusts," on the other hand, are treated as separate taxpayers for Federal income tax purposes, with trust income subject to a separate graduated rate structure.

The rules for determining whether a trust will be treated as a grantor trust are highly complex. In general, however, the test is whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. For example, to the extent that the grantor (or a party whose interests are not adverse to the grantor) has the right to vest the trust's income or assets in the grantor, the trust will be treated as a grantor trust. Similarly, to the extent that the trust's assets or income may reasonably be expected to revert to the grantor within ten years of the trust's creation, the trust will generally be treated as a grantor trust.

In general, the income of a non-grantor trust is subject to one level of tax; it is taxable either to the trust itself or to the beneficiaries of the trust. Under this general model, trust income is included as gross income of the trust, but distributions of such income to trust beneficiaries are deductible by the trust and includable in the income of the beneficiaries.

The maximum distribution deduction permitted to a trust, and the maximum amount includable in the income of trust beneficiaries, is the trust's distributable net income ("DNI"). A trust's DNI consists of its taxable income computed with certain modifications, the most significant of which are the subtraction of most capital gains and the addition of any tax-exempt income earned by the trust.

To the extent that a trust distribution carries out DNI to a beneficiary, the trust essentially serves as a conduit, with the beneficiary taking into account separately his or her share of each trust item included in DNI. Under a complex set of rules, the computation of each beneficiary's share of an item of trust income generally depends upon the amount distributed to the beneficiary and the "tier" to which the beneficiary belongs. A distribution that does not carry out DNI -- such as one in satisfaction of a gift or bequest of specific property or a specific sum of money, or one in excess of DNI -- is not deductible by the trust and is not includable in the recipient's income. Similarly, because capital gains generally are excluded from the computation of DNI, a trust ordinarily is subject to taxation on the entire amount of its capital gain income even when it distributes an amount in excess of its DNI.

Adoption of Taxable Year

The trustee of a non-grantor trust may select a year ending on the last day of any month as the trust's taxable year. Although a trust distribution that carries out DNI is generally deductible by the trust in the taxable year during which it is made, the distribution is not taxable to the beneficiary until his or her taxable year with which or in which the trust's taxable year ends. Thus, for example, if an individual is a calendar-year taxpayer and is the beneficiary of a trust with a taxable year ending January 31, distributions made by the trust with respect to its year ending January 31, 1984, will not be subject to tax until the beneficiary's year ending December 31, 1984, even if they were made as early as February 1983.

Throwback Rules

The so-called "throwback rules" are applicable only to trusts that accumulate income rather than distribute it currently to the beneficiaries. These rules limit the use of a trust as a device to accumulate income at a marginal tax rate lower than that of the trust's beneficiaries. DNI that is accumulated rather than distributed currently becomes undistributed net income ("UNI") and may be subject to additional tax when distributed to the beneficiaries.

The rules for determining the amount, if any, of such additional tax are complex. In general, however, if a trust's current distributions exceed its DNI and the trust has UNI from prior taxable years, the excess distributions (to the extent of UNI), increased by the taxes paid by the trust on such distribution, will be taxed at the beneficiary's average marginal tax rate over a specified period preceding the distribution as reduced by a credit for the tax paid by the trust on such distribution.

Reasons for Change

Taxpayer Fairness

Present law permits a grantor to shift income to family members through creation of a trust, even when the grantor retains significant control over or a beneficial interest in the trust's assets. For example, trust income is not taxed to the grantor even though the trust's assets will revert to the grantor as soon as ten years after the trust's creation. Similarly, trust income is not taxed to the grantor even though the grantor appoints himself or herself as trustee with certain discretionary powers to accumulate income or distribute trust assets. Significantly broader discretion over trust income and distributions may be vested in an independent trustee, who, although not formally subject to the grantor's control, may be expected to exercise his or her discretion in a manner that minimizes the aggregate tax burden of the trust's grantor and beneficiaries.

During the lifetime of the grantor, there is no persuasive justification for taxing a trust under its own graduated rate schedule. Permitting a grantor to create trusts and thereby obtain the benefit of multiple graduated rate schedules is inconsistent with the principle that all income of an individual taxpayer should be subject to tax under the same progressive rate structure. A trust is simply an arrangement established by the grantor to manage investment assets and to allocate the income from those assets to beneficiaries. Where the grantor has effectively divested himself of control and enjoyment of trust income is irrevocably fixed or determined, such income should be taxed to the beneficial owners of the trust. Where this divestment has not taken place, however, the trust's income should be included in the grantor's income or taxed at the grantor's marginal tax rate.

On the other hand, after the grantor's death it may not be unreasonable to respect trusts as separate taxable entities. In such instances, it is likely that non-tax factors outweigh any Federal income tax considerations in the grantor's decision whether to create a trust. For example, it is reasonable to assume that a grantor creating an inter vivos trust with discretion in the trustee over the ultimate beneficiary of the property is creating the trust, at least in substantial part, to obtain preferential income tax treatment; ordinarily, the grantor could accomplish most of the non-tax objectives for the creation of the trust by retaining the property. At the least, the tax system should not create a preference for utilizing the trust vehicle. In contrast, a trust may be the only form in which to preserve such discretion and flexibility after the grantor's death. Precise rules that would define when post-death trusts would be granted the benefit of separate graduated rate schedules would be complex and would lead to harsh results in many cases.

Efficiency and Simplification

The significant income-splitting advantages that may be gained by placing income-producing assets in trust have resulted in greater utilization of the trust device than would be justified by non-tax economic considerations. Moreover, even where there are non-tax reasons for a trust's creation, tax considerations heavily influence the trustee's determination of whether to accumulate or distribute trust income. No discernable social policy is served by this tax incentive for the creation of trusts and the accumulation of income within them. Thus, current tax policy has not only sacrificed tax revenue with respect to trust income, it also has encouraged artificial and inefficient arrangements for the ownership and management of property. In addition, the fact that the tax benefits of the trust form can be increased through the creation of multiple trusts has resulted in the creation of numerous trusts with essentially similar dispositive provisions.

The tax advantages that current law provides to trusts also have spawned a complex array of anti-abuse provisions. The grantor trust rules and the throwback rules are highly complex and often arbitrary in their application. Rules that attribute capital gain of certain non-grantor trusts to the grantor are also complex in operation and can have unforeseen consequences to trust grantors.

Proposal

Taxation of Trusts During Lifetime of Grantor

1. Overview

During the lifetime of the grantor, all trusts created by the grantor would be divided into two categories: trusts that are treated as owned by the grantor for Federal income tax purposes, because the grantor has retained a present interest in or control over the trust property; and trusts that are not treated as owned by the grantor, because the grantor does not have any present interest in or control over the property. As under current law, the income of a trust classified as a grantor-owned trust generally would be taxed directly to the grantor to the extent that the grantor is treated as the owner. A non-grantor-owned trust generally would be respected as a separate taxable entity. During the grantor's lifetime, however, income would be taxed to the trust at the grantor's marginal tax rate, unless the trust instrument requires the income to be distributed to or irrevocably set aside for specified beneficiaries.

2. Grantor-owned trusts

The grantor would be treated as the owner of a trust to the extent that (i) payments of property or income are required to be made currently to the grantor or the grantor's spouse; (ii) payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either one of them; (iii) the grantor or the grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them; (iv) the grantor or the grantor's spouse has any power to cause the trustee to lend trust income or corpus to either of them; or (v) the grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year. For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person or persons would be characterized as "adverse parties" under present law. In addition, a United States person who transfers property to a foreign trust having one or more U.S. beneficiaries would continue to be treated as the owner of the portion of the trust attributable to that property to the extent required under present law.

The present law rules under which a person other than the grantor may be treated as owner of a trust would be retained and made consistent with these rules. A grantor or other person who is treated as the owner of any portion of a trust under these rules would be subject to tax on the income of such portion. Transactions between the trust and its owner would be disregarded for Federal income tax purposes where appropriate.

3. Non-grantor-owned trusts

(a) In general. A trust that is not treated as owned by the grantor or by any other person under the rules described above would be subject to tax as a separate entity. Unlike present law, however, non-grantor-owned trusts would be required to adopt the same taxable year as the grantor, thereby limiting the use of fiscal years by trusts to defer the taxation of trust income.

The trust would compute its taxable income in the same manner as an individual, but would not be entitled to a zero bracket amount or a personal exemption (or deduction in lieu of a personal exemption). As under current law, the trust would be entitled to a deduction for charitable contributions made within 65 days of the close of the trust's taxable year.

(b) Distribution deduction. The present rules regarding the deductibility of distributions made by a trust to non-charitable beneficiaries would be substantially changed. First, during the lifetime of the grantor, only mandatory distributions would be deductible by a trust. A distribution would qualify for this deduction only if a fixed or ascertainable amount of trust income or property is required to be distributed to a specific beneficiary or beneficiaries. As under present law, distributions required to be made would be deductible regardless of whether actually made by the trustee.

The amount of a mandatory distribution would be considered fixed or ascertainable if expressed in the governing instrument as a portion or percentage of trust income. The requirement that each beneficiary's share be fixed or ascertainable also would be satisfied by a requirement that distributions be made on a per capita or per stirpital basis that does not give any person the right to vary the beneficiaries' proportionate interests. Thus, distributions would not qualify as mandatory if the governing instrument requires the distribution of all income among a class of beneficiaries, but gives any person the right to vary the proportionate interests of the members of the class in trust income.

A distribution would be considered mandatory if required upon the happening of an event not within the control of the grantor, the grantor's spouse, or the trustee, such as the marriage of a beneficiary or the exercise by an adult beneficiary of an unrestricted power of withdrawal. The requirement that the governing instrument specify the beneficiary or beneficiaries of a mandatory distribution would be satisfied if a class of beneficiaries were specified and particular beneficiaries could be added or removed only upon the happening of certain events not within the control of the grantor, grantor's spouse, or trustee, such as the birth or adoption of a child, marriage, divorce, or attainment of a certain age.

Second, unlike present law, property required to be irrevocably set aside for a beneficiary would be treated as a mandatory distribution, provided the amount set aside is required to be distributed ultimately to the beneficiary or the beneficiary's estate, or is subject to a power exercisable by the beneficiary the possession of which will cause the property to be included in the beneficiary's gross estate for Federal estate tax purposes. Thus, the trustee could designate property as irrevocably set aside for a beneficiary and obtain a distribution deduction (provided that a distribution or set-aside is mandatory under the governing instrument) without making an actual distribution to the beneficiary. To qualify for the set-aside deduction, the beneficiary would have to agree to include the amount in income.

If the tax imposed on a beneficiary by reason of a set-aside exceeds the amount actually distributed to the beneficiary in any year, and if the governing instrument permits the beneficiary to obtain a contribution from the trustee equal to the tax liability imposed by reason of the set-aside (less any amounts previously distributed to the beneficiary during the taxable year), such contribution would be treated as paid out of the amount set aside, and therefore would not carry out additional DNI. This structure, unlike present law, would permit a fiduciary to obtain the benefit of a beneficiary's lower tax bracket through an irrevocable set-aside. Accordingly, tax motivations would not override non-tax factors which might indicate that an actual distribution is undesirable.

Third, whether mandatory or not, distributions to non-charitable beneficiaries would not be deductible during the lifetime of the grantor under the following circumstances indicating incomplete relinquishment of interest in or dominion and control over the trust:

(i) If any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse;

(ii) If any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion cannot occur prior to the death of the income beneficiary of such portion and such beneficiary is younger than the grantor, or prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or the funding of the trust;

(iii) If any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administrative powers in a non-fiduciary capacity without the consent of a fiduciary;

(iv) If and to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or grantor's spouse, including a legal obligation of support or maintenance; or

(v) If trust income or corpus can be used to carry premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership.

(c) Computation of tax liability. Once the taxable income of a non-grantor inter vivos trust has been computed under the rules described above, the trust's tax liability would be determined. This liability would be the excess of (i) the tax liability that would have been imposed on the grantor had the trust's taxable income been added to the greater of zero or the grantor's taxable income and reported on the grantor's return, over (ii) the tax liability that is actually imposed on the grantor. Thus, the trust's tax liability generally would equal the incremental amount of tax that the grantor would have paid had the trust been classified as a grantor trust, with two exceptions. First, to avoid the difficulty associated with any recomputation of a grantor's net operating loss carryover and other complexities, if the grantor has incurred a loss in the taxable year or in a prior taxable year, such loss would be disregarded and the grantor would be deemed to have a taxable income of zero for purposes of computing the trust's tax liability. Second, the addition of the trust's taxable income to the taxable income of the grantor would not affect the computation of the grantor's taxable income. For example, trust income would not be attributed to the grantor for purposes of determining the grantor's floor on various deductions.

If the grantor has created more than one non-grantor trust, then each such trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income. If one or more trusts do not cooperate with the grantor and other trusts created by the grantor in determining their tax liability under these rules, the trusts failing to cooperate would be subject to the highest marginal rate applicable to individuals. Similarly, if the grantor does not provide a trustee with information sufficient to enable the trustee to compute the trust's tax liability under these rules, the trustee would be required to assume (for purposes of computing the trust's tax) that the grantor had taxable income placing him or her in the highest marginal rate.

(d) Taxation of beneficiaries. As under current law, distributions to beneficiaries that are deductible by a trust would be taxable to the beneficiaries, with the trust's DNI representing the maximum amount deductible by the trust and includable in the income of the beneficiaries. Capital gain deemed to be distributed would be included in the computation of the trust's DNI. Capital gain income would be deemed to be distributed if the trust instrument requires that it be distributed or if and to the extent that mandatory distributions and set-asides exceed DNI (as computed without regard to such gain). Each recipient of a required distribution or set-aside would take into account his or her proportionate share of DNI. Thus, the tier rules of present law would be eliminated. Each item entering the computation of DNI, including capital gains that are deemed to be distributed and hence are included in DNI, would be allocated among the beneficiaries and the trust, based on the proportionate amounts distributed to or set aside for each beneficiary.

(e) Multiple grantors. For purposes of determining whether the grantor is the owner of any portion of a trust, and for purposes of determining whether a mandatory distribution is deductible, a trust having more than one grantor would be treated as consisting of separate trusts with respect to each grantor. If a husband and wife are both grantors with respect to a trust, however, they would be entitled to elect one of them to be treated as the grantor with respect to the entire trust for all Federal income tax purposes, such as determining the marginal rate of the trust and the treatment of the trust as a lifetime or post-death trust. The election would have to be made on the trust's first income tax return. Once made, such an election would be irrevocable and would apply to all subsequent transfers to such trust made during the course of the marriage by either spouse.

Taxation of Trusts After Death of Grantor

For all taxable years beginning after the death of an individual, all inter vivos and testamentary trusts established by such individual would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption (or deduction in lieu of a personal exemption), and with a distribution deduction for all distributions, whether mandatory or discretionary, actually made to or for non-charitable beneficiaries. As under present law, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. A similar rule would apply to set-asides. Charitable contributions would be deductible as under current law. All trusts would compute DNI in the same manner as non-grantor inter vivos trusts. Any taxable income of the trust would be subject to tax under a graduated rate schedule which is the same as that for married individuals filing separately.

In order to prevent the use of such post-death trusts as income-splitting devices, the throwback rules of present law would continue to apply. Because the present throwback rules often do not fully recapture the tax savings from the accumulation of income within the trust, consideration would be given to provisions such as the imposition of an interest charge on the tax payable with respect to an accumulation distribution and the application of the throwback rules to income accumulated while the beneficiary is under 21 years of age and to capital gain income. In addition, consideration would be given to a more restrictive multiple trust rule to limit the tax benefits of the trust form where two or more trusts have any common primary beneficiaries.

In order to simplify the transition of inter vivos trusts to the post-death rules and to achieve consistent treatment with the decedent's estate (see Ch. 3.15), a trust created during the grantor's lifetime would continue to be treated as an inter vivos trust through the end of the taxable year in which the grantor's death occurs. Thus, for the taxable year in which the grantor's death occurs, income of a grantor-owned trust would be taxed to the grantor. Similarly, during the grantor's final taxable year, a non-grantor-owned inter vivos trust would compute its taxable income in the same manner as before the death of the grantor. Accordingly, such a trust would be entitled to a deduction for qualifying distributions to charity and for all mandatory distributions or set-asides with respect to non-charitable beneficiaries. The trust's taxable year would not terminate with the death of the grantor and the trust would compute its tax liability for the grantor's final year by reference to the taxable income of the grantor.

Testamentary trusts would compute their income using the same taxable year as the decedent and the decedent's estate. A testamentary trust created before the end of the taxable year of the decedent's death would compute its tax liability for its first (short) taxable year along with all other trusts created by the decedent, by reference to the decedent's taxable income for that year.

Effective Date

The proposal would apply generally to irrevocable trusts created after 1985 and to trusts that are revocable on January 1, 1986, for taxable years beginning on or after January 1, 1986. A trust that is irrevocable on January 1, 1986, would nevertheless be treated as created after 1985 if any amount is transferred to such trust by a grantor after such date. Similarly, a trust that is revocable on January 1, 1986, and that becomes irrevocable after such date would be treated as a new trust for purposes of these rules.

For trusts that are irrevocable on January 1, 1986, the proposal would apply according to the following rules. Trusts that are grantor trusts under present law would be subject to the new rules beginning with the first taxable year of the grantor that begins on or after January 1, 1986. If a trust that is classified as a grantor trust under present law is classified as a non-grantor trust under the new rules, however, it would be entitled to elect to be treated as if the grantor were the owner for Federal income tax purposes (such election to be made jointly by the grantor and the trustee).

With respect to trusts that are irrevocable on January 1, 1986, and are not classified as grantor trusts under present law, the proposal would apply to taxable years beginning on or after January 1, 1986, with the following exceptions. First, if such a trust has already validly elected a fiscal year other than the grantor's taxable year on a return filed before January 1, 1986, the trust would be entitled to retain that year as its taxable year. In a case where the grantor and the trust have different taxable years, the trust would compute its tax liability by reference to the grantor's income for the grantor's taxable year ending within the taxable year of the trust. Second, such trusts would be entitled to a distribution deduction for all distributions and set-asides, whether discretionary or mandatory, made during the grantor's lifetime. Finally, such trusts would be entitled to elect to continue the tier system of present law for allocating DNI among trust beneficiaries.

Analysis

The proposal would limit the use of trusts as an income-splitting device. In this respect, the proposal would reinforce the integrity of the progressive rate structure and thus enhance the fairness of the tax system.

The proposal would, in general, permit the use of non-grantor inter vivos trusts to shift income among family members only if distributions or set-asides are mandatory and only if the grantor has effectively relinquished all rights in the trust property (other than the exercise of certain powers as trustee). With respect to such a trust, present law would be liberalized in that amounts irrevocably set aside for a beneficiary would be treated as actually distributed. At the same time, wholly discretionary distributions would be ineffective to shift income to trust beneficiaries regardless of the identity of the trustee.

The proposal also would result in substantial simplification of the rules for taxation of trust income. The tier system and the special rule taxing some trust capital gains to the grantor would be repealed. The throwback rules would no longer be applicable to any trust income accumulated during the grantor's lifetime after 1985. Similarly, it would not be necessary to apply the multiple trust rules until after the year in which the grantor's death occurs. Requiring virtually all new trusts to use a calendar year would eliminate the unwarranted tax advantage often created by the selection of fiscal years. The simplicity created by these rules would more than offset whatever complexity is created by taxing inter vivos trusts at the grantor's marginal rate in certain circumstances.

The removal of the artificial tax advantages of trusts would cause decisions regarding the creation of trusts to be based on non-tax considerations. For example, because the income of a ten-year "Clifford" trust would be taxed at the grantor's marginal rate with no distribution deduction, such trusts would be created only where warranted by non-tax considerations. Because many inter vivos trusts are created solely for tax reasons, fewer such trusts would be established under the proposed rules, thus simplifying the financial affairs of taxpayers and reducing the number of trust income tax returns that have to be filed. At the same time, however, the proposal would not impose a tax penalty on the use of a trust to hold and to manage a family's assets. As a general rule, during the grantor's lifetime, accumulated trust income would be taxed as if the grantor had not established the trust. After the grantor's death, a more liberal treatment allowing a graduated rate schedule to the trust would apply. This treatment reflects the substantial non-tax considerations that affect how an individual disposes of his or her estate. Moreover, after the death of the grantor, all trusts created by the grantor would be taxed in the same manner as the grantor's estate; as a result, the proposal would not affect an individual's decision whether to use a trust to avoid probate.

REVISE INCOME TAXATION OF ESTATES

General Explanation

Chapter 3.15

Current Law

Under present law, a decedent's estate is recognized as a separate taxable entity for Federal income tax purposes. The separate existence of the estate begins with the death of the decedent, and the estate computes its income without regard to the decedent's taxable income for the period prior to the decedent's death. Because the estate's separate existence begins with the decedent's death, the estate is entitled to adopt its own taxable year without regard to the taxable year of the decedent or the taxable year of any beneficiary of the estate. Furthermore, any trust created by the decedent's will is entitled to select its own taxable year without regard to the taxable year selected by the estate.

An estate generally computes its income in the same manner as an individual, with a $600 deduction allowed in lieu of the personal exemption. The amount of tax on an estate's income generally is determined in the same manner as a trust -- with a deduction allowed for distributions not in excess of distributable net income ("DNI") -- except that the throwback rules applicable to trusts do not apply to estates. Thus, an estate can accumulate taxable income using its separate graduated rate structure and distribute the income in a later year free of any additional tax liability.

Under present law, the decedent's final return includes all items properly includable by the decedent in income for the period ending with the date of his death. The tax paid with this return is generally deductible as a claim against the estate for Federal estate tax purposes. For Federal income tax purposes, all income received or accrued after the date of death is taxed to the estate rather than the decedent. The decedent's surviving spouse may elect, however, to file a joint Federal income tax return for the taxable year in which the decedent's death occurs.

Reasons for Change

The availability to an estate of a taxable year other than the calendar year creates tax avoidance opportunities. By appropriately timing distributions to beneficiaries of the estate, tax on income generated in the estate may be deferred for a full year. This deferral potential is exacerbated through the use of different fiscal years by testamentary trusts. Estates can also use "trapping distributions" to allocate estate income among the maximum number of taxpayers and thereby minimize the aggregate tax burden imposed on estate income.

The current rules for taxation of income during the taxable year in which the decedent dies create additional distortions. There is no necessary correlation between the timing of items of income and deduction and the date of death. Thus, for example, deductible expenses incurred prior to the date of death are not matched against income received after the date of death. This can result in the wasting of deductions on the decedent's final return or the stacking of income in the decedent's estate.

Proposal

The rules governing the taxation of estates would be changed so that the decedent's final taxable year would continue through the end of the taxable year in which his death occurs. Distributions by the decedent's personal representative to beneficiaries of the decedent's estate would not give rise to a distribution deduction against the decedent's income. As under current law, income tax accrued through the date of the decedent's death would be deductible for Federal estate tax purposes.

The first taxable year of the estate as a separate entity would be the first taxable year beginning after the decedent's death. The estate would be subject to tax at a separate rate schedule, with no zero bracket amount and no personal exemption (or deduction in lieu of a personal exemption), but with a deduction for distributions to beneficiaries. Although the estate would not be entitled to any personal exemption, an estate having gross income of less than $600 would be exempt from Federal income tax liability and would not be required to file a return (as under present law).

An estate would compute its taxable income in the same manner as any trust following the death of the grantor. Thus, the estate would be entitled to a deduction for distributions that carry out DNI, and such distributions would be taxable to the beneficiaries. For this purpose, distributions made within 65 days of the close of the taxable year would be treated as made on the last day of the taxable year. As under present law, distributions that are made in satisfaction of a bequest or gift of specific property or a specific sum of money would not carry out DNI.

Effective Date

The proposal would apply to estates of decedents dying on or after January 1, 1986.

Analysis

By placing estates on the same taxable year as the decedent, the proposal would eliminate the selection of a taxable year for an estate that defers the taxation of the estate's income. Continuing the decedent's final taxable year through the last day of the year in which the decedent's death occurs would simplify the Federal income tax returns of most decedents and their estates, and would also permit simpler rules for taxing inter vivos trusts created by the decedent. See Ch. 3.14. Providing the estate with a separate rate structure and a deduction for distributions would continue some income-shifting opportunities that exist under present law; however, placing all trusts created by the decedent on the same calendar year and applying a strict multiple trust rule would limit the use of trapping distributions to shift income from estates to trusts.

CHAPTER 4

REDUCE RECORDKEEPING AND COMPLEXITY

Simplification is advanced by a number of the Administration proposals discussed in other chapters. This chapter is devoted to proposals particularly aimed at reducing recordkeeping and complexity for individuals.

The proposals would repeal the political contribution credit, the presidential campaign check-off, and the adoption expense deduction. A floor would be imposed on employee business expenses and miscellaneous itemized deductions. Income averaging would be repealed in light of the flatter tax rate schedules and lower marginal tax rates under the Administration proposals. Finally, the penalty provisions would be rationalized and simplified.

IMPOSE FLOOR ON EMPLOYEE BUSINESS EXPENSE AND OTHER MISCELLANEOUS DEDUCTIONS

General Explanation

Chapter 4.01

Current Law

Four categories of employee business expenses may be deducted by taxpayers regardless of whether they itemize deductions. These are:

- expenses paid by the employee and reimbursed by the employer;
- employee expenses of travel, meals, and lodging while away from home;
- employee transportation expenses; and
- business expenses of employees who are outside salesmen.

Various miscellaneous itemized deductions are allowed for taxpayers who itemize deductions. These miscellaneous itemized deductions comprise all itemized deductions other than medical expenses, charitable contributions, interest, taxes, and theft and casualty losses. They include:

- employee business expenses other than those described above, including educational expenses, union and professional dues, safety equipment, small tools, supplies, uniforms, protective clothing, professional subscriptions, and employment agency fees;
- gambling losses not in excess of gambling winnings;
- expenses of producing certain income, including fees for investment services, safe deposit box rentals, trustee fees, and tax return preparation and tax advice fees.

Reasons for Change

Allowance of the various employee business expense deductions and the miscellaneous itemized deductions complicates recordkeeping for many taxpayers. Moreover, the small amounts that are typically involved present significant administrative and enforcement problems for the Internal Revenue Service. These deductions are also a source of numerous taxpayer errors concerning what amounts and what items are properly deductible.

Proposal

Employee business expenses (other than those reimbursed by the employer) and the miscellaneous itemized deductions would be consolidated into a single category, together with the deduction for State and local taxes (other than income taxes) which are currently required to be itemized on Schedule A but which are incurred in carrying on an income-producing activity. To the extent that these items, in the aggregate, exceed one percent of a taxpayer's adjusted gross income ("AGI"), they would be deductible by the taxpayer, whether or not he itemizes deductions. The amount allowed as a deduction would reduce the taxpayer's adjusted gross income. However, the one percent floor would be based on AGI as computed without regard to the deduction. In lieu of a deduction, employer reimbursements would be excluded from the employee's income to the extent that the employee would have been entitled to a deduction without regard to the one percent floor.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses.

In 1982, one-half of all itemizers claimed miscellaneous deductions of less than one-half of one percent of their AGI. Fifty-eight percent claimed deductions of less than one percent of their AGI, and 93 percent claimed deductions of less than five percent of their AGI. Thus, introduction of a floor or threshold of one percent of AGI would substantially reduce the number of returns claiming this deduction.

REPEAL POLITICAL CONTRIBUTION CREDIT

General Explanation

Chapter 4.02

Current Law

Individuals are allowed a nonrefundable tax credit for contributions to political candidates and political action committees. The credit equals one-half of the first $100 ($200 for joint returns) of an individual's contributions during the year.

Reasons For Change

The tax credit for political campaign contributions is not related to the proper measurement of income, but rather is intended to encourage individuals to contribute to the cost of the political process. The efficacy of the political contribution credit in producing additional political contributions is open to question. The credit produces no marginal incentive for taxpayers who without regard to the credit would make contributions of $100 or more. The credit also creates no incentive for low-income individuals who have no income tax liability.

The political contribution credit presents administrative and compliance problems for the Internal Revenue Service. The subject matter of the credit may involve the Internal Revenue Service in sensitive inquiries about political affiliation. Moreover, the small dollar amounts involved on each tax return make verification difficult and expensive relative to the revenue at stake. There are some indications that increasing numbers of taxpayers may be claiming credits for which no contributions have been made.

Finally, the political contribution credit creates complexity for taxpayers. It adds a line to income tax forms and entails an additional recordkeeping burden.

Proposal

The credit for political contributions would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

In 1982, the political contribution credit was claimed on about 5.2 million returns, or about 6.6 percent of all individual returns with some tax liability before deducting tax credits.

As shown in Table 1, the number of users of the credit is skewed heavily toward higher-income taxpayers. Only 2.8 percent of all returns with income of $10,000 or less (and with some tax liability) used the credit whereas 38.4 percent of all returns with income of $100,000 or more claimed the credit. However, because the credit is limited to $50 ($100 on joint returns), tax benefits slightly favor those in lower-income brackets. In 1982, the Federal revenue loss from the credit was $270 million. The percentage distribution of those benefits is shown in the Table 1.

Table 4.02-1

Use of the Political Contributions Tax Credit -- 1982

AGI Class	Percentage of Returns Claiming the Credit 1/	Distribution of Tax Benefit from Credit	Distribution of Tax Liability
$ 0 - 9,999	2.8 %	8.2 %	2.5 %
10,000 - 19,999	4.5	17.1	12.5
20,000 - 29,999	6.5	20.9	18.8
30,000 - 49,999	10.0	29.4	30.8
50,000 - 99,999	20.8	16.6	18.2
100,000 or more	38.4	7.8	17.2
All Returns	6.6 %	100.0 %	100.0 %

Office of the Secretary of the Treasury May 28, 1985

1/ Percentage of all returns with some tax liability before tax credits.

Even if a large portion of the tax reduction attributable to the credit is not simply a windfall benefit to taxpayers who would have made a contribution anyway, the total subsidy from the credit represents only a small portion of total political campaign expenditures in the United States.

Repeal of the credit would not cause a significant increase in tax liability for any group of taxpayers.

REPEAL PRESIDENTIAL CAMPAIGN CHECK-OFF

General Explanation

Chapter 4.03

Current Law

The Presidential election campaign check-off permits each individual who has income tax liability to elect to have one dollar of that liability used to finance Presidential election campaigns. By statute, the check-off information must be either on the first page of the income tax return or on the page that bears the taxpayer's signature.

Reasons For Change

The Presidential election campaign check-off is unrelated to the purposes of the income tax and is a source of complexity for taxpayers. The check-off does not directly affect individual tax liabilities, but simply allows taxpayers to direct that a small portion of their taxes be spent in a particular way. The use of the tax return system for this purpose is unique to the campaign check-off. For the many taxpayers who do not understand its purpose or effect, the check-off is a source of confusion. In addition, the check-off complicates tax forms, significantly in the case of the shorter forms, such as the 1040EZ.

Proposal

The Presidential election campaign check-off would be repealed.

Effective Date

The repeal would be effective for tax liability in taxable years beginning on or after January 1, 1986.

Analysis

Approximately one-fourth of all taxpayers (one-third of those taxpayers with some income tax liability) use this provision to earmark funds for Presidential campaigns. The percentage of taxpayers using the provision varies somewhat between election and nonelection years.

Since use of the campaign check-off does not increase any individual's income tax liability, taxpayers would not be adversely affected by repeal of this provision. Repeal of the check-off would eliminate public funds for Presidential campaigns unless direct appropriations were provided.

REPEAL ADOPTION EXPENSE DEDUCTION

General Explanation

Chapter 4.04

Current Law

Current law permits a deduction for "qualified adoption expenses" paid or incurred during the taxable year. In general, qualified adoption expenses include the reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses directly related to the legal adoption of a "child with special needs" as defined in the Social Security Act.

The maximum amount of qualified adoption expenses that may be deducted with respect to a child is $1,500. Moreover, no expense may be deducted as a qualified adoption expense if a credit or deduction is otherwise allowable for such expense or if such expense is paid for by a grant from a Federal, State, or local program.

Reasons for Change

The allowance of a deduction for certain adoption expenses is an inappropriate way of providing Federal support for those who adopt children with special needs. Federal programs supporting such children or the families who adopt them should be under the supervision and control of agencies familiar with their needs. Such agencies should also have budgetary responsibility for the cost of programs serving these purposes. Providing Federal support through the tax system is inconsistent with each of these objectives.

Proposal

The deduction for qualified adoption expenses would be repealed.

Effective Date

The proposal would generally be effective for taxable years beginning on or after January 1, 1987, and would generally apply to expenses paid or incurred after such date. Taxpayers having incurred qualified adoption expenses with respect to a child before January 1, 1986, would be entitled to deduct qualified adoption expenses paid or incurred after the effective date with respect to such child.

Analysis

It is anticipated that a direct expenditure program would be enacted to continue Federal support for families adopting children with special needs. The effective date of such program should be coordinated with the proposed repeal of the current deduction.

REPEAL INCOME AVERAGING

General Explanation

Chapter 4.05

Current Law

Because of the progressive tax rate structure, an individual whose income varies widely from year to year pays more tax over a period of years than an individual who earns comparable income evenly over the same period. The income averaging provisions mitigate this effect. Under these provisions, if an eligible individual's income for the taxable year exceeds 140 percent of his average income for the three preceding years ("base years"), the effective tax rate applicable to such excess income ("averagable income") generally will be the rate that would apply to one-fourth of the averagable income. The individual's tax liability will be an amount equal to the sum of (i) the tax on 140 percent of the three-year base period income, plus (ii) four times the extra tax from stacking one-fourth of the averagable income on top of 140 percent of base period income.

Two basic eligibility requirements restrict the availability of income averaging. First, the individual must have been a citizen or resident of the United States during the current year and each of the base years. Second, the individual (and the individual's spouse) generally must have provided at least 50 percent of his or her support during each of the three base years. This support test need not be satisfied if:

(1) the individual has attained the age of 25 and was not a full-time student during at least four years after attaining the age of 21;

(2) more than one-half of the individual's taxable income for the current year is attributable to work performed during two or more of the base years; or

(3) the individual files a joint return for the current year and not more than 25 percent of the aggregate adjusted gross income on the joint return is attributable to such individual.

Reasons for Change

Income averaging was intended to provide taxpayers whose income fluctuates widely from year to year with relief from the effect of the progressive rate structure. The changes in the rate structure included in the Administration proposal would reduce the need for income averaging in two respects. First, with fewer but wider brackets, taxpayers would be able to experience greater fluctuations in income without becoming subject to higher progressive rates. Second, with the overall reduction in marginal rates, the additional tax paid as a result of large income fluctuations would generally be less.

The eligibility requirements and computations relating to income averaging are extremely complex. In spite of that complexity, current law does not succeed in restricting the benefits of income averaging to taxpayers with widely fluctuating income. Thus, many of the beneficiaries of income averaging are taxpayers who experience sharp, sustained increases in income, such as young people who complete their studies and enter the work force for the first time. The availability of income averaging for such taxpayers is inconsistent with the principles of a progressive tax system.

Proposal

The income averaging provisions would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

For taxpayers with truly fluctuating income, the need for income averaging would be reduced by the proposed rate structure. Repeal of the income averaging provisions would simplify the tax code and forms.

SIMPLIFY PENALTY PROVISIONS

General Explanation

Chapter 4.06

Current Law

The Internal Revenue Code provides civil penalties for failure to file information returns and for failure to furnish statements to persons with respect to whom an information return was required to be filed. The amount of the penalty is $50 for each statement or return that is not filed or furnished. Some of the penalty provisions have a $50,000 per year maximum amount. The Code does not provide a penalty (except a $5 penalty for failure to include a correct taxpayer identification number) for including incorrect information on information returns or statements.

The Code provides a penalty for failure to pay tax when due of 0.5 percent of the overdue tax per month, not exceeding 25 percent.

Reasons for Change

An effective system of information reporting is essential to ensure even-handed enforcement of the tax laws, to broaden the tax base by including currently unreported income, and to facilitate a shift to a largely return-free system. The present penalty structure, which is the result of piecemeal additions to the Internal Revenue Code, does not provide a clear, consistent set of rules covering information reporting violations. In addition, maximum penalty amounts undermine horizontal equity and weaken the information gathering system.

The existing penalty for failure to pay taxes when due is overly burdensome, and generally falls on taxpayers whose failure to pay is not willful.

Proposal

The penalties for failure to furnish copies of information returns to payees would be eliminated as a separate section of the Internal Revenue Code and would be incorporated into the existing provision for failure to file information returns. A new penalty provision also would be included in the same section for filing an incorrect return or statement. The amount of the penalties, generally the same as current law, would be as follows:

(a) failure to file information return: $50 for each return;

(b) failure to furnish statement to payee: $50 for each statement; and

(c) furnishing incorrect information on a return or statement: $5 for each incorrect return or statement.

The current $50,000 maximum on certain information return penalties would be eliminated. Failure both to file an information return and to furnish a statement to a payee would result in a combined penalty of $100. Only one $5 penalty would be imposed for a return or statement that included more than one piece of incorrect information.

In addition, the present penalty for failure to pay taxes would be eliminated and replaced with a cost of collection charge. Current law does not permit the charging of collection fees, which is standard practice in the private sector. This proposal would allow the Internal Revenue Service to recoup its cost of collecting delinquent amounts and would encourage taxpayers to pay more promptly. Like penalties, this fee would not be deductible by taxpayers.

Effective Date

The proposals would apply to returns due on or after January 1, 1986 (determined without regard to extensions).

Analysis

The proposed restructuring of the penalty provisions should promote simplification in the administration of the provisions and provide greater fairness in their application. The proposal would integrate certain information reporting penalties into a single provision which should promote compliance with the tax laws by enabling taxpayers to understand more easily the consequences of noncompliance.

Under the proposal, the existing heavier penalty for intentional disregard of the filing requirements would remain intact and would be imposed if the violation is willful rather than merely inadvertent or careless. The proposal does not affect existing penalties for information returns involving foreign persons or transactions, employee plans, or exempt organizations.

The elimination of the $50,000 maximum penalty amount would serve the interests of fairness and compliance. Maximum penalty amounts do not encourage compliance with the tax laws, nor do they promote uniformity of treatment. There is no reason, for example, that an employer who fails to file 5,000 W-2 reports should receive relatively more favorable treatment than an employer who fails to file 50 or 500 such reports. Yet that is the result under current law, which imposes a statutory maximum on the penalty paid by the larger employer.

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CHAPTER 5

SIMPLIFY THE SYSTEM OF FILING

IMPLEMENT RETURN-FREE SYSTEM

General Explanation

Chapter 5.01

Current Law

Individuals whose income exceeds specified levels are required to file income tax returns each year.

Reasons for Change

The requirement to file income tax returns imposes a paperwork burden on taxpayers. This burden should be reduced to the extent consistent with sound tax administration.

Proposal

As a supplement to other alternatives to the filing of proper income tax returns that are already under study by the Internal Revenue Service, the Internal Revenue Service would be given authority to implement a return-free tax system. Under such a system, individual taxpayers who meet requirements to be specified by the Internal Revenue Service would not be required to file income tax returns. Instead, the Internal Revenue Service would, at the election of each eligible taxpayer, compute the taxpayer's liability, based on withholding and information reports provided to the Internal Revenue Service currently. The taxpayer would be sent a report, which would set forth the taxpayer's tax liability, and the taxpayer would be free to challenge the Internal Revenue Service's calculation of tax.

Analysis

Institution of the return-free system, together with the increases in zero bracket amounts and the personal exemptions, would substantially reduce the number of returns that taxpayers need to file with the Internal Revenue Service each year. This, in turn, would eliminate burdensome recordkeeping required of taxpayers and costs incurred by them in preparing returns. If the return-free system were to be implemented, it would initially be limited to single wage earners with uncomplicated financial transactions, roughly 21 million taxpayers (17 million of which would otherwise file the simplified Form 1040EZ and 4 million of which would otherwise file the Form 1040A only because they had more than $400 in interest income). After a pilot program and further study, the system could be extended to other individual taxpayers and, by the early 1990's, more than 50 percent of all taxpayers could be covered by the return-free system. It is estimated that at this level of participation the return-free system would save taxpayers annually approximately 71 million hours in actual return preparation and $1.6 billion in fees paid to professional tax preparers.

II. BUSINESS AND CAPITAL INCOME TAXES

CHAPTER 6

REVISE THE TAXATION OF CORPORATE INCOME

Equity investment in the corporate sector is discouraged by the relatively high effective rate of taxation imposed on the return from such investment. Current law imposes double taxation on corporate income distributed as dividends, mitigated only by the exclusion available to individual shareholders for the first $100 of dividend income received. The Administration proposes to repeal this exclusion and to institute a corporate-level deduction for 10 percent of previously taxed corporate earnings paid out as dividends. In addition, the Administration proposal would reduce the marginal tax burden on corporate income by lowering the top corporate tax rate from 46 percent to 33 percent. A graduated rate structure for corporations would be maintained, in order not to increase the burden on small corporations.

REDUCE CORPORATE INCOME TAX RATES

General Explanation

Chapter 6.01

Current Law

In general, a tax is imposed on the taxable income of corporations at a maximum rate of 46 percent for all such income in excess of $100,000. For corporate income under $100,000, tax generally is imposed under the following schedule:

(1) 15 percent on taxable income up to $25,000;

(2) 18 percent on taxable income between $25,000 and $50,000;

(3) 30 percent on taxable income between $50,000 and $75,000; and

(4) 40 percent on taxable income between $75,000 and $100,000.

The graduated rates are phased out for corporations with taxable income over $1,000,000, so that corporations with taxable income of $1,405,000 or more pay, in effect, a flat tax at the 46 percent rate.

Reasons for Change

The current corporate income tax overtaxes some corporations and undertaxes others. Although corporations generally are subject to a uniform rate structure, the base of income subject to tax differs depending on the extent to which corporations are able to generate preferred sources of income or deductions. For corporations with overstated deductions or losses, or deferred or exempt income, the effective rate of tax may be far below the prescribed statutory rate.

A variety of the existing provisions that narrow the base of corporate taxable income are explicitly intended to lower the effective tax rate on corporate investment and income. By establishing preferences for particular forms of investment, however, such provisions override private decisionmaking and stimulate non-economic, tax-motivated activity. In contrast, tax relief provided in the form of lower statutory rates creates an incentive for investment that is neutral across assets and industries, and allows the choice among various investments to be based on economic rather than tax considerations. Although the Administration proposals retain certain targeted investment incentives, the general thrust of the proposals is to reduce the influence of the tax law on private commercial activity. Thus, the Administration proposals would expand the base of corporate taxable income in order that statutory rates of tax applicable to such income may be substantially reduced.

Proposal

Under the proposal, a tax would be imposed on taxable income of a corporation at a rate of 33 percent for all such income in excess of $75,000. For corporate income under $75,000, tax would be imposed under the following schedule:

(1) 15 percent on taxable income up to $25,000;

(2) 18 percent on taxable income between $25,000 and $50,000; and

(3) 25 percent on taxable income between $50,000 and $75,000.

The graduated rates would be phased out for corporations with taxable income over $140,000, so that corporations with taxable income of $360,000 or more would pay, in effect, a flat tax at the 33 percent rate.

Effective Date

The proposed corporate tax rates would be effective July 1, 1986. Thus, the rate schedule for taxable years including July 1, 1986, would reflect blended rates based on the new rates effective on such date.

Analysis

Lowering the maximum corporate tax rate generally would reduce the after-tax cost of corporate equity capital and therefore would encourage increased corporate equity investment. Reducing the after-tax cost of corporate equity relative to debt could also lessen upward pressures on interest rates caused by current heavy borrowing in the corporate sector.

The proposal retains a modified graduated rate structure for small corporations in recognition of the fact that complete elimination of the graduated rate structure would dramatically increase effective tax rates for many smaller corporations, thus nullifying the positive effects, for such corporations, of the proposed reduction in the maximum marginal rate.

REDUCE DOUBLE TAXATION OF CORPORATE EARNINGS DISTRIBUTED TO SHAREHOLDERS

General Explanation

Chapter 6.02

Current Law

In general, corporations are treated as taxpaying entities separate from their shareholders for Federal income tax purposes. Thus, a corporation separately reports and is directly taxable on its income. Correspondingly, the income of a corporation is not taxable to its shareholders until actually distributed to them. An exception to these rules is provided on an elective basis under Subchapter S of the Code. Taxable income of an S corporation is allocated among and taxed directly to its shareholders. This pass-through tax regime is limited to corporations meeting certain requirements, including that the corporation have only one class of stock and 35 or fewer shareholders.

Dividends paid by corporations other than S corporations are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Corporate shareholders generally are taxed on only 15 percent of dividends received from other corporations, and are not subject to tax on dividends received from certain affiliated domestic corporations, such as controlled subsidiaries. Corporations are not entitled to a deduction for dividends paid to shareholders. Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax. Corporations are permitted, however, to deduct interest paid on corporate indebtedness, even if paid to creditors who also are shareholders.

Corporate distributions to shareholders generally are taxable "dividends" to the extent of (i) the corporation's earnings and profits in the year of distribution plus (ii) earnings and profits accumulated in prior years. In concept, a corporation's earnings and profits represent its ability to make distributions to shareholders without impairing invested capital. Thus, earnings and profits, in general, measure economic income of the corporation available for distribution to shareholders. Distributions to shareholders in excess of current and accumulated earnings and profits first reduce the shareholders' basis in their stock, and, to the extent of the excess, are taxed as amounts received in exchange for the stock.

If a corporation redeems its stock from a shareholder, the distribution from the corporation generally is treated as a payment in exchange for the stock and any resulting gain to the shareholder is taxed as a capital gain. Similarly, amounts received by a shareholder in a distribution in complete liquidation of the corporation are treated as payments in exchange for the stock. Such sale or exchange treatment also applies to distributions in partial liquidation to noncorporate shareholders.

Reasons for Change

The disparate tax treatment of debt and equity in the corporate sector distorts a variety of decisions concerning a corporation's capitalization as well as its policies with regard to investment or distribution of earnings. Because interest payments are deductible by a corporation and dividend distributions are not, corporate earnings distributed to shareholders are subject to both corporate and shareholder income taxes, while corporate earnings distributed as interest are taxable only to the creditor. The effective double taxation of dividends encourages corporations to finance their operations with debt rather than equity. This reliance on debt capital increases the vulnerability of corporations both to the risks of bankruptcy and to cyclical changes in the economy.

The different treatment of interest and dividends under current law also places great significance on rules for distinguishing debt from equity. Historically, the distinction for tax purposes has rested on a series of general factors which have been given different weight depending on the circumstances of the taxpayer and on the particular court making the determination. This approach has increasingly generated uncertainty, especially as more sophisticated financial instruments have merged the traditional characteristics of debt and equity. Although attempts have been made to formulate and codify more or less mechanical tests for distinguishing debt from equity, no consensus exists concerning the proper criteria for such tests. Considerable uncertainty thus remains under current law concerning whether instruments will be treated as debt or equity for tax purposes.

The double taxation of earnings distributed as dividends to shareholders also affects corporate distribution policy in ways that detract from the efficiency of the economy. Corporations with shareholders in relatively high tax brackets are encouraged to retain earnings, in order to defer shareholder level income tax. Corporations with shareholders who are tax exempt or in relatively low tax brackets are encouraged to distribute earnings, so that the shareholders may invest those earnings without bearing future corporate-level income tax. These incentives for or against distribution of earnings interfere with ordinary market incentives to place funds in the hands of the most efficient users.

The double taxation of corporate earnings distributed to shareholders also increases the cost of capital for corporations and discourages capital-intensive means of production in the corporate sector. Similarly, double taxation discriminates against goods and services that are more readily produced or provided by the corporate sector as well as activities customarily engaged in by corporations.

Investors are thus discouraged from using the corporate form, even in circumstances where nontax considerations make it desirable. The elective provisions of Subchapter S provide only limited relief from these effects.

Proposal

Deduction for Dividends Paid. The double taxation of corporate earnings distributed as dividends would be partially relieved under the Administration proposal by allowing domestic corporations, other than those subject to special tax regimes (e.g., regulated investment companies), a deduction equal to 10 percent of dividends paid to their shareholders ("dividends paid deduction"). The amount of dividends subject to the dividends paid deduction would be limited, however, to ensure that the deduction is allowed only with respect to dividends attributable to corporate earnings that have borne the regular corporate income tax. Thus, relief from double taxation of dividends would be provided only when the income with respect to which the dividends are paid is actually taxed at the corporate level. The dividends paid deduction, therefore, would not be available with respect to corporate distributions from so-called tax preference income.

The limitation on the source of deductible dividends would be provided by requiring every corporation to maintain a Qualified Dividend Account. The amount of dividends with respect to which a deduction could be claimed in any taxable year would be limited to the Qualified Dividend Account balance as of the end of the year during which the dividends were paid. Dividends paid during a taxable year in excess of the Qualified Dividend Account balance as of the end of the year would not be eligible for the dividends paid deduction. Moreover, these excess dividends could not be carried forward and deducted with respect to amounts added to the Qualified Dividend Account in subsequent years.

The Qualified Dividend Account would consist of all earnings that have borne the regular corporate tax, less any deductible dividends paid by the corporation. Thus, the Qualified Dividend Account would be increased each year by the amount of the corporation's taxable income (computed without regard to the dividends paid deduction). The corporation's taxable income would be added to the Qualified Dividend Account even if it was taxed at a rate below 33 percent. The amount of taxable income added to the Qualified Dividend Account each year, however, would be reduced by the amount of any taxable income that, because of any allowable credit, did not actually bear the corporate tax. For this purpose, foreign tax credits would be treated the same as any other credit.

The Qualified Dividend Account would be decreased each year by the amount of any dividends paid by the corporation with respect to which a dividends paid deduction was allowable. Dividends paid during a year in excess of the Qualified Dividend Account balance as of the end of the year, however, would have no effect. Thus, the Qualified Dividend Account balance would never be reduced below zero. As described below, the Qualified Dividend Account also would be reduced to reflect distributions in redemption or in partial or complete liquidation. Rules would be provided to govern the transferability of the Qualified Dividend Account in mergers and acquisitions.

The dividends paid deduction allowed to corporations would be treated similarly to other business deductions. For example, the deduction would enter into the determination of a corporation's net operating loss and thus could be carried back and forward. Similarly, the dividends paid deduction would be taken into account for purposes of computing a corporation's estimated tax liability, and would be allocated to income from foreign countries in a manner that would relate the deduction to the amount of earnings in the Qualified Dividend Account from the particular country.

Distributions in Redemption, Partial Liquidation, and Complete Liquidation, and Other Corporate Distributions. A corporation would not be entitled to the dividends paid deduction with respect to distributions in redemption of stock, including distributions in partial or complete liquidation, that are not taxed as dividends to the shareholders. In addition, the Qualified Dividend Account would be reduced by a proportionate amount of the redemption or liquidation proceeds. In the case of a distribution in complete liquidation, the liquidating corporation would simply extinguish its Qualified Dividend Account balance at the time of the liquidation. In the case of a distribution in redemption or partial liquidation, the Qualified Dividend Account would be reduced using a computation similar to the one used under current law to determine the portion of a distribution in redemption that is properly chargeable to earnings and profits. Accordingly, the Qualified Dividend Account generally would be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed (but not in excess of the amount of proceeds distributed to shareholders).

Under current law, certain transactions not formally denominated as dividends by distributing corporations are treated as dividends for tax purposes. These transactions include certain redemptions (section 302(d)), certain stock purchases by corporations related to the issuer (sections 302(d) and 304), certain stock dividends (sections 305(b) and (c)), certain sales and other distributions of preferred stock (section 306), and certain "boot" received in otherwise tax-free reorganizations or divisions (sections 356(a)(2), 356(b), and 356(e)). Corporations making distributions to shareholders in such transactions would be permitted to treat the distributions as dividends subject to the dividends paid deduction, provided that the corporations treated the distributions as dividends for information reporting purposes. In the event a distributing corporation did not treat such a distribution as a dividend for information reporting purposes and therefore did not claim a dividends paid deduction, the Internal Revenue Service would have the authority to allow the deduction if the transaction were subsequently characterized as a dividend and the corporation and shareholder treated the transaction consistently.

Intercorporate Investment. The treatment under the proposal of dividends paid to corporate shareholders would ensure that the partial relief from double taxation of corporate earnings would not be available until the earnings were distributed outside the corporate sector. In addition, current law applicable to the receipt of dividends by corporate shareholders would be changed under the Administration proposal to eliminate the small portion of certain dividends (generally 15 percent) that is currently subject to more than two levels of tax.

Under the proposal, a corporation paying dividends would compute its dividends paid deduction without regard to whether the recipient shareholders were corporations. A payor corporation, however, would be required to report to its corporate shareholders the amount of dividends paid to such shareholders with respect to which a deduction was allowed to the payor corporation.

Corporate shareholders would be required to include in their taxable income the portion of dividends for which the payor corporation received the dividends paid deduction. Accordingly, the dividends received deduction would be reduced to 90 percent of any dividends with respect to which the payor corporation claimed the dividends paid deduction. A 100 percent dividends received deduction would be allowed, however, with respect to dividends that were not deducted by the payor corporation. Thus, a corporate shareholder would be entitled to a 100 percent dividends received deduction with respect to dividends paid in excess of the payor corporation's Qualified Dividend Account balance.

Although a corporate shareholder generally would be taxed on only 10 percent of the dividends it receives, the full amount of such dividends would increase the corporate shareholder's own Qualified Dividend Account balance. This full increase would ensure that the partial relief from double taxation is not diminished simply because of the existence of multiple layers of corporate shareholders.

A foreign corporation would not be eligible for the dividends paid deduction. However, the dividends received deduction allowable under current law with respect to dividends received by a domestic corporate shareholder from a foreign corporation's earnings subject to United States corporate tax would be increased to 100 percent of such dividends received.

The current law rules that fully tax certain dividends received by corporate shareholders would not be changed by the proposal. If, therefore, a corporate shareholder would not be entitled to a dedution under current law with respect to the receipt of a particular dividend, the dividend would not be subject to the special intercorporate rules of the proposal. Accordingly, the payor corporation would be eligible for the 10 percent deduction with respect to the dividend paid, the full amount of the dividend would be taken into account in computing the corporate shareholder's taxable income, no dividends received deduction would be allowed to the shareholder, and no special rules would be used to compute the shareholder's Qualified Dividend Account.

The application of these intercorporate rules may be illustrated by assuming that a wholly owned subsidiary corporation with a Qualified Dividend Account balance of $1,500 paid a $500 dividend to its parent corporation. The entire $500 dividend would be eligible for deduction by the subsidiary, which would thus be entitled to a dividends paid deduction of $50 and would be required to reduce its Qualified Dividend Account by the amount of the dividend to $1,000. The subsidiary also would be required to inform its parent that it was allowed a $50 dividends paid deduction with respect to the $500 dividend. The parent would thus include $500 in its gross income and would be entitled to a $450 dividends received deduction. The parent would thus be taxed on 10 percent of the dividends received from its subsidiary. The parent's Qualified Dividend Account, however, would be increased by $500 with respect to the dividend received.

In summary, the subsidiary corporation would be subject to tax on $450 with respect to the earnings from which the dividend is treated as having been paid. In addition, if the parent corporation made no distributions to its shareholders, it would be subject to tax on $50 of income with respect to the intercorporate dividend. Under current law, an equivalent $500 of income would be taxed to the two corporations, although the entire amount would be taxed to the subsidiary. The proposal thus imposes the full measure of the corporate tax, but no more than that, in the case of intercorporate dividends that are not distributed outside the corporate sector.

If, however, the parent paid $500 in dividends to its shareholders it would be entitled to a $50 dividends paid deduction. Accordingly, the parent would not be subject to any tax with respect to the earnings attributable to the intercorporate dividend and, while its shareholders, assuming they were not corporations, would have been fully taxed on the distribution, 10 percent of the double taxation would be relieved. Finally, the parent's Qualified Dividend Account would be reduced by $500 with respect to the dividends paid to its shareholders.

Treatment of foreign shareholders. A compensatory withholding tax would be imposed on dividends paid to foreign shareholders who are not entitled to the benefits of a bilateral tax treaty. The compensatory withholding tax rate would equal the corporate income tax rate times the percentage of qualified dividends allowable as a deduction. Thus, the compensatory withholding tax rate would be 3.3 percent (10 percent of the maximum corporate income tax rate). Dividends that were not eligible for the dividends paid deduction, because they exceeded the balance in the corporation's Qualified Dividend Account, would not bear the compensatory withholding tax. The compensatory withholding tax would be imposed in addition to the basic 30 percent withholding tax on dividends paid to foreign shareholders who are not entitled to treaty benefits. In addition, subject to the reservations expressed in the Analysis section of this chapter, the compensatory withholding tax would not initially be imposed on dividends paid to foreign shareholders entitiled to treaty benefits.

Earnings and Profits. The measurement of the extent to which corporate distributions to shareholders constitute dividends would continue to be based on the payor corporation's current and accumulated earnings and profits. Earnings and profits would continue to be a measure of the economic income of the corporation. The precise definition of earnings and profits, however, would be modified as necessary to reflect other proposed changes.

Effective Date

The proposal generally would be effective on January 1, 1987. The Qualified Dividend Account would include taxable income only for taxable years beginning after December 31, 1986. In addition, dividends paid after December 31, 1986, in taxable years beginning before January 1, 1987, would be treated for purposes of the dividends paid deduction as having been paid during the first taxable year beginning after December 31, 1986.

Analysis

In General. Although the proposal provides only limited relief from the double taxation of corporate earnings distributed as dividends, a 10 percent dividends paid deduction represents a meaningful first step toward reducing the tax burden on corporate equity. The proposal would thus somewhat reduce the existing incentive for corporations to raise capital by issuing debt and would make equity securities more competitive with debt. Because dividend relief also would reduce the incentive to retain earnings, corporations would be likely to pay greater dividends and to seek new capital, both equity and debt, in the financial markets. Corporations would thus be subject to greater discipline in deciding whether to retain or how to invest their earnings. The increased level of corporate distributions would expand the pool of capital available to new firms. This should, in turn, enhance productivity and efficiency across the economy.

Effect of Reduction in Tax Rates. Under current law, corporate earnings paid out as dividends to an individual shareholder in the highest tax bracket may be subject to an overall tax rate of 73 percent (46 percent on the earnings at the corporate level and 50 percent on the after-tax amount of the dividend at the individual shareholder level). Because interest payments are deductible by the corporation, earnings paid out as interest to an individual creditor are taxed at a maximum rate of only 50 percent. Consequently, earnings distributed as dividends are relatively overtaxed by 23 percentage points. Without other changes, lowering the maximum corporate rate to 33 percent and the maximum individual rate to 35 percent would reduce the relative overtaxation only by a small amount, from 23 points to approximately 21 points. Under the proposal for partial dividend relief, the maximum overall tax rate on corporate earnings distributed as dividends to individual shareholders would generally be approximately 54 percent. This rate exceeds the maximum rate on corporate earnings paid out as interest by approximately 19 percentage points.

Effects on Specific Industries. Industries and firms that distribute a large fraction of their earnings as dividends are more seriously affected by the current double taxation of dividends. The proposal, therefore, may increase the flow of resources to these industries. Prime examples of industries that may derive relatively greater benefit from the dividends paid deduction are the communication industry and public utilities, such as electric, natural gas, and sanitary utilities. These industries each distributed nearly 100 percent of their after-tax profits as dividends during the period from 1980 through 1983.

Foreign Experience. The United Kingdom, France, West Germany, Japan, Canada, and other countries have adopted tax regimes that partially relieve the double taxation of dividends. Many of these countries enacted relief for policy reasons that do not apply equally to the United States, and have chosen different systems than the one proposed by the Administration. The extent of dividend relief provided by these countries ranges from 38 percent to 100 percent. The Administration proposal for a 10 percent dividends paid deduction would provide less relief than these countries. Nevertheless, the proposal represents a first step toward reducing the double taxation of dividends.

Treatment of Foreign Shareholders. Most of the countries that have adopted some form of relief from the classical system of double taxation of corporate earnings distributed to shareholders have denied part or all of the benefits of that relief to foreign shareholders, although some countries have granted dividend relief to foreign shareholders through bilateral tax treaties. The United States has been only partially successful in obtaining the benefits of other countries' dividend relief provisions for its citizens and residents.

The most common method of dividend relief that has been adopted by these countries is the so-called "imputation" system. Under such a system, shareholders include in income and are entitled to claim a credit for a portion of corporate taxes paid on distributed earnings. The benefits of such a system usually are denied to foreign shareholders simply by allowing only domestic shareholders to obtain the credit for taxes paid by the corporation.

In contrast to the imputation system adopted in many countries, the proposal would allow domestic corporations a deduction equal to 10 percent of certain dividends paid to their shareholders. The benefits of this dividend deduction system could be denied to foreign shareholders by imposing a compensatory withholding tax on deductible dividends paid to foreign shareholders. The amount of the compensatory withholding tax would exactly offset the deduction allowable to the payor corporation.

Virtually all United States bilateral tax treaties, however, establish a maximum rate at which withholding taxes may be assessed on dividends. Those treaty provisions would be directly violated if the benefits of the dividends paid deduction were denied to foreign shareholders by imposing a compensatory withholding tax on dividends paid to residents of treaty countries.

Countries using the imputation system have avoided this treaty difficulty, while denying the benefits of dividend relief to foreign shareholders, because, as a purely formalistic matter, no increased withholding tax is imposed when the ability to obtain the credit is limited to domestic shareholders. Accordingly, the denial of the benefit to foreign shareholders technically does not result in a direct treaty violation.

As a matter of economic substance, there is no difference between denying foreign shareholders a credit for corporate taxes paid under an imputation system of dividend relief and imposing a compensatory withholding tax on distributions to foreign shareholders under a dividends paid deduction system. Because the two schemes are economically equivalent, it would be unwarranted to adopt an imputation system, rather than a dividend deduction system, merely to avoid technical treaty violations. Moreover, in the context of the United States economy and tax system, an imputation approach to dividend relief would be extremely cumbersome. A dividend deduction system, therefore, has been proposed.

The United States benefits significantly from its bilateral income tax treaties and takes seriously its obligations under those treaties. It is therefore reluctant unilaterally to violate the treaties. Accordingly, subject to the limitation expressed below, the proposed compensatory withholding tax initially would not be imposed generally with respect to dividends paid to shareholders resident in treaty countries, and the benefits of dividend relief thus would be extended unilaterally to such shareholders.

This unilateral extension of dividend relief to certain foreign shareholders is troubling in two respects. The first concern involves "treaty shopping," which is the use, through conduit corporations, of tax treaties by residents of non-treaty countries. Only a limited number of treaties presently lend themselves to abuse in this way, and negotiations aimed at resolving this problem with these countries are continuing. The incentives to engage in treaty shopping, however, may be increased under the proposal. Therefore, efforts to eliminate treaty shopping would be intensified. If it is not possible to resolve this problem in the very near future, then the United States should, at a minimum, refuse to allow the benefits of the dividends paid deduction to persons claiming benefits under treaties that lend themselves to treaty shopping.

Second, as already noted, countries with imputation systems generally have not unilaterally extended the benefits of dividend relief to United States residents, although several have extended some or all of the benefits through treaty negotiations. The United States would expect that countries that have not previously done so would extend the benefits of their dividend relief rules to United States residents. Treaty negotiations would thus be undertaken with that view. Unwillingness of treaty partners to negotiate meaningfully on this issue should cause a reversal in the decision unilaterally to extend benefits to foreign shareholders in treaty countries. The Administration would therefore propose to retain the authority, through certification by the Secretary of the Treasury, to impose a compensatory withholding tax on the residents of those treaty partners with which it is not possible to resolve issues concerning treaty shopping or the granting of reciprocal benefits under the foreign imputation system.

REPEAL $100/$200 DIVIDEND INCOME EXCLUSION

General Explanation

Chapter 6.03

Current Law

Dividend income received by an individual generally is subject to Federal income taxation. There is, however, an exclusion from gross income for the first $100 of dividend income received by an individual from domestic corporations. In the case of a husband and wife filing a joint return, the first $200 of dividend income is excluded regardless of whether the dividend income is received by one or both spouses.

Reasons for Change

The $100 dividend exclusion narrows the base of income subject to tax without creating a proportionate incentive for investment in domestic corporations. The exclusion provides no marginal investment incentive for individuals with dividend income in excess of $100, and only a minor incentive for other individual taxpayers. In addition, the partial dividends-received exclusion contributes to complexity in the tax system by adding an extra line (and two entries) on the individual tax Form 1040 and two lines on the Form 1040A.

Proposal

The partial exclusion for dividends received by individuals would be repealed.

Effective Date

The provision would apply to taxable years beginning on or after January 1, 1986.

Analysis

Repeal of the dividend exclusion is not likely to have a significant effect on aggregate economic behavior. The great majority (76 percent) of taxpayers who receive dividends claim the full amount of the dividend exclusion. For these taxpayers, repeal of the exclusion would have no effect on marginal tax rates and thus should not affect investment decisions. Even for those taxpayers who do not receive sufficient dividends to claim the full amount of the exclusion, repeal should not have a significant impact. Although the current marginal rate of tax for such persons on additional dividends (up to the amount of the exclusion) is zero, the relatively small tax savings available from the exclusion (up to $50 for individuals and $100 for joint returns, assuming a maximum tax rate of 50 percent) is not a substantial investment incentive.

CHAPTER 7

REVISE TAXATION OF BUSINESS PROPERTY AND CAPITAL ASSETS

This Chapter presents the Administration proposals on taxation of investment in business property and capital assets. The proposals would preserve certain investment incentives for businesses and individuals, but would provide such incentives in a relatively neutral manner in order to limit investment distortions created under current law. The proposals would also adjust the tax system for inflation on a relatively comprehensive basis.

The centerpieces of the Administration proposals on capital formation are the proposed Capital Cost Recovery System, retention of favorable tax treatment for capital gains, and the proposal to allow businesses to index inventories. These proposals would stimulate private sector saving and investment and produce a more efficient allocation of capital. These proposals also would facilitate repeal of provisions such as the investment tax credit and selective rapid amortization rules that bias investment toward particular assets.

ADOPT NEW CAPITAL COST RECOVERY SYSTEM (CCRS)

General Explanation

Chapter 7.01

Current Law

The Accelerated Cost Recovery System ("ACRS") was established by the Economic Recovery Tax Act of 1981 and generally governs depreciation allowances for tangible property placed in service after 1980. ACRS assigns all "recovery property" to a class with a specified recovery period and depreciation schedule. In general, recovery property is defined to include all depreciable property placed in service after 1980, except intangible property, property subject to amortization, and property for which the taxpayer properly elects a method of depreciation, such as the units of production method, that is not expressed in terms of years.

The pre-ACRS depreciation rules remain in effect for property placed in service by a taxpayer prior to 1981. In general, these rules require taxpayers to recover an asset's original cost less salvage value over its estimated useful life. Taxpayers can elect among several rates of recovery ranging from straight line to methods that are substantially accelerated. Certain taxpayers can elect to depreciate assets under a system employing prescribed industry-wide class lives, with additional rules for salvage values, retirement, repair deductions, and other matters (the ADR system).

ACRS differs from prior depreciation rules in many important respects. ACRS recovery periods are not based on the useful economic lives of assets, and for most assets are significantly shorter than under prior law. ACRS employs accelerated depreciation schedules and also allows recovery of full original cost without reduction for salvage value. Thus, for most assets, ACRS allows much faster cost recovery and greater present value depreciation deductions than were obtainable under prior law.

ACRS classifies all personal property (other than public utility property) as three-year or five-year property. Automobiles, light trucks and research and experimentation property are the principal three-year property items, while most other personal property, including machinery and equipment, is recovered over five years. Most real property is classified as 18-year property, although some real property, including real property placed in service prior to March 16, 1984, qualifies as 10-year or 15-year property. Low-income housing is classified as 15-year property. Public utility property may be five-year, 10-year or 15-year property depending upon the class life of such property under prior law.

Under ACRS, foreign property (property used predominantly outside the United States during the taxable year) is generally subject to longer recovery periods than comparable domestic property. Generally, foreign personal property is recovered over the pre-ACRS class life of an asset or 12 years and foreign real property is recovered over 35 years.

The ACRS depreciation schedules for three-year, five-year and ten-year property are based on the 150 percent declining-balance method switching to the straight-line method. The schedules reflect a half-year convention which halves the first year's depreciation rate regardless of when during the year the property is placed in service. No depreciation deduction is allowed in the year of disposition of personal property.

The depreciation schedule for 18-year real property, except for special transition rules, is based on the 175 percent declining-balance method switching to the straight-line method. The depreciation schedule for 15-year low-income housing is based on the 200 percent declining balance method switching to the straight-line method. First-year depreciation rates for 15-year and 18-year real property are reduced to reflect the number of months during the first year in which property is held in service. Depreciation deductions for real property are allowed for the year of disposition, based on the number of months during which the property was in service for that year.

Under ACRS, the cost of building components, such as air-conditioning and electrical systems, is not recoverable over periods shorter than the building's recovery period. The recovery period for a component generally begins at the later of the time the component or the building is placed in service. The cost recovery for the component is accounted for separately from the building. Substantial improvements to a building are treated as a separate property item entitled to a separate recovery period and depreciation rate.

A lessee who makes capital improvements to leased ACRS property may recover the cost of such improvements over the remaining lease term, if such term is less than the ACRS recovery period. If the lessor and lessee are related parties, however, leasehold improvements must be recovered over the ACRS recovery period, even if the remaining lease term is shorter.

A taxpayer may elect longer recovery periods than the prescribed ACRS recovery period, but in doing so must use the straight-line method for determining the depreciation allowance. A taxpayer may also elect to use the straight-line method over the ACRS recovery period.

Taxpayers may elect to establish mass asset accounts for assets where separate identification is impractical. Only assets of the same recovery class which are placed in service in the same year may be included in a single mass asset account. Gain or loss is not computed upon dispositions of items from a mass asset account, and instead all proceeds from sales of items from a mass asset account are treated as ordinary income. Correspondingly, dispositions do not reduce the unadjusted basis of the mass asset account, so that original cost basis can be fully recovered over the class recovery period.

A special exception to ACRS allows taxpayers to expense a small amount of property used in a trade or business. For taxable years beginning before 1988, a taxpayer may elect to expense a maximum of $5,000 per year. The limit on expensing increases to $7,500 for taxable years beginning in 1988 and 1989 and to $10,000 thereafter. No investment tax credit may be taken on expensed property.

Generally, ACRS depreciation schedules apply to the unadjusted cost basis of an asset. However, if an investment tax credit is taken, the cost basis of an asset must be reduced by 50 percent of the amount of the credit before applying the depreciation rate. Gain or loss is generally recognized on the disposition (including retirement) of ACRS property. Gain or loss is computed with respect to the adjusted basis of property which reflects previously taken depreciation.

ACRS deductions are subject to recapture upon an asset's disposition. For all personal and most real property, gain recognized upon sale is recharacterized as ordinary income to the extent of previously allowable depreciation. There is no depreciation recapture on property for which a straight-line method has been elected. Only the excess of ACRS deductions over the straight-line method is recaptured on residential rental property, low-income housing and property used predominantly outside the United States.

ACRS does not apply to intangible assets. Amortization allowances are available under current law for intangible assets of limited useful life that are used in a business or held for the production of income. Generally, amortization allowances are computed using a straight-line method. Certain income-producing properties, such as motion picture and television films, may be amortized under the income forecast method which allocates costs proportionately to income expected to be produced.

Reasons for Change

Disregard of Economic Depreciation. Depreciation allowances should reflect the economic fact that, on average, the values of assets decline over time due to a variety of factors, including declining productivity, wear and tear, and obsolescence. If depreciation allowances understate real economic depreciation of a particular asset, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. Similarly, if depreciation allowances exceed real economic depreciation, incentives are created for investment in depreciable property.

The pre-ACRS depreciation system required capital costs to be recovered over the useful economic life of particular property. Generally, useful lives for particular types of property were significantly longer than the recovery periods introduced with ACRS. The rate of recovery over the useful life was often determined by election of the taxpayer. The pre-ACRS depreciation system did not take account of inflation. Thus, pre-ACRS depreciation deductions for many assets understated real economic depreciation and thus resulted in overtaxation of the income from such assets.

The cost recovery system introduced with ACRS addressed the prior overtaxation of capital investment by providing for more rapid acceleration of depreciation deductions. However, at low inflation rates, ACRS reverses the general overtaxation of capital investment. Moreover, ACRS does not differentiate between assets with varying experienced economic depreciation rates. Thus, under the broadly defined class of 5-year ACRS property, the same depreciation allowances are provided for assets with significantly different rates of economic depreciation. In addition, ACRS continues to base depreciation allowances on historic costs rather than current replacement costs; thus, the present value of fixed depreciation deductions varies with the rate of inflation. At recently experienced levels of inflation, ACRS, in combination with investment tax credits, reduces effective tax rates on investment in depreciable assets substantially below statutory tax rates. Under certain assumptions, for certain assets, ACRS, in combination with investment tax credits, is equal to or more favorable than current expensing, which is tantamount to tax exemption of the income from such depreciable assets.

Table 1 displays Treasury Department estimates, based on certain stated assumptions, of average effective tax rates for income derived from assets in the various ACRS classes. Table 1 demonstrates (1) the substantial extent to which ACRS and investment tax credits reduce effective tax rates below statutory tax rates, (2) the variance among ACRS classes in the extent to which ACRS and investment tax credits reduce effective tax rates, and (3) the volatility of effective tax rates in response to different inflation rates.

Non-neutrality of ACRS Investment Incentives. The low effective tax rates on ACRS property at current rates of inflation provide incentives for investment in depreciable property. However, these incentives are not distributed among depreciable assets in a neutral or systematic manner. As Table 1 demonstrates, effective tax rates on machinery and equipment are substantially lower than effective tax rates on structures for all rates of inflation. This substantial variance in effective tax rates is due in part to the application of a one-time, up-front investment tax credit for machinery and equipment and, in part, to the accelerated depreciation schedules for three-year and five-year ACRS property. A more neutral cost recovery system would preserve investment incentives while equalizing effective tax rates across assets.

Table 7.01-1

Effective Corporate Tax Rates on Income from Equity Financed Investments with Various Rates of Inflation for 46 Percent Taxpayer Under Current Law 1/

Asset Class (Years)	Inflation Rate (Percent)		
	0	5	10
3	-75	-9	18
5	-47	-4	16
10	-6	19	31
15	8	33	43
18	27	39	45

Office of the Secretary of the Treasury May 28, 1985

1/ Assumptions: Real return after tax is four percent. The investment tax credit selected is the maximum allowable for new equipment (six percent on three-year equipment and ten percent on five-, ten-, and 15-year equipment). Effective tax rates are the difference between the real before-tax rate of return and the real after-tax rate of return divided by the real before-tax rate of return.

Apart from the operation of the investment tax credit, significant distortions are inherent in the ACRS classification of machinery and equipment. With the limited exceptions of the assets assigned to the three-year ACRS class and assets of regulated public utilities, all types of machinery and equipment are classified as five-year ACRS property and depreciated according to the same schedule. Thus, ships and heavy machinery used in manufacturing receive the same depreciation allowances as computers and trucks. Plainly, these disparate assets experience significantly different rates of real economic depreciation. The effect of a uniform depreciation allowance is that slower depreciating assets, such as ships and heavy machinery, receive a substantially greater investment incentive than do faster depreciating assets. Thus, ACRS, by the very nature of its all-inclusive classification of machinery and equipment in the five-year class, distorts investment decisions across assets and industries.

Investment distortions created by ACRS, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. Paradoxically, these distortions do not reflect stated government policy to favor particular assets or industries. As a result, ACRS operates as an undeclared government industrial policy which largely escapes public scrutiny and systematic review.

ACRS also fails to provide a systematic level of investment incentives. Since ACRS does not take inflation or real replacement costs into account, the benefits of accelerated depreciation diminish as inflation increases. The variability of inflation over time precludes certainty as to the incentive actually provided for an investment in depreciable property. Such uncertainty acts as a depressant on economic activity. Increasing the certainty of obtaining inflation-proof cost recovery would stimulate risk taking and lead to more efficient allocation of investment funds.

Finally, ACRS has fueled the growth of tax shelters. The low or negative effective tax rates on ACRS property, especially in the early years of acquisition, make possible the sheltering of an investor's unrelated income and the accompanying deferral of tax liability. This encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. Also, the prospect of substantial up-front deductions encourages excessive leveraging and churning of assets. The resulting tax-motivated transactions and divergence from market determined patterns of investment impair economic productivity.

As tax shelter activity has increased due to ACRS and other provisions that mismeasure income, abuses have proliferated, the need for anti-abuse rules has grown, and the Internal Revenue Service has been required to devote additional resources to policing tax shelter investments. Moreover, whether or not abusive, tax shelters invite disrespect for the tax laws from those who perceive, correctly or not, that the laws are unfair and, hence, not worthy of compliance.

Proposal

New capital cost recovery rules would be established that preserve investment incentives while explicitly accounting for inflation and different rates of economic depreciation. The new Capital Cost Recovery System ("CCRS") would modify ACRS in several important respects. First, CCRS would allow cost recovery of the real or inflation-adjusted cost of depreciable assets, rather than only the original, nominal cost. Second, CCRS would assign property among new recovery classes based upon economic depreciation rates. Third, CCRS would prescribe depreciation schedules and recovery periods which produce systematic investment incentives that are neutral across recovery classes.

Under CCRS, all depreciable tangible assets would be assigned to one of six classes, which would replace the present five ACRS recovery classes. Each CCRS class would be assigned a declining-balance depreciation rate, ranging from 55 percent to four percent. The depreciation rate would be applied to an asset's inflation-adjusted basis in a manner described below. Applying a fixed declining-balance depreciation rate of less than 100 percent to the adjusted basis of an asset would never fully recover such basis. To ensure that depreciation accounts close out in a reasonable number of years, each CCRS class would be assigned a recovery period of between four and 28 years. The recovery period is not an estimate of the economic useful life of an asset and hence, is not comparable to recovery periods under pre-ACRS depreciation rules based on economic useful lives.

To avoid bunching of the depreciation allowance in the last year of the recovery period, CCRS depreciation schedules for each class would switch from the declining-balance rate to the straight-line depreciation method in the year in which, assuming a half-year convention, the straight-line method yields a higher allowance than the declining-balance rate. The half-year convention means that, for the CCRS class with a four year recovery period, the straight-line method is applied assuming placement in service on July 1 of the first year and retirement on July 1 of the fifth year. Since a half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method, depreciation schedules cover one year more than the assigned recovery period.

Under CCRS, the first-year depreciation rate would be prorated based upon the number of months an asset was placed in service. A mid-month convention would be assumed for the month an asset is placed in service. For example, an asset placed in service by a calendar year taxpayer during any part of April would obtain a depreciation rate equal to the full first-year rate multiplied by a percentage equal to (12-3.5)/12.

Table 2 lists the CCRS depreciation schedules for each of the six recovery classes. The schedules for each class prescribe the depreciation rate which would be applied to the adjusted basis of an asset in each year. Table 2 identifies the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. The apparent increase in depreciation rates after the switch-over to the straight-line method does not mean that CCRS would be a back-loaded depreciation system. Relative to inflation-adjusted original cost, the straight-line method produces constant depreciation rates. It is only with respect to adjusted basis that straight-line method depreciation rates increase over time. Thus, under the straight-line method, in the close-out year, the applicable depreciation rate is always 100 percent and the remaining adjusted basis of an asset is fully recovered.

Table 3 converts the CCRS depreciation schedules from Table 2 to a different format. Table 3 presents CCRS depreciation rates as a percentage of inflation-adjusted original cost for each recovery class over the term of its recovery period. Table 3 demonstrates that CCRS would not be a back-loaded depreciation system. For each recovery class, 100 percent of the inflation-adjusted original cost would be recovered over the recovery period. For each recovery class, a greater proportion of inflation-adjusted original cost would be recovered in early years than in later years. The percentages of cost recovery in each year that are given in Table 3 reflect assumptions that property is placed in service on July 1 and that the mid-month convention is ignored. If actual depreciation allowances in the first year differ from those computed under the assumptions in Table 3, the percentage of cost recovery in subsequent years would differ accordingly.

CCRS would adjust depreciation allowances for inflation by means of a basis adjustment. Under ACRS, only the unadjusted original cost basis of an asset is recovered over the class recovery period. Under CCRS, after adjustment for allowable depreciation in the prior year, an asset's unrecovered basis would be adjusted for inflation during the current year using an appropriate government price index. The applicable depreciation rate would be applied to the resulting adjusted basis. There would be no inflation adjustment in the year in which an asset is placed in service; inflation adjustments would begin with the second year in which the asset is in service. Thus, the scheduled depreciation rate in Table 2 would be applied as of the end of a taxable year to an asset's basis which had been adjusted first for the prior year's depreciation and then for the current year's inflation. An asset's unrecovered basis would continue to be indexed for inflation after the switch-over to the straight-line method. The year in which the switch-over occurs would be dependent only on the class depreciation rate and recovery period, and not on the inflation rate.

Table 7.01-2

Capital Cost Recovery System Depreciation Schedule (as a Percent of Inflation-Adjusted Basis) 1/

Year	Class 1	Class 2	Class 3	Class 4	Class 5	Class 6
1 2/	27.5	22	16.5	11	8.5	2.00
2	55	44	33	22	17	4.00
3	55	44	33	22	17	4.00
4	67	44	33	22	17	4.00
5	100	67	40	29	17	4.08
6		100	67	40	18	4.26
7			100	67	22	4.44
8				100	29	4.65
9					40	4.88
10					67	5.13
11					100	5.41
12						5.71
13						6.06
14						6.45
15						6.90
16						7.41
17						8.00
18						8.70
19						9.53
20						10.53
21						11.76
22						13.33
23						15.38
24						18.18
25						22.22
26						28.57
27						40.00
28						66.67
29						100.00

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1/ A half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. Consequently, the depreciation schedules cover one year more than the recovery period for each class.

2/ First-year allowance shown assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention. Actual allowance in first year would vary depending on when asset is placed in service.

Table 7.01-3

Capital Cost Recovery System Depreciation Schedule (as a Percent of Inflation-Adjusted Original Cost) 1/

Year	Class 1	2	3	4	5	6
1	27.5	22.0	16.5	11.0	8.5	2.0
2	39.9	34.3	27.6	19.6	15.6	3.9
3	17.9	19.2	18.5	15.3	12.9	3.8
4	8.1	10.8	12.4	12.0	10.7	3.6
5	6.6	9.1	10.0	12.0	8.9	3.5
6		4.6	10.0	12.0	7.9	3.5
7			5.0	12.0	7.9	3.5
8				6.0	7.9	3.5
9					7.9	3.5
10					7.9	3.5
11					3.9	3.5
12						3.5
13						3.5
14						3.5
15						3.5
16						3.5
17						3.5
18						3.5
19						3.5
20						3.5
21						3.5
22						3.5
23						3.5
24						3.5
25						3.5
26						3.5
27						3.5
28						3.5
29						1.8

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1/ Depreciation allowances are computed assuming an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention.

Although there would be no inflation adjustment to basis for purposes of determining depreciation in the year in which an asset is placed in service, there would be a full year's inflation adjustment in the close-out year if property is retained in service to the end of the close-out year. Retirement of an asset prior to the end of the close-out year would be treated as a disposition, upon which a taxpayer would obtain full recovery of an asset's remaining adjusted basis and recognize gain or loss. For retirements and other taxable dispositions, such as sales, there would be a pro-rata inflation adjustment to basis in the year of disposition for purposes of computing gain or loss. Such pro-rata adjustment would be based on the number of full months the asset was held during the year of disposition.

An asset's adjusted basis for depreciation purposes would be used for purposes of computing gain or loss upon disposition of a depreciable asset. The Administration is proposing to tax all real gains on sales or dispositions of depreciable property as ordinary income. There would be no preferential tax rate applied to long-term gains on depreciable assets. Losses from sales or dispositions of depreciable property would not offset capital gains but would be fully deductible against ordinary income. See Ch. 7.03.

Intangible assets would not be subject to CCRS and would be amortized generally under current law rules. For example, assets that are depreciable under the income forecast method or other method not measured in terms of years, such as motion pictures, would continue to be depreciable under rules similar to current law. The basis of depreciable property not subject to CCRS would be indexed for inflation beginning with the second year of amortization. Similarly, gains from sales or dispositions of amortized property which is indexed for inflation would be taxed at ordinary income rates.

Assets that are eligible for cost depletion, such as timber, oil and coal, would not be subject to CCRS. Depletable assets would be indexed for inflation, by means of an inflation adjustment to an asset's cost depletion basis used for purposes of determining ordinary income realized upon sale of the asset.

Foreign property would be recovered under a system of real economic depreciation that would not contain the investment incentives available to domestic property under CCRS. That is, for foreign property, the CCRS depreciation rates and recovery periods would be adjusted along the lines of the real economic depreciation system contained in the Treasury Department's Report to the President, Tax Reform For Fairness, Simplicity and Economic Growth, published in November 1984. The classification of foreign property would be on the same basis as the CCRS recovery classes. Indexing of foreign property would use the inflation rate of the taxpayer's functional currency.

Earnings and profits of domestic and foreign corporations would be computed on the same basis as depreciation deductions are allowed for foreign property.

The current law provision permitting taxpayers to elect to expense the aggregate cost of personal property not in excess of $5,000 would be retained. The scheduled increases in the ceiling to $10,000 would be repealed. See Ch. 7.05. Vintaged mass asset accounts would also be retained for property qualifying for such treatment under current law. CCRS would retain the current law distinction between deductible repairs and expenditures that appreciably prolong an asset's useful life or materially add to its value, and thus, must be capitalized. Capitalized costs would generally be added to the adjusted basis of the underlying asset or, in some cases, depreciated separately. Each CCRS class would be assigned a safe-harbor repair allowance factor. The safe-harbor would permit expenses incurred after the asset is placed in service to be deducted without challenge, if such expenses are allocable to the asset and do not exceed the product of the asset's remaining inflation-adjusted basis and the repair allowance factor.

Under CCRS, the cost of leasehold improvements that may be deducted by a lessee would be recovered under the general rules applicable to such property, regardless of the term of the lease. However, in the event leasehold improvements are reasonably expected to have no residual value upon expiration of the lease term, special rules would be provided to permit different depreciation rates to be applied to such improvements, taking into account the term of the lease (including any renewal options and reasonably expected renewal periods). In the case of leasehold improvements depreciated by a lessee under the general rules, a lessee would treat the termination of a lease as a disposition of the leasehold improvements and would compute gain or loss upon the adjusted basis in such improvements.

The scope of each CCRS class would be defined by reference to existing ACRS classes in the following manner. All three-year ACRS property would be classified in CCRS Class 1. All 18-year ACRS property and low-income housing, which is 15-year ACRS property, would be classified in CCRS Class 6.

ACRS five-year, 10-year, and 15-year public utility property would be classified in CCRS Classes 2 through 5. Class 2 would encompass trucks (other than light purpose trucks which are three-year ACRS property), buses, and office, computing and accounting equipment. Class 3 would cover construction machinery, tractors, aircraft, mining and oil field machinery, service industry machinery and equipment and instruments. Class 5 would include railroad structures, ships and boats, engines and turbines, plant and equipment for the generation, transmission and distribution of electricity, gas and other power, and distribution plant for communications services. All other ACRS five-year, 10-year and 15-year public utility property would be grouped in Class 4. If an item of machinery, equipment or other property is not described by the asset-types listed in Classes 2, 3 and 5, and is not reclassified specifically under the procedure described below, such item would be assigned to Class 4.

Table 4 summarizes the classification of ACRS assets among the six CCRS classes.

CCRS would not prescribe a special class exclusively for property of regulated public utilities. Thus, unregulated companies generating their own electricity or providing communications services would depreciate assets on the same basis as regulated companies. For example, computers of regulated utilities would be in Class 2, while co-generation electric power plants of unregulated companies would be in Class 5. Furthermore, in recognition of the historic practice of requiring normalization of investment incentives for regulated public utilities, CCRS would contain normalization rules for regulated utilities comparable to those under ACRS.

The principle underlying CCRS classification of assets among the six CCRS recovery classes is that assets should be grouped on the basis of equivalent economic depreciation rates. Treasury Department empirical studies show that a geometric pattern of constant-dollar depreciation is generally an appropriate method to apply to all classes of business assets, even though the geometric pattern may not accurately characterize economic depreciation for all items within a class. Each of the six CCRS classes that resulted from the Treasury Department studies is comprised of a group of asset-types that, on average, have approximately the same present value of economic depreciation. The six CCRS classes are organized so as to minimize the variance in observed economic depreciation rates for assets within a class. (For a published account of Treasury Department commissioned studies, see "The Measurement of Economic Depreciation," by Charles R. Hulten and Frank C. Wykoff in Depreciation, Inflation, and the Taxation of Income from Capital (ed. C. Hulten, 1981.)

Table 7.01-4

CCRS Asset Classes

CCRS Class	Classification of ACRS Property 1/	Depreciation Rate 2/	Recovery Period 3/
Class 1	3-year property	55 %	4
Class 2	Trucks, Buses, and Trailers Office, Computing, and Accounting Equipment	44 %	5
Class 3	Construction Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, and Instruments	33 %	6
Class 4	5-year, 10-year, and 15-year public utility property not assigned to Class 2, 3, or 5 -- E.g., Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Communications Equipment, Fabricated Metal Products, and Railroad Track and Equipment	22 %	7
Class 5	Railroad Structures, Ships and Boats, Engines and Turbines, Plant and Equipment for Generation, Transmission and Distribution of Electricity, Gas and Other Power, and Distribution Plant for Communications Services	17 %	10
Class 6	18-year property; 15-year low-income housing	4 %	28

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1/ Items of property are assigned to CCRS classes under rules described in the text of the General Explanation.

2/ The depreciation method switches from a constant declining-balance rate to the straight-line method in the year of service in which the straight-line method produces greater depreciation allowances than the declining-balance rate would, assuming a half-year convention for computation of the straight-line method.

3/ The recovery period is the number of years over which cost recovery is computed under the straight-line method. A consequence of assuming a half-year convention for purposes of computing depreciation rates under the straight-line method is that depreciation schedules cover one year more than the recovery periods.

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The CCRS depreciation schedules assigned to each CCRS class in Table 2 build in incentives in excess of the economic depreciation rates used to classify property. The incentive depreciation schedules would reduce the effective tax rates on all CCRS classes. Table 5 contains the effective tax rates on property in each CCRS class, calculated on the basis of specified assumptions.

The proposed CCRS system contemplates that the Treasury Department would establish permanent facilities to conduct empirical studies of economic depreciation. Such studies would gather evidence for all types of assets of changing economic depreciation rates due to such factors as technological obsolescence, changing market conditions or changing utilization rates. In addition, the Treasury Department would develop data that would enable economic depreciation rates to be measured more precisely for specific asset-types within each CCRS class. The Treasury Department would review data on economic depreciation and would promulgate regulations to reclassify asset-types upon evidence that economic depreciation for an asset-type deviates significantly from its class norm. Pending development of an institutionalized process for reviewing economic depreciation rates, ACRS property would be classified among CCRS classes in the manner described above.

Table 7.01-5

Effective Tax Rates on Equity Financed Investments in Equipment and Structures 1/

Class	Paid 2/	Held 3/
1	16 4/	18
2	16	18
3	17	18
4	17	18
5	17	18
6	23	25

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1/ Assumes 33 percent statutory tax rate and 4 percent required return after tax and inflation. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt-finance and the relation between the interest rate on debt and the rate of return on the investment. Effective tax rates on different property within a recovery class may vary somewhat depending on experienced economic depreciation rates.

2/ Assumes application of a 10 percent dividend paid deduction to a corporation which distributes 100 percent of its earnings derived from depreciable assets.

3/ Assumes no distribution of corporate earnings derived from depreciable assets.

4/ The differences between the 16 percent effective tax rate for Classes 1 and 2 and the 17 percent effective tax rate for Classes 3 through 5 are due to rounding and are not significant.

Effective Date

CCRS would be effective for property placed in service on or after January 1, 1986. Anti-churning rules, similar to those enacted as part of ACRS, would be provided to prevent a taxpayer from treating property owned prior to January 1, 1986, as being subject to CCRS on or after such date. An asset acquired in a transaction in which the basis of such asset carries over from the transferor to the transferee would not be subject to CCRS if placed in service by the transferor prior to January 1, 1986.

Analysis

Improvements in Capital Cost Recovery System. The proposed CCRS depreciation system, in conjunction with repeal of the investment tax credit and other capital and business taxation proposals, makes possible a substantial lowering of statutory tax rates for individuals and corporations. This reduction in statutory tax rates is accomplished without sacrificing investment incentives necessary to stimulate continued economic growth for the economy as a whole. The CCRS depreciation rates and recovery periods produce effective tax rates which would stimulate new investment in depreciable assets. The indexing of depreciation allowances for inflation and the classification of assets on the basis of economic depreciation would ensure that the CCRS system provides neutral investment incentives. Thus, CCRS, in conjunction with repeal of the investment tax credit, would correct three principal defects of the capital cost recovery system of current law -- the variance in effective tax rates among different assets and industries; the volatility of effective tax rates in response to fluctuating inflation; and the excessive acceleration or front-loading of capital cost recovery which make possible negative effective tax rates exploited by tax shelters.

CCRS would be less distortive of economic choices among new investments in equipment and structures in different industries. Since CCRS incentive depreciation rates are derived separately for each CCRS class based upon economic depreciation rates, the variance of effective tax rates across different industries and assets would be minor compared to the unsystematic distortions created under current law. Some differences would remain, however, in the effective tax rates on income from depreciable and non-depreciable assets.

CCRS would contribute further to economic neutrality by accounting for the effects of inflation. For each recovery class, CCRS would produce the same real present value of depreciation deductions regardless of inflation rates, while ACRS and unindexed straight-line methods, which recover original cost only, yield real present value deductions which decrease as inflation increases. Moreover, for all six CCRS classes, at an assumed inflation rate of five percent and an assumed real discount rate of four percent, the incentive depreciation rates under CCRS produce greater present value depreciation benefits than does ACRS without the investment tax credit. At higher assumed inflation rates, the CCRS incentives are even greater relative to ACRS. The CCRS incentives are provided without the front-loaded acceleration of depreciation deductions available under ACRS.

Investment Incentives. CCRS would provide depreciation rates in excess of estimated economic depreciation rates. CCRS recovery periods would be shorter than the recovery periods under a system of real economic depreciation. CCRS depreciation rates and recovery periods would combine to produce approximately equivalent effective tax rates of 18 percent on all types of equipment and machinery, regardless of the inflation rate. The effective tax rate on structures would be higher, although the recovery period would be significantly shorter than under a system with real economic depreciation rates. Moreover, the disparity under current law in effective tax rates for machinery and equipment compared to structures would be substantially narrowed under CCRS. When the effects of debt finance are taken into account, the difference in effective tax rates would likely be reduced further.

For all six CCRS classes, CCRS depreciation allowances would be more valuable than accelerated ACRS depreciation allowances (without regard to the repealed investment tax credit) under most inflation conditions. Tables 6 through 11 illustrate the present values of depreciation deductions available over the entire life of an asset under CCRS, ACRS and unindexed straight-line methods. These tables demonstrate both the incentive advantages of CCRS and the protection afforded from fluctuating and unpredictable inflation.

Comparisons of CCRS with current law should also consider the effects of CCRS in combination with other Administration proposals for taxing capital and business income. Table 12 compares the combined effective tax rates at the corporate and individual levels on equity financed investments under different cost recovery systems. Table 13 similarly compares effective tax rates at the corporate level only under different cost recovery systems. Tables 12 and 13 demonstrate that, under the stated assumptions, CCRS would produce generally lower and more uniform effective tax rates than current law or the system of real economic depreciation proposed by the Treasury Department report in 1984. However, the effective tax rate on equipment would be increased somewhat relative to current law, resulting in more nearly equal effective tax rates on different types of capital.

Neutrality of CCRS Asset Classification. CCRS is designed to provide neutral investment incentives while at the same time preserving the simplicity of a depreciation system based on relatively few classes of property, each of which would have a single depreciation rate to be applied to inflation-adjusted basis. In modifying the ACRS class-based system, CCRS does not revert to prior flawed methods of depreciation which depended upon determining each asset's useful life, without regard to the pattern of economic depreciation over such life. Rather, CCRS is premised on the theory that a neutral depreciation system is one which produces the same effective tax rate for all depreciable assets. The equivalence of effective tax rates can be accomplished by classifying property on the basis of economic depreciation. Even though CCRS depreciation rates contain incentives in excess of economic depreciation rates, classification of assets on the basis of economic depreciation permits the investment incentives to be of approximately equal effect for all depreciable assets, regardless of inflation.

The asset types classified in Table 4 are obviously broad categorizations of the myriad of depreciable assets. These asset types are much broader than the categorization of assets under the ADR depreciation system which preceded ACRS. The six CCRS classes however, are more differentiated and hence, fairer depreciation rates than are obtained under ACRS. ACRS has a single depreciation rate for assets as diverse as computers and ships. The single ACRS depreciation rate applicable to these diverse assets may be simple in application, but it is neither fair nor conducive of efficient resource allocation.

The classification of assets under CCRS is not more complex than under ACRS. CCRS would be a relatively simple system for taxpayers to comply with and for the Internal Revenue Service to administer. Recordkeeping would be no more involved than under ACRS. Although there would undoubtedly be a need for regulations to refine technical classification of certain items of property, such regulations would not be more complex than existing regulations under ACRS.

CCRS Class 4 would initially serve as a residual class for five-year ACRS property not specifically classified in Classes 2, 3, or 5. Further refinement of property classification would be expected as the Treasury Department conducts ongoing studies of economic depreciation for different assets and industries. These studies would take into account not only inflationary changes in replacement costs but also dynamic factors, such as technological change, capacity utilization and changing market conditions, which determine rates of economic depreciation. For example, economic depreciation of telecommunications equipment and plant may be affected by technical change and deregulation of markets. These factors would have to be studied in reclassifying such property.

Reclassification of assets would also take into account the fact that certain equipment used to manufacture other depreciable property might depreciate at nearly the same rate as the end product. For example, equipment used to produce computer components might be so specialized that it depreciates at the same rate as the computers produced. Further consideration of actual evidence of rates of economic depreciation for types of assets included in the categories of assets listed in Table 4 would be conducted by an institutionalized office of the Treasury Department operating under administrative procedures affording the public an opportunity to participate.

It can be expected that additional items of five-year ACRS property which are classified in CCRS Class 4 could be reclassified among CCRS Classes 2, 3, or 5. Future studies might also justify reclassifying assets in CCRS Classes 1 or 6. For example, long-lived electric power plants initially classified in Class 5 might experience economic depreciation more nearly equivalent to real property in Class 6 than to the other types of property in Class 5. The initial overinclusiveness of Class 4 would be mitigated by the fact that the present value of depreciation deductions for an asset in CCRS Class 4 would exceed the present value of depreciation deductions for 5-year ACRS property for all but de minimus rates of inflation.

Simplification of Other Tax Provisions. CCRS and other proposed reforms of the capital cost recovery system of current law would permit a further simplification of the tax system. Even where existing complex rules are retained, their significance to taxpayers and the Internal Revenue Service would be lessened with a more neutral measure of taxable income. For example, recapture rules could be simplified considerably under CCRS, since all gain upon sale or disposition of depreciable property would be taxed as ordinary income. Consideration would be given to simplifying taxpayer accounting by permitting an election to maintain open accounts for certain classes of CCRS property.

CCRS would apply to mixed-use property which is partially used for personal use and partially for business purposes. For taxpayers whose portion of business use varies over time, indexing of depreciable basis may require more complicated recordkeeping than is customary under current law.

CCRS should reduce the proliferation of tax shelters based on the accelerated capital cost recovery rules of current law. As a consequence, the significance of many anti-tax shelter rules would be lessened, enabling Internal Revenue Service enforcement resources to be committed elsewhere.

Table 7.01-6

Depreciation Allowances Under Alternative Depreciation Methods for a Class 1 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 55 Percent 0 Percent Inflation	5 Percent Inflation	10 Percent Inflation	ACRS 3 Years	Straight-Line 3 Years
1	$275	$275	$275	$250	$167
2	399	419	439	380	333
3	179	198	217	370	333
4	81	93	107	0	167
5	66	80	97	0	0
Nominal total 2/					
	$1,000	$1,065	$1,135	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$948	$930
Present value 4/					
0% inflation	$953	NA	NA	$957	$944
5% inflation	NA	954	NA	908	879
10% inflation	NA	NA	955	865	824

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1/ Depreciation is computed on an asset placed in service by a calendar year taxpayer on July 1 of year 1 without regard to the mid-month convention.

2/ Current dollars.

3/ Assumes 5 percent inflation rate.

4/ Assumes a 4 percent real rate of return.

Table 7.01-7

Depreciation Allowances Under Alternative Depreciation Methods for a Class 2 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 44 Percent			ACRS	Straight-Line
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation	5 Years	5 Years
1	$220	$220	$220	$150	$100
2	343	360	378	220	200
3	192	212	233	210	200
4	108	125	143	210	200
5	91	111	134	210	200
6	46	58	74	0	100
Nominal total 2/					
	$1,000	$1,086	$1,181	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$904	$888
Present value 4/					
0% inflation	$939	NA	NA	$922	$908
5% inflation	NA	940	NA	837	810
10% inflation	NA	NA	940	766	729

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See footnotes for Table 7.01-6

Table 7.01-8

Depreciation Allowances Under Alternative Depreciation Methods for a Class 3 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 33 Percent: 0 Percent Inflation	CCRS Depreciation Rate - 33 Percent: 5 Percent Inflation	CCRS Depreciation Rate - 33 Percent: 10 Percent Inflation	ACRS 5 Years	Straight-Line 5 Years
1	$165	$165	$165	$150	$100
2	276	289	303	220	200
3	185	204	223	210	200
4	124	143	165	210	200
5	100	122	147	210	200
6	100	128	162	0	100
7	50	67	89	0	0
Nominal total 2/					
	$1,000	$1,119	$1,254	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$904	$888
Present value 4/					
0% inflation	$919	NA	NA	$922	$908
5% inflation	NA	920	NA	837	810
10% inflation	NA	NA	920	766	729

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See footnotes for Table 7.01-6

Table 7.01-9

Depreciation Allowances Under Alternative Depreciation Methods for a Class 4 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 22 Percent: 0 Percent Inflation	CCRS Depreciation Rate - 22 Percent: 5 Percent Inflation	CCRS Depreciation Rate - 22 Percent: 10 Percent Inflation	ACRS 5 Years	Straight-Line 5 Years
1	$110	$110	$110	$150	$100
2	196	206	215	220	200
3	153	168	185	210	200
4	120	139	160	210	200
5	120	146	176	210	200
6	120	154	194	0	100
7	120	161	213	0	0
8	60	85	117	0	0
Nominal total 2/					
	$1,000	$1,169	$1,371	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$904	$888
Present value 4/					
0% inflation	$889	NA	NA	$922	$908
5% inflation	NA	890	NA	837	810
10% inflation	NA	NA	891	766	729

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See footnotes for Table 7.01-6

Table 7.01-10

Depreciation Allowances Under Alternative Depreciation Methods for a Class 5 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 17 Percent			ACRS	Straight-Line
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation	10 Years	10 Years
1	$ 85	$ 85	$ 85	$ 80	$ 50
2	156	163	171	140	100
3	129	142	156	120	100
4	107	124	143	100	100
5	89	108	130	100	100
6	79	101	127	100	100
7	79	106	140	90	100
8	79	111	154	90	100
9	79	117	169	90	100
10	79	122	186	90	100
11	39	64	102	0	50
Nominal total 2/					
	$1,000	$1,244	$1,564	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$819	$791
Present value 4/					
0% inflation	$853	NA	NA	$851	$827
5% inflation	NA	853	NA	707	665
10% inflation	NA	NA	853	603	551

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See footnotes for Table 7.01-6

Table 7.01-11

Depreciation Allowances Under Alternative Depreciation Methods for a Class 6 Asset 1/

(In Current Dollars Per $1,000 Investment)

Year	CCRS Depreciation Rate - 4 Percent			ACRS	Straight-Line
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation	18 Years	18 Years
1	$20	$ 20	$ 20	$50	$28
2	39	41	43	90	56
3	38	41	46	80	56
4	36	42	48	80	56
5	35	43	52	70	56
6	35	45	57	60	56
7	35	47	63	60	56
8	35	50	69	50	56
9	35	52	76	50	56
10	35	55	83	50	56
11	35	58	92	50	56
12	35	61	101	50	56
13	35	64	111	40	56
14	35	67	122	40	56
15	35	70	134	40	56
16	35	74	148	40	56
17	35	77	163	40	56
18	35	81	179	40	56
19	35	85	197	20	28
20	35	89	216	0	0
21	35	94	238	0	0
22	35	99	262	0	0
23	35	104	288	0	0
24	35	109	317	0	0
25	35	114	349	0	0
26	35	120	383	0	0
27	35	126	422	0	0
28	35	132	464	0	0
29	18	69	255	0	0
Nominal total 2/					
	$1,000	$2,128	$4,997	$1,000	$1,000
Inflation adjusted total 3/					
	$1,000	$1,000	$1,000	$715	$666
Present value 4/					
0% inflation	$610	NA	NA	$760	$723
5% inflation	NA	610	NA	570	502
10% inflation	NA	NA	610	454	377

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See footnotes for Table 7.01-6

Table 7.01-12

Effective Corporate and Personal Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/

	All 2/ Capital	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10% inflation	63	63	52	67	62
ACRS 5/					
With investment tax credit					
at 10% inflation	59	57	44	61	62
at 5% inflation	51	47	21	54	59
Without investment tax credit					
at 5% inflation	55	54	55	54	59
RCRS					
With 50% dividend relief 6/	42	41	41	42	42
Capital Cost Recovery System					
With 10% dividend relief 7/	41	39	35	40	46

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1/ Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the given statutory rate less the applicable exclusion. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt finance and the relation between the interest rate on debt and the rate of return on the investment.

2/ All capital includes equipment, structures and inventories.

3/ Assumes LIFO accounting with no reduction in inventories and inventory prices rising with inflation.

4/ Assumes 46 percent corporate statutory tax rate and 32.7 percent personal tax rate and 60 percent capital gains exclusion. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4-year life for structures.

5/ Assumes 46 percent corporate tax rate and 32.7 percent personal tax rate with 60 percent capital gains exclusion. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.

6/ RCRS with 50% dividend relief refers to the cost recovery system and dividend relief proposals contained in the Treasury Department's report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984. Assumed tax rates are given in footnote 7.

7/ Assumes 33 percent corporate rate and 26.5 percent personal rate with 50 percent capital gains exclusion. Assumes 10 percent corporate deduction for net dividends paid. Deviations in economic depreciation rates among assets may slightly alter tax rates.

Table 7.01-13

Effective Corporate Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/

	All 2/ Capital	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10% inflation	48	48	31	53	46
ACRS 5/					
With investment tax credit					
at 10% inflation	41	40	20	45	46
at 5% inflation	35	31	-4	39	46
Without investment tax credit					
at 5% inflation	41	39	41	39	46
RCRS					
With 50% dividend relief 6/	26	26	25	26	27
Capital Cost Recovery System With 10% dividend relief 7/	25	22	17	24	32

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See footnotes for Table 7.01-12, except only corporate tax rates apply.

REPEAL INVESTMENT TAX CREDIT

General Explanation

Chapter 7.02

Current Law

A credit against income tax liability is provided for a taxpayer's investment in certain depreciable property. Subject to a long list of exceptions, the following classes of property qualify for the investment credit: (1) tangible personal property (other than air conditioning or heating units); (2) certain other tangible property (not including buildings and their structural components); (3) elevators and escalators; (4) single purpose agricultural or horticultural structures; (5) rehabilitated buildings; (6) certain timber property; and (7) storage facilities (not including buildings and their structural components) used in connection with the distribution of petroleum or certain petroleum products.

In general, the credit is equal to ten percent of qualified investment in property that is placed in service during the taxable year. In the case of ACRS three-year property, the applicable credit rate is generally six percent. All qualifying costs for new property are eligible for the credit; in the case of used property, the qualifying costs that may be taken into account are generally limited to $125,000 for each taxable year. The investment tax credit is not available for property which is expensed.

The basis of depreciable property for which an investment tax credit is taken is reduced by 50 percent of the amount of such credit. A taxpayer may elect a two percent reduction in the investment tax credit in lieu of a basis reduction. A similar basis reduction is required of regulated utilities under normalization rules. If property for which an investment tax credit was taken is disposed of prior to the end of its recapture period, a portion of the credit previously allowed may be recaptured and added to the tax due in the year of disposition.

The amount of tax liability that may be offset by investment tax credits in any year may not exceed $25,000 plus 85 percent of the tax liability in excess of $25,000. Credits in excess of this limitation may be carried back three years and forward 15 years.

Reasons for Change

The investment tax credit was originally introduced and has been periodically modified to serve two principal purposes -- to prevent capital consumption allowances based on historical cost from being eroded by inflation and to stimulate increased levels of investment. Under current law, the investment tax credit, in combination with the

Accelerated Cost Recovery System ("ACRS") provides investment incentives that are neither systematically protected from inflation nor allocated in a neutral or efficient manner. For example, a ten percent investment tax credit without full basis adjustment results in a greater reduction in the effective tax rate for assets with faster economic depreciation rates. In addition, a ten percent investment tax credit reduces effective tax rates more during periods of low inflation than in periods of high inflation.

The investment tax credit is, in addition, excessively "front-loaded." The one-time, up-front credit makes possible the sheltering of an investor's unrelated income. Thus, the investment tax credit is a standard element of numerous tax shelter offerings that depend upon up-front deductions and credits for their viability. To the extent taxpayer energy and resources are consumed in pursuing tax rather than economic advantage, the growth and productivity of the economy as a whole are weakened.

The front-loading of the credit also limits its incentive effect for start-up, fast-growing or currently unprofitable businesses. There are substantial variations in tax rates among firms and industries that are caused by differences in their capacity to utilize credits currently. Table 1 shows the industry variations in the capacity to use the investment credit.

The capital formation objectives for which the investment credit was adopted would be better served under the Administration proposal for a new Capital Cost Recovery System ("CCRS"). See Ch. 7.01. Investment incentives would be built into depreciation allowances in a manner that would be inflation-proof, relatively neutral across assets, and distributed more evenly over the life of the investment. In addition, consolidation of incentives in the depreciation system would improve public understanding and awareness of the extent to which the tax system is being employed to encourage investment. By providing incentives through the investment credit and through the depreciation system, current law may cause taxpayers to believe that only the more visible credit is an incentive, and thus that depreciation deductions properly measure economic income.

Finally, although the concept of the investment tax credit is straightforward, the applicable statutory provisions are exceedingly complex. Repeal of the credit would substantially simplify the tax system by eliminating these rules.

Proposal

The investment tax credit would be repealed. See Ch. 12.01 for a discussion of repeal of the investment credit for rehabilitated buildings. Normalization rules would be retained for the unamortized portion of pre-repeal investment tax credits allowed to regulated public utilities.

Table 7.02-1

Utilization of Investment Tax Credits in 1981

($ millions)

Industry	Investment Credit Earned	Investment Credit Used Against 1981 Tax Liabilities	Percent of Earned Credit Allowed	Unused Investment Credit
All manufacturing	**$11,327**	**$ 9,116**	**80**	**$ 6,720**
Food manufacturing	1,025	831	81	403
Tobacco manufacturing	144	151	105 1/	0
Textile mill products	146	125	86	83
Apparel	60	56	93	25
Lumber and wood	309	48	16	392
Furniture and fixtures	38	30	79	14
Paper products	373	303	81	207
Printing and publishing	482	345	72	218
Chemicals	1,134	872	77	653
Petroleum and refining	2,332	2,295	98	209
Rubber and plastic	132	111	84	120
Leather products	20	19	95	4
Stone, clay and glass	264	148	56	242
Primary metals	492	649	132 1/	981
Fabricated metals	447	326	73	229
Machinery	1,166	938	80	420
Electrical equipment	1,081	631	58	1,080
Motor vehicles	865	739	85	877
Transportation equipment	418	123	29	501
Instruments	296	293	99	24
Other manufacturing	103	81	79	42
Utilities	**4,844**	**3,047**	**63**	**7,939**
Other sectors	**9,831**	**6,649**	**68**	**8,022**
Total	**$26,002**	**$18,812**	**72**	**$ 22,681**

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1/ Percentage greater than 100 indicates that credits were carried forward and used from previous years.

Effective Date

The proposal generally would be effective for property placed in service on or after January 1, 1986.

Analysis

The Administration CCRS proposal would replace both the investment tax credit and the ACRS depreciation system without sacrificing investment incentives necessary to stimulate continued economic growth for the economy as a whole. While providing investment incentives, CCRS would permit a substantial reduction in statutory tax rates for both corporations and individuals. Moreover, CCRS would correct three principal defects in the investment tax credit and depreciation system of current law -- the variance in effective tax rates among different assets and industries; the volatility of effective tax rates in response to fluctuating inflation; and the excessive acceleration or front-loading of capital cost recovery which make possible negative effective tax rates exploited by tax shelters.

Since repeal of the investment tax credit would eliminate the bias in favor of property that is eligible for the credit, investment in some such property may diminish. Aggregate business investment, however, should not be diminished, given the incentive effects of lower overall tax rates and the CCRS proposal.

Repeal of the investment tax credit also would eliminate complexity associated with existing rules (1) to distinguish qualified from non-qualified property, (2) to determine the amount of the credit, (3) to adjust basis as a result of the credit, (4) to determine the amount of previously allowed credits subject to recapture in the event of early disposition of an asset, and (5) to carryback and carryforward unused credits. Other rules also would be repealed: the at-risk rules for the credit, the rules which deny the credit to certain noncorporate lessors, the rules governing pass-through of the credit, the definition of qualified United States production costs and other special rules for films and sound recordings, the rules governing property used by certain tax-exempt entities, the rules pertaining to the treatment of qualified progress expenditures, the rules denying the credit for foreign use property (other than property that meets one of eleven exceptions) and for certain property used in connection with the furnishing of lodging, the rules governing the credit for livestock, the rules governing the credit for certain boilers, and the rules distinguishing used and new property.

REVISE TAX TREATMENT OF CAPITAL GAINS

General Explanation

Chapter 7.03

Current Law

Gains or losses from the sale or exchange of capital assets held for more than six months (one year for assets acquired before June 23, 1984) are treated as long-term capital gains or losses. Long-term capital gains receive preferential tax treatment. For individuals and other noncorporate taxpayers, 60 percent of net capital gain is excluded from income, with the balance of 40 percent taxable at ordinary rates. Thus, a taxpayer in the maximum 50 percent tax bracket has a marginal tax rate on net capital gain of 20 percent. For corporations, the regular maximum tax rate of 46 percent is reduced to 28 percent on net capital gain if the tax computed using that rate is lower than the corporation's regular tax.

A taxpayer determines net capital gain by first netting long-term capital gain against long-term capital loss and short-term capital gain against short-term capital loss. The excess of any net long-term capital gain over any net short-term capital loss equals net capital gain entitled to the preferential tax rate.

Capital losses are deductible under different rules for corporate and noncorporate taxpayers. For corporations, any net short-term or long-term capital loss is offset against any net long-term or short-term gain. Excess capital losses are not deductible against other income, but may generally be carried back for three taxable years and forward for five taxable years as a short-term capital loss in the carryover year.

Individuals and other noncorporate taxpayers also deduct any net short-term or long-term capital loss first against any net long-term or short-term gain. In addition, a noncorporate taxpayer with an excess net capital loss may generally take up to $3,000 of such loss as a deduction against other income. For this purpose, only one-half of net long-term capital loss is usable. Net capital loss in excess of the deduction limitations may be carried forward indefinitely, retaining its character in the carryover year as either a short- or long-term loss. Special rules allow individuals to treat losses with respect to a limited amount of stock in certain samll business corporations as ordinary losses rather than as capital losses.

A capital asset is defined generally as property held by a taxpayer other than (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) rights to literary or artistic works held by the creator of such works, or acquired from the creator in certain tax-free transactions, (4) accounts and notes receivable, and (5) certain publications of the government.

Special rules apply to gains and losses with respect to "section 1231 property," "section 1256 contracts," and certain rights to a patent. Section 1231 property is defined as (1) depreciable or real property held for more than six months and used in a taxpayer's trade or business, but not includable in inventory or held primarily for sale in the ordinary course of a trade or business, (2) property subject to compulsory or involuntary conversion, and (3) special property, including certain interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops. Gains and losses from all transactions involving section 1231 property are netted for each taxable year. Only gains that are not subject to recapture as ordinary income are included in the netting. If there is a net gain from section 1231 property, all gains and losses from section 1231 property are treated as long-term capital gains and losses and are combined with the taxpayer's other capital gains and losses. If there is a net loss from section 1231 property, all transactions in section 1231 property produce ordinary income and ordinary loss. However, net gain from section 1231 property is converted into ordinary income to the extent net losses from section 1231 property in the previous 5 years were treated as ordinary losses.

Depreciation recapture rules recharacterize a portion of gains upon dispositions of depreciable property as ordinary income. These rules vary with respect to the type of depreciable property. Under ACRS, for all personal and non-residential rental real property, all previously allowed depreciation, not in excess of total realized gain, is recaptured as ordinary income. However, if taxpayers elect straight-line depreciation over longer recovery periods, there is no depreciation recapture upon disposition of the asset. With respect to residential rental property, only the excess of ACRS deductions over the straight-line method is recaptured as ordinary income. Depreciation recapture also is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of depreciable property.

Section 1256 contracts are defined to include (1) any regulated futures contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer option. Gain or loss with respect to a section 1256 contract generally is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent.

Capital gains and losses are generally taken into account when "realized" upon sale, exchange, or other disposition of the property. By contrast, section 1256 contracts generally are marked to market and treated as if sold on the last business day of the taxable year in which held and accrued gains or losses are realized upon such deemed sales. Certain hedging transactions involving section 1256 contracts are not marked to market. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for tax purposes. Thus, usually, in the case of gifts, no gain or loss is realized by the donor and, in general, the donor's basis in the property carries over into the hands of the donee. In certain circumstances, such as the gift of a bond with accrued market discount or of property which is subject to indebtedness in excess of the donor's basis, the donor may recognize ordinary income upon making a gift. Gain or loss also is not realized on transfer at death, even though the transferee's basis in the property is stepped-up to fair market value at the time of death.

The amount of a seller's gain or loss is equal to the difference between the amount realized by the seller and the seller's adjusted basis (i.e., the cost or other original basis adjusted for items chargeable against basis). Under various nonrecognition provisions, however, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain like-kind exchanges of property, involuntary conversions followed by an acquisition of replacement property, corporate reorganizations, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing for a substitution of basis from the old property to the new or for a carryover basis from the old holder to the new holder.

Reasons for Change

Change in Exclusion Rate. The Administration proposals include a substantial reduction in marginal tax rates. With the reduction in the maximum marginal tax rate from 50 percent to 35 percent, a reduction in the exclusion rate applied to net capital gain is appropriate. The reduction in the exclusion for capital gains, however, should substantially preserve the relative tax preference that is available under current law for investments in capital assets.

Effects of Inflation. During periods of inflation, nominal gains or losses on sales of capital assets will reflect inflationary increases in the value of property which do not represent real changes in economic value. Although the preferential tax rate for capital gains is often explained as compensation for the fact that current law does not adjust capital gains for inflation, the preference serves this function only in a rough way. Because the preferential tax rate does not account systematically for the effects of inflation, investors currently face substantial uncertainty regarding the eventual effective rate of tax on their investments, and may even be taxed on investments that produce an economic loss. The availability to investors of an election to index the basis of capital assets, in lieu of a preferential rate, would reduce uncertainty over effective tax rates and ensure that only real gains are subject to tax.

Treatment of Gain on Depreciable Assets. Gains and losses from sales or other dispositions of depreciable property should be treated in the same manner as other business income or loss and gains or losses from sales of other business property (e.g., inventory). The current asymmetrical treatment of gains and losses from depreciable property, i.e., the availability of capital gain treatment for gains and ordinary loss treatment for losses, is without justification as a matter of tax policy and should be discontinued.

Historically, the availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions. These historical circumstances offer no continuing justification for the current treatment of depreciable assets, given the absence of exceptional wartime gains and the low, historically unprecedented (in the post-World War II era) statutory tax rates incorporated in the Administration proposals.

In addition, capital gain treatment for depreciable assets can not be justified by the factors that make such treatment appropriate for investment property qualifying as a capital asset. (See below **"Analysis - Retention of a Preferential Rate for Capital Gains".**) Under current law, the capital gain preference serves in part as a rough adjustment for the effects of inflation, since nominal rather than economic gains are included in the tax base. The Administration proposal for a new Capital Cost Recovery System ("CCRS") would account explicitly for inflation with respect to depreciable property, however, and thus a preferential rate on gain from sales of such property is unnecessary as an inflation adjustment.

The capital gain preference also serves as an incentive for saving and investment, and to encourage the flow of capital to new and innovative activities that involve high risk yet offer large economic and social returns. Incentives for investment in depreciable property, however, would be provided through the proposed CCRS depreciation allowances. These incentives would be systematically applied, in order to establish relative neutrality in the taxation of income from depreciable assets. The retention of an additional incentive in the form of capital gain treatment would create a preference for investment in depreciable property likely to yield significant gains on sale. Such additional incentive is neither necessary nor appropriate.

Finally, the timing of sales of depreciable business assets is more likely to be determined by the condition of the particular asset or by routine business cycles of replacement than would be true of capital assets held by investors. As a consequence, taxation of gains on sales of depreciable assets at ordinary rates is less likely to affect taxpayer decisions about sales and reinvestment. Conversely, taxation of gains on sales of depreciable assets at preferential rates would create an unjustified bias toward certain sources of business income.

Treatment of Gain on Special Section 1231 Property. Under current law, gains on dispositions of certain interests in timber, coal, iron ore, livestock and unharvested crops, are eligible for capital gain treatment regardless of whether the property is held for sale in the ordinary course of the taxpayer's business. This special treatment violates the distinction, which is inherent in the definition of a capital asset, between investment property and business property. Business income, whether derived from the sale of property used in a trade or business or from the sale of property to customers in the ordinary course of business, should be taxed as ordinary income. The preferential tax rate on capital gains should apply only to investment assets. Gains from dispositions of interests in certain natural and agricultural resources should be taxed in accordance with these generally applicable rules.

Proposal

The exclusion rate for net capital gain of individuals and noncorporate taxpayers would be reduced from 60 percent to 50 percent, producing a maximum tax rate on capital gain under the Administration proposals of 17.5 percent. The current law tax rate on net capital gain of corporations would remain at 28 percent.

The current law definition of a capital asset would be retained. However, gain from the sale or disposition or the compulsory or involuntary conversion of depreciable or depletable property used in a trade or business would not be treated as gain from the sale or exchange of a capital asset. As under current law, recognition of involuntary gains could be deferred if proceeds of the conversion were reinvested in similar property. Land used in a trade or business would continue to receive capital gain and ordinary loss treatment. Gain or loss with respect to a section 1256 contract would be treated as under current law, so that 60 percent of the gain or loss would be treated as long-term capital gain and 40 percent of the gain or loss would be treated as short-term capital gain or loss.

Depreciable property used in a trade or business and property eligible for cost depletion which does not qualify as a capital asset would be indexed under rules applicable to those assets. See

Ch. 7.01. Property which is held for sale in the ordinary course of business or as inventory would be indexed under separate rules. See Ch. 7.04.

Interests in timber, coal, iron ore, livestock and unharvested crops which are treated as special section 1231 property under current law would be treated in the same manner as other assets. That is, gains from the dispositions of such interests would be treated as capital gains only if such interests satisfy the definition of a capital asset in the hands of a particular taxpayer.

Beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991. The election would be in lieu of eligibility for the preferential tax rate on capital gains. An election would be effective for all capital assets disposed of in a particular year. Indexed capital losses would remain subject to current law limitations on deductibility. The election would not be available to corporations.

Under the indexing election, a capital asset obtained prior to January 1, 1991 would be indexed as if acquired on that date for an amount equal to the taxpayer's adjusted basis in the asset. Inflation adjustments would be based on a Federal government price index. Capital assets would be required to be held more than 12 months to be eligible for indexing. The proposal to allow elective indexing of capital assets after 1991 would not alter the basic realization and nonrecognition rules of current law. If capital assets are held by a taxpayer who employs a functional currency other than the U.S. dollar, the measure of inflation generally would be based on the inflation rate in the functional currency (as determined by the Internal Revenue Service).

Retention of the preferential tax rate on capital gains, in general, would not affect nonrecognition provisions of current law requiring realized gains or losses to be deferred. In particular, homeowners would be permitted, subject to existing rules, to roll over gain on the sale of a principal residence, if a new principal residence is acquired within 2 years of the sale of the prior principal residence. Moreover, subject to existing rules, homeowners who are age 55 or older would exclude permanently the first $125,000 of inflation adjusted gain upon the sale of a principal residence.

<u>**Effective Date**</u>

The proposal to reduce the exclusion rate to 50 percent would be effective on July 1, 1986 for all capital assets. The proposal to revise the treatment of gains from sales or dispositions of depreciable property used in a trade or business would apply to any property placed in service by the taxpayer on or after January 1, 1986. The proposal to repeal capital gain treatment for special section 1231 property would be phased out over three years, becoming fully effective January 1, 1989. See Ch. 9.04 for the specific phase-out rules.

Analysis

Retention of a Preferential Rate for Capital Gains. The capital gain preference serves a variety of purposes that, despite the inherent difficulties in a preferential rate, make its retention appropriate. Under current law, the capital gain preference compensates for the fact that nominal gains, unadjusted for inflation, are included in income. The inflation adjustment provided by the preference is, of course, imprecise, since it does not vary with the experienced rate of inflation or with the period of time the asset is held. On the other hand, the preference is computationally easy and is generally familiar and understandable to taxpayers.

Since the Administration proposals would allow elective inflation indexing for capital assets beginning in 1991, retention of a capital gain preference, in the long run, must rest on grounds other than its function as an indirect inflation adjustment. The most significant of these other grounds concerns the incentive effect of the preference. There is broad concern that elimination of the capital gain preference would adversely affect saving and investment, and thus impair the capital formation necessary to continued economic growth. Moreover, many argue that, because of risk or other factors, investment needed to generate new and innovative technology would not be pursued at optimal levels absent a favorable rate of taxation. Although it might be possible to address these concerns through a preference limited to particular activities or forms of investment, the complexity entailed in defining and enforcing those limits would substantially offset the simplification benefits of a change from current law.

Preferential treatment of capital gain may also be justified because of the longstanding treatment of unrealized gains. Capital gains are not subject to tax until the underlying asset is sold, and thus, capital gains from assets held for any significant period of time are accorded preferential treatment without regard to a preferential rate. Moreover, the deferral advantage for unrealized gains grows to one of total exemption if the underlying asset is held until death. Because the taxation of gain is deferred until realization, taxpayers are encouraged to retain appreciated capital investments in circumstances where alternative investments offer a greater economic return. The significance of this so-called "lock-in effect" is a function of the rate at which realized gains are taxed. By reducing the rate of tax on realized gains, the preference limits the lock-in effect, and thus may improve the allocation of capital within the economy. By encouraging realization of accrued gains, it may also offset the revenue loss attributable to a preferential rate.

Finally, the preferential rate for capital gain serves to offset the impact of the progressive rate structure on gains that are accrued over a period of time but realized in a single year. In this respect, a capital gain preference operates as an implicit, though very rough, averaging device.

The purposes served by the capital gain preference are listed with full recognition of the difficulties the preference has created under current law. The capital gain preference has generated significant complexity, reflected in the substantial body of statutory and case law concerned solely with identifying income entitled to the preference. Just as clearly, preferential treatment of capital gains stimulates artificial behavior, by encouraging taxpayers to structure their affairs so as to bring particular transactions or sources of income within the scope of the preference. Whether these costs outweigh the purposes served by the preference is one of the recurring themes of tax policy debate. The conclusion reached in the Administration proposals is that, on balance, the preference should be retained.

Effect on Saving and Investment. The proposal to retain a preferential tax rate on capital gain, in combination with the proposed substantial reduction in tax rates, should have a stimulative effect on saving, investment and capital formation.

The effect on investment of the proposal to treat all gain from the sale of depreciable property as ordinary income should be examined in light of the CCRS proposal for depreciable assets. The basis of a depreciable asset would be indexed for both depreciation purposes and for purposes of computation of gain. Thus, the inflationary component of gain on a depreciable asset would not be subject to tax under the Administration proposals. Moreover, indexing of depreciable assets would produce more accurate measurement of real losses. In addition, the incentives built into the depreciation allowances would be applied in a neutral manner to all depreciable assets. Consequently, the treatment of gain on disposition of these assets as ordinary income should not impede overall capital formation or the efficient allocation of capital.

Effect on risk-taking. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. The venture capital and associated high-technology industries seem particularly sensitive to changes in effective tax rates. Shareholders in such ventures that are highly successful would not face higher effective tax rates under the Administration proposal. Also, the increase in savings stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences and the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high-risk ventures and high-technology industries. In addition, all investors would continue to benefit from the deferral of tax on accrued but unrealized gains.

Retention of Realization Principle. The proposal would retain the longstanding realization principle of current law, under which gains and losses generally are not taxed until realized by sale, exchange or other disposition. As discussed above, the realization requirement and the lock-in effect it produces impair capital resource allocation to the extent taxpayers are deterred from reallocating investments by the tax costs of realizing accrued appreciation. Repeal of the realization requirement on any broad basis, however, would meet strong taxpayer resistance and could involve significant administrative and economic costs. Requiring recognition of gain on an annual or other current basis would necessitate a system for valuing unsold assets, which could be burdensomely complex for taxpayers as well as for the Internal Revenue Service. Moreover, a current realization requirement could in certain situations force taxpayers to liquidate investments in order to satisfy accrued tax liabilities.

The proposal retains the mark-to-market accounting concept currently applicable to section 1256 contracts. The primary advantage of the mark-to-market concept in this limited context is that it negates the need to identify offsetting positions for purposes of the loss deferral rules applicable to straddles. Straddle transactions utilizing section 1256 contracts would provide numerous opportunities for abuse for taxpayers with large volumes of trades in such contracts absent retention of mark-to-market accounting for these assets.

Scope of Loss Limitation Rules. In general, the proposal would retain the capital loss limitation rules of current law for assets held for investment and not for use in a trade or business. Such limitations are appropriately applied to investors who may selectively realize gains and losses on investment assets. Were capital losses deductible without limit, taxpayers would dispose of capital assets selectively to produce a net loss with which to shelter noninvestment income.

Simplification of Recapture Provisions. Depreciation recapture has been necessary under ACRS and prior depreciation rules to prevent excessive depreciation deductions from being converted into capital gain. Indexing depreciation allowances and treating gains from dispositions of depreciable property as ordinary income obviates the need for the complicated depreciation recapture provisions of current law. Although a taxpayer would receive an investment incentive from depreciation allowances in excess of economic depreciation, taxing all gain from depreciable property as ordinary income would permit repeal of many of the recapture provisions for depreciable property acquired after January 1, 1986. Existing recapture rules would remain in effect for depreciable property placed in service prior to January 1, 1986.

The recapture rules of current law also serve to limit nonrecognition rules applying to gains realized in certain transactions (e.g., gains realized on corporate liquidations or pre-liquidation sales and gains realized on sales under the installment method). In general, such nonrecognition rules would be limited in a similar fashion under the Administration proposals. Consideration would be given to applying such limits on a parallel basis for realized gains with respect to personal and real property.

Treatment of Special Section 1231 Property. Denial of special capital gain treatment for timber, coal, iron ore, livestock and unharvested crops would result in a consistent limitation of the capital gain preference to investment property qualifying as a capital asset. Thus, if special section 1231 property were used in a trade or business, it would be subject to cost recovery rules and ordinary income treatment applicable to trade or business property. See Ch. 7.01. If special section 1231 property were held for sale to customers or as inventory, it would be subject to rules applicable to all inventory property. See Ch. 7.04. If special section 1231 property were held as a capital asset, it would be eligible for the capital gain preference.

In addition, consideration would be given to treating land held for use in a trade or business as ordinary income property. If so treated, land used in a trade or business would be eligible for inflation indexing on the same basis as depletable property.

Collateral Issues. Denial of capital gain treatment to depreciable assets would expand the scope of current law rules treating gain recognized on sale or disposition of a partnership interest as ordinary income to the extent attributable to the selling partner's interest in certain assets of the partnership that would produce ordinary income if sold by the partnership. Consideration would be given to extending similar rules to dispositions of interests in S corporations and stock in subsidiaries which are included in an affiliated group filing a consolidated return.

Finally, consideration would be given to treating gain realized upon the disposition of rights to a patent as ordinary income to the extent that the creator of the patented invention or a holder of rights to the patent claimed deductions from ordinary income for the costs of developing the invention.

INDEX INVENTORIES

General Explanation

Chapter 7.04

Current Law

In general, current law requires the use of inventory accounting methods where necessary to determine clearly a taxpayer's income. Treasury regulations implementing this rule generally require inventories to be maintained where the production, purchase or sale of merchandise is an income-producing factor. A taxpayer that keeps inventories for tax purposes must use the accrual method of accounting with respect to purchases and sales of inventory items.

Inventory accounting assists in accurately measuring income from the sale of goods; this measurement, in turn, depends on the value for tax accounting purposes of the goods on hand at the close of the taxable year. The cost of goods sold during the year is generally equal to the dollar value of beginning inventory, plus purchases and other inventoriable costs incurred during the year, minus the dollar value of ending inventory. Thus, for example, a taxpayer with beginning inventory of $100, purchases and other inventoriable costs of $500, and ending inventory of $150, has a cost of goods sold for the year of $450 ($100 plus $500 minus $150 = $450). The measurement of income from the sale of goods changes with any change in the valuation of ending inventory. Thus, if ending inventory, in the preceding example, had a higher value, the cost of goods sold would have been lower, and gross income from sales would have been correspondingly higher. Conversely, a lower figure for ending inventory would have increased the cost of goods sold and reduced gross income.

Under Treasury regulations, inventories generally are valued at cost, although in certain cases the lower of cost or market value is permitted. In order to determine the cost of ending inventory, a taxpayer may identify each specific item of inventory and ascertain its actual cost or value. In most cases, however, this "specific identification" method is impractical because of the number and fungible nature of the goods on hand. The Internal Revenue Code and regulations therefore permit alternative methods which employ simplifying assumptions regarding the flow of goods from inventory.

The first-in, first-out (FIFO) method assumes that the first goods purchased or produced are the first goods sold. Under FIFO the most recently purchased or produced goods are deemed on hand at year-end, and ending inventories are thus valued at the most recent purchase or production costs. The last in, first-out (LIFO) method assumes that the last goods purchased or produced are the first goods sold. Since LIFO accounting values ending inventory at the oldest purchase or production costs, in periods of increasing purchase or production costs its use results in a higher cost of goods sold and lower taxable income than FIFO.

Since 1939, taxpayers who use the LIFO method for tax purposes have been required to use LIFO in preparing annual financial statements for credit purposes and for reports to stockholders, partners, proprietors or beneficiaries (the "LIFO conformity requirement").

Reasons for Change

Taxes should be imposed on real economic income, not on increases that are attributable to inflation. Current inventory accounting methods used for tax purposes depart from this principle by failing to reflect inflation in a consistent manner.

Because the LIFO method treats the most recently acquired goods as the first goods sold, LIFO accounting reflects income from inventory sales more accurately during periods of inflation than does FIFO. Notwithstanding the advantages of LIFO accounting in an inflationary economy, many businesses continue to use the FIFO method. Although many small firms are reluctant to use LIFO accounting because of the perceived complexity, some businesses are simply unwilling to use LIFO for financial accounting purposes -- as required by the LIFO conformity requirement. The disincentive for LIFO accounting that is created by the conformity requirement is inappropriate in a tax system designed to neutralize the effects of inflation.

Although LIFO measures the effects of inflation better than FIFO, it does not fully account for these effects. LIFO takes account only of price changes in the inventoried goods, which may or may not correspond to the effects of inflation on prices generally. Moreover, since LIFO represents only a flow of goods assumption rather than an adjustment of inventory costs in line with inflation, it results in only the deferral rather than the elimination of inflationary gains. When a firm that uses the LIFO method either liquidates or reduces inventories, it is taxed on previously deferred inflationary gains. This factor distorts business decisions concerning inventory levels and creates an incentive for transactions, such as a merger or reorganization, which permit continued deferral of the inflationary gain.

Proposal

Taxpayers would be permitted the option of using an Indexed FIFO method in addition to the current LIFO and FIFO methods of accounting. Under the Indexed FIFO method, inventories would be indexed using inflation adjustment factors based on a Federal government price index. Indexing would be based on relatively simple computational methods, such as applying the percentage increase in the price index (such as the Consumer Price Index) to the FIFO cost of the number of units in beginning inventory which does not exceed the number of units in ending inventory. Indexing would also be permitted for inventory assets for which the specific identification method is used, as well as for property held primarily for sale in the ordinary course of business that may not constitute inventory (e.g., certain real estate held for sale by a dealer in such property).

Indexing would be allowed only with respect to inflation occurring after the effective date of the proposal. The requirement under current law that the Internal Revenue Service consent to changes in accounting methods would be waived for taxpayers changing to LIFO or to Indexed FIFO accounting methods during an appropriate transition period. In addition, the LIFO conformity requirement would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

About two-thirds of inventories in the United States are owned by firms which continue to use FIFO accounting, despite the resulting overstatement of income tax liability during inflationary times. Table 1 provides data on the use of FIFO by industry group. The proposal would permit such firms to switch to either Indexed FIFO or LIFO inventory tax accounting, while continuing to use the unindexed FIFO method for financial accounting purposes. It is expected that taxpayers that currently use the unindexed FIFO method would switch to the Indexed FIFO method or the LIFO method. An immediate switch by all firms that currently use FIFO to either Indexed FIFO or LIFO would result in a maximum aggregate annual tax saving to those firms of approximately $6 billion.

Firms that currently use LIFO, however, would be unlikely to change to Indexed FIFO, unless the economic advantages were sufficient to offset the associated administrative costs as well as the tax costs resulting from recapture of LIFO reserves. LIFO inventories would not be eligible for an inflation adjustment. Such an adjustment would generally be inappropriate since LIFO accounting permits indefinite deferral of inflationary gains. Moreover, LIFO accounting, unlike the Indexed FIFO method, permits deferral of real inventory gains; thus, to combine LIFO with indexation would be a form of double benefit. For LIFO firms that do switch to Indexed FIFO, inventory stocks would thereafter be valued more accurately. Moreover, the influence of tax considerations over decisions as to liquidation of a business or levels of inventory would be reduced.

The proposal to index the FIFO method would improve the measurement of income for tax purposes since inflationary gains would be permanently removed from the tax base. The Indexed FIFO method would also be analogous to the proposed treatment for depreciable assets, where depreciation allowances would be indexed for general inflation. In this respect, the Indexed FIFO method will provide greater neutrality between investment in inventory and in depreciable property during periods of inflation.

Finally, the current disincentive to entry into industries that have historically used the FIFO accounting system and thus borne an artificially high tax burden would be removed.

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Table 7.04-1

Percentage of Ending Inventory Valued by the FIFO Method by Industry

Industry	Value of Ending Inventory (Billions)	Percentage FIFO
Agriculture	$ 4.6	97 %
Mining	8.2	81
Construction	23.1	97
Food	24.0	66
Tobacco	6.7	15
Textiles	5.8	50
Apparel	8.3	82
Lumber	6.0	77
Furniture	6.0	77
Pulp and Paper	6.5	60
Printing and Publishing	5.4	70
Chemicals	26.4	50
Petroleum	23.9	41
Rubber	5.1	63
Leather	2.1	74
Stone, Clay and Glass Products	5.9	58
Primary Metals	20.7	39
Fabricated Metals	20.7	39
Machinery	38.9	67
Electrical Equipment	30.1	68
Motor Vehicles	16.1	47
Instruments	8.2	57
Transportation Equipment	18.3	78
Transportation Public Utilities	31.9	92
Communications	6.5	99
Wholesale Trade	108.8	80
Retail Trade	102.2	69
Finance, Insurance, and Real Estate	12.8	89
Services	11.0	95
Total All Industries	**$ 594.2**	**70 %**

Office of the Secretary of the Treasury May 28, 1985

Source: 1981 Corporation Income Tax Returns, computed by the Bureau of Economic Analysis

RETAIN $5,000 LIMIT ON EXPENSING DEPRECIABLE BUSINESS PROPERTY

General Explanation

Chapter 7.05

Current Law

Under current law, taxpayers may elect to expense the cost of a limited amount of qualifying property rather than to recover such cost over time through deductions for depreciation. In general, property qualifying for this expensing election must be purchased for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable with respect to amounts expensed under this rule.

For taxable years beginning before 1988, the dollar limitation on the amount that may be expensed is $5,000 per year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for taxable years beginning after 1989. In each case, the limitation that applies to a married individual who files a separate return is one-half of the dollar limitation described above.

Reasons for Change

Expensing the cost of an asset that produces income for more than one year overstates the taxpayer's cost of producing income for the year. The overstatement of current deductions shelters other income from tax and thus results in a deferral of tax liability. This deferral advantage creates some incentive for investment in assets eligible for expensing, but only for taxpayers who would not otherwise have acquired qualifying property up to the amount eligible for expensing. For other taxpayers, the limited expensing election creates no marginal investment incentive.

In addition, permitting taxpayers to expense the cost of an asset creates compliance problems. After the year in which the asset is expensed, the asset is removed from the tax form. As a result, it is relatively easy to convert the asset to personal use or to sell the asset without complying with the rules requiring recapture of the deduction.

A limited expensing election does, however, have certain simplification advantages. For smaller businesses, expensing eliminates or reduces the recordkeeping and computational burdens of recovering an asset's cost over a number of years.

Proposal

The scheduled increases of the dollar limitation on expensing of depreciable business property would be eliminated, leaving in place the current limit of $5,000.

Analysis

The proposal would not change the current treatment of any taxpayer. Elimination of the increase in the limitation should have little effect on investment in depreciable assets. The proposal would simply retain a de minimis alternative to the more complicated depreciation rules.

REPEAL RAPID AMORTIZATION RULES

General Explanation

Chapter 7.06

Introduction

Current law contains a number of special amortization and expensing rules that allow taxpayers to elect premature deductions for certain capital expenditures. The deferral of income tax that these provisions permit is intended to create incentives or subsidies for investment in certain assets or activities.

Some of these provisions were originally intended to be effective only for brief periods, but were later extended. Others have expired in whole or in part since they do not apply to expenditures made in the current year or in future years. Although these provisions target various industries and various assets, they have similar effects on the efficiency and fairness of the tax system and present related questions of tax and economic policy.

Current Law

1. Five-year amortization of trademark and trade name expenditures. Current law permits taxpayers to amortize over a period of at least 60 months any expenditure paid or incurred in the taxable year for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. (Section 177.) A separate election may be made by the taxpayer with respect to each separate trademark or trade name expenditure.

2. Five-year amortization of pollution control facilities. Current law permits taxpayers to amortize the cost of a certified pollution control facility over a 60-month period. (Section 169.) To the extent, however, that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation or through the Accelerated Cost Recovery System (ACRS).

A certified pollution control facility is a treatment facility used in connection with a plant or other property to abate or control water or air pollution, if (1) the plant or other property was in operation before January 1, 1976, (2) the facility is certified by the appropriate State and Federal authorities as meeting certain pollution control standards, and (3) the facility does not significantly increase the output, extend the life, or reduce the operating costs of the plant or other property. In general, a profitable or "break even" facility is not eligible for certification.

If an election is not made with respect to a certified pollution control facility, its cost may be recovered through depreciation or, in the case of recovery property, through ACRS.

3. **Five-year amortization of certain expenditures for qualified child care facilities.** Current law permitted employers to amortize over a 60-month period capital costs incurred before January 1, 1982, to acquire, construct, or rehabilitate child care facilities for their employees. (Section 188.)

4. **Five-year amortization of expenditures to rehabilitate low-income housing.** Current law permits taxpayers to amortize over a 60-month period expenditures to rehabilitate low-income rental housing (other than hotels or other similar facilities primarily serving transients). (Section 167(k).) Expenditures qualify for 60-month amortization only if they are incurred for additions or improvements to property with a useful life of at least five years. Expenditures for a taxable year with respect to a dwelling unit are eligible for 60-month amortization only if the aggregate of such expenditures over two consecutive taxable years including the taxable year exceeds $3,000. In general, a taxpayer's rehabilitation expenditures with respect to a dwelling unit are not eligible for five-year amortization to the extent that the aggregate of such expenditures exceeds $20,000. In certain cases, this limitation is increased to $40,000.

The election to amortize expenditures to rehabilitate low-income housing will not be available for expenditures incurred afer December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).

5. **Five-year amortization of certain railroad rolling stock.** At the election of the taxpayer, current law permitted taxpayers to amortize over a 60-month period the adjusted basis of railroad rolling stock placed in service after 1968 and before 1976. (Section 184.)

6. **Fifty-year amortization of qualified railroad grading and tunnel bores.** Current law permits domestic railroad common carriers to amortize the cost of qualified railroad grading and tunnel bores over a 50-year period. (Section 185.) "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

Amortizable basis is not reduced upon the retirement of qualified railroad grading or tunnel bores, but no additional deduction is allowed on account of such retirement.

7. Expensing of soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and field clearing expenditures. Current law permits taxpayers engaged in the business of farming ("farmers") to deduct a variety of costs that would otherwise be capitalized or inventoried, as follows:

a. Farmers may deduct currently soil and water conservation expenditures that do not increase the basis of depreciable assets. (Section 175.) The deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Deductible expenditures include costs of the following: leveling, grading, and terracing; contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; the eradication of brush; and the planting of windbreaks. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

b. Farmers may deduct currently expenditures for fertilizer or other material used to enrich, neutralize, or condition farmland. (Section 180.)

c. Farmers may deduct currently expenditures incurred to clear land and make the land suitable for farming. (Section 182.) The deduction is limited in any taxable year to the lesser of $5,000 or 25 percent of the farmer's taxable income from farming. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

8. Seven-year amortization of and ten percent credit for reforestation expenditures. Current law permits taxpayers to amortize over an 84-month period up to $10,000 of reforestation expenditures incurred in each taxable year. (Section 194.) A ten percent investment tax credit is also allowable for such expenditures. Reforestation expenditures include amounts spent on site preparation, seed or seedlings, labor, and tools. Amortized expenditures are subject to recapture if the underlying property is disposed of within ten years from the year of the expenditure. The credit is subject to the normal investment tax credit recapture rules.

Reasons For Change

Summary

Targeted government subsidies for particular industries and assets override market-based resource allocations and the consumer preferences on which they are based. In circumstances where private markets fail to reflect the social value of particular goods or services, government intervention in the form of a subsidy may be appropriate. However, many narrowly targeted tax incentives for business do not address problems of market failure, but instead subsidize specific business activities at some cost in overall economic efficiency.

1. Trademark and trade name expenditures. A trademark or trade name distinguishes a firm and/or its products from other firms and/or their products. The costs of acquiring a trademark are capital outlays for an intangible asset, similar to expenditures to organize a business. Investors are willing to make such expenditures because in doing so they acquire an asset that will, over the course of time, yield a rate of return at least as high as could be earned by other investments. Although a trademark or trade name may prove to be unprofitable, or even worthless, there can be no presumption that it will decline in value. To the contrary, the ordinary investor acquiring a trademark or trade name expects the value of the asset to appreciate along with the development of the products that it represents. Thus, where normal product development, including advertising, occurs on an ongoing basis, there is no ground for imputing deductions for "capital cost recovery" for investments in trademarks or trade names.

There is no evidence that investment in a trademark or trade name yields a greater benefit to society than is reflected in the expected market return to the investor. Allocation of resources to such investment should thus be determined by general market principles. There is correspondingly no basis for a tax incentive through premature recovery of the costs of such investment.

2. Certified pollution control facilities. The special amortization rules for pollution control facilities were enacted in 1969, shortly after the enactment of Federal legislation which imposed phased-in restrictions on industrial plant emissions. The thrust of the environmental protection laws was to require producers and their customers to pay the costs of avoiding environmental damage in excess of the standards imposed. At the same time, concern was expressed that existing plants would be subject to burdensome retrofitting costs, which would place them at a competitive disadvantage compared to newer plants that were designed after pollution control requirements were imposed. The special amortization rules were adopted to mitigate the cost of retrofitting older facilities. Consistent with the transitional objective, the special rules were scheduled to expire after seven years (December 31, 1975), a period presumably long enough to bring pre-1969 plants into compliance with emission standards.

The special amortization rules for pollution control facilities are poorly designed to offset the burden, if any, that revised environmental standards imposed on operators of existing plants. Ordinarily, plants in industries where emissions are a major concern are continuously "replaced" and their capacity altered in an orderly process of maintenance, repair, and modernization. Thus, at the margin, revised emission standards raised investment and operating costs for "old" and "new" plants alike. The only cost disadvantage to "old" plants was the difference between (a) the total additional cost of incorporating emission control features into "modernization" programs, and (b) the total additional cost of incorporating emission control features into the construction of new plants. This difference, which reflected differences in operating costs as well as capital costs, presumably varied from industry to industry, and from plant to plant. Thus, the extra burden imposed on taxpayers operating old plants, if any, was not related in some simple way to the cost of a depreciable retrofit facility, nor was it approximately equal to the interest savings on deferred taxes provided by five-year amortization.

The five-year amortization rules are also poorly targeted to encourage pollution control activities. The subsidy is available only with respect to depreciable assets, and thus provides no incentive for numerous other ways of reducing pollution from existing plants, such as using cleaner but more expensive grades of fuel and other raw material inputs. Favoring capital intensive pollution control measures wastes scarce resources to accomplish the program objective.

Finally, although the special amortization rule for pollution control facilities was originally a temporary measure, it was extended indefinitely in 1976. Even if some justification existed for transitional relief to operators of old plants, there is no basis for an ongoing subsidy of pollution control costs.

3. **Qualified child care facilities.** The special rule permitting five-year amortization of expenditures to construct or rehabilitate child care facilities applies only to expenditures made before January 1, 1982, and, therefore, has effectively expired.

4. **Rehabilitation of low-income housing.** Historically, low-income housing has benefited from a variety of direct and indirect government subsidies, including rental subsidies, grants, loans, and credit supports and guarantees. A number of Federal programs, including the housing voucher program initiated in 1983, have provided direct or indirect assistance to low-income families unable to afford market rents. Also initiated in 1983 were two programs providing grants to assist rehabilitation and new construction of low-income housing by the private sector. Direct low-interest loans are made available to assist low-income individuals in rural areas to obtain adequate housing. Finally, a number of mortgage insurance and guarantee programs make credit available to many families who could not afford to purchase homes in the absence of such measures.

In addition to these targeted direct subsidies, the current income tax laws contain numerous provisions which encourage investment in real estate, including housing. These provisions include (1) accelerated depreciation of real property, (2) full deductibility of interest, including the portion of interest intended to compensate the lender for the effects of inflation, (3) reduced tax rates for capital gains realized on disposition of real property, (4) relaxed recapture rules for dispositions of real property, (5) exemption of real estate investments from the limitation of losses to amounts at risk, and (6) tax-exempt status for bonds issued to finance low-income rental property. In addition, several special provisions apply only to low-income housing, including (1) immediate deductibility of construction-period interest and taxes, (2) the 15-year ACRS recovery period, and (3) five-year amortization of rehabilitation expenditures.

The tax benefits associated with real estate investment attract capital from high-income taxpayers who are willing to trade negative cash flows or below-market returns for substantial tax savings, and therefore appear to cause increased investment in real estate, including low-income housing. However, in a 1977 report entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," the Congressional Budget Office estimated that, because of the costs of packaging tax shelters and the high after-tax returns enjoyed by tax shelter investors, less than one-half of government revenue losses attributable to real estate tax shelters ever reach builders and developers. Thus, to the extent that the current tax laws encourage investment in low-income housing, the incentive is unnecessarily costly to the government.

If additional measures are needed to stimulate investment in low-income housing, existing targeted spending programs should be expanded.

5. **Railroad rolling stock.** The special rule permitting five-year amortization of the adjusted basis of railroad rolling stock applies only to rolling stock placed in service before 1976, and, therefore, has effectively expired.

6. **Qualified railroad grading and tunnel bores.** For much of its history, the U.S. railroad industry was subject to rate and service regulation designed to favor shipments of bulk raw materials over shipments of finished and semi-finished products. As a consequence, the industry's capacity to haul bulk commodities, demand for which is highly seasonal in volume, depended heavily on cross-subsidization from rates that were charged for "high value" manufactured goods.

In general, such cross-subsidization was possible so long as the railroad industry held a virtual monopoly on long distance overland haulage. Competition from trucking progressively eroded this monopoly, however, shifting the railroads' mix of transported goods to the low-value markets. Railroad rate schedules failed to keep pace with the shift in markets, depressing industry earnings and causing investment in right of way and rolling stock to decline.

In 1969, Congress responded to the railroad industry's financial plight by allowing 50-year amortization for the cost of railroad grading (the basic roadway, but not the track, ties, and ballast) and tunnel bores, which, as assets in the nature of land improvements, had previously been considered nondepreciable. This special amortization rule, after its expansion in 1976, applied regardless of when the assets were placed in service, effectively granting railroad companies a 50-year stream of tax deferrals.

The special amortization rule for railroad grading and tunnel bores is a poorly conceived subsidy. The value of the subsidy depends on a railroad's historical investment in grading and tunnel bores. In many cases, these costs were incurred prior to imposition of the income tax, and, in any event, are not correlated with regulatory mispricing.

In addition, the subsidy targets its benefits to railroads least in need of or entitled to relief. Those railroads most affected by regulatory mispricing may not have significant taxable income, and thus may realize no benefit from the subsidy. Only profitable railroads can take full advantage of the special amortization rules, yet they may have escaped the burdens that the subsidy is intended to offset.

7. <u>Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures</u>. In recognition of various economic conditions which disfavor small unit farming, often called family farming, Federal programs to mitigate farm price and income instability have been in place since 1926. In addition to price support programs, farmers have access to Federal credit on a subsidized basis. The Department of Agriculture also administers programs for agricultural conservation and rural water supply, as well as providing farmers broad scale technical and management assistance.

The extensive Federal involvement in agricultural input and output markets makes additional tax-based subsidies unnecessary and inefficient. Outlays to drain marshy soil, create ponds, install irrigation ditches, and condition soil all have the objective of yielding greater farm output in the future. Under ordinary accounting principles they should be capitalized or inventoried -- treated as the purchase of an asset -- rather than treated as a cost of the current year's output. If the land-improving investments are rationally made, the farmer has merely exchanged cash for an asset of equal value -- improved land -- the expected market value of which will accrue to him as output occurs.

Finally, as with many other tax-based subsidies, the special expensing rules for farmers are of full value only to those with significant income. This effectively denies the benefits of the subsidy to the small, new, or unprofitable farmer, who is thus given a relative disincentive for farm improvements. As a result, such farmers operate at a competitive disadvantage, since market prices for farm products will tend to reflect the tax advantages from which such farmers do not benefit.

8. <u>Reforestation expenditures</u>. It has been argued that the market price of timber understates the social value of forested land because some important benefits are not expressed in the market price.

National security, flood control, arresting land erosion that degrades the quality of streams, and opportunities for outdoor recreation are claimed to be among the additional benefits derived from forested land.

In view of these "externalities," government invervention to increase the volume of forest output may be justified. Thus, $1.8 billion was spent in fiscal year 1984 for management of more than 100 million acres of national forests and for cooperative forestry and forestry research.

In addition to these direct budget expenditures, present law contains tax subsidies intended to encourage forestry by small-scale landowners. All taxpayers investing in timberland are entitled to an investment tax credit equal to ten percent of up to $10,000 of reforestation expenditures each year. In addition, the total amount eligible for the credit may be amortized over seven years, notwithstanding the fact that the taxpayer has expended only 90 percent of that amount and the trees planted are likely to appreciate in value.

Even if one agrees that there are "externalities" in forestry in excess of the direct expenditures presently provided in the Federal budget, the reforestation credit and amortization provisions are so poorly designed that their continuation is difficult to justify. Any reforestation expenditure qualifies for the investment credit and amortization, whether or not it yields recreational, flood control, or erosion control benefits, or relates to a tree species with national security significance. Moreover, the provisions are so structured that they cannot appreciably affect marginal industry investment. Due to economies of scale, most commercial forestry (i.e., that type which is likely to produce external benefits of the kind that justify a subsidy) requires reforestation expenditures far in excess of $10,000 per year. For most commercial forestry, therefore, these tax provisions are the equivalent of a fixed grant plus assured tax deferral each year, and are independent of the taxpayer's decision to increase marginal qualified expenditures. Repeal of the reforestation credit and amortization provisions would increase revenue collection without measurably increasing soil erosion and flood damage, or reducing recreational opportunities and national security.

Proposals and Effective Dates

1. **Trademark and trade name expenditures.** The current election to amortize trademark and trade name expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

2. **Certified pollution control facilities.** The election to amortize the cost of certified pollution control facilities would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

3. Qualified child care facilities. This provision would be deleted from the Code as deadwood, since it applies only to costs incurred prior to January 1, 1982.

4. Rehabilitation of low-income housing. The election to amortize expenditures to rehabilitate low-income housing would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

5. Railroad rolling stock. This provision would be deleted from the Code as deadwood, since it applies only to rolling stock placed in service prior to 1976.

6. Qualified railroad grading and tunnel bores. The election to amortize the cost of qualified railroad grading and tunnel bores would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

7. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. The elections to deduct currently expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing, would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

8. Reforestation expenditures. The election to amortize reforestation expenditures and the investment tax credit for such expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

Analysis

In general, costs that currently qualify for the special expensing and amortization rules discussed in this section create wasting or non-wasting long-lived assets. Thus, repeal of the special rules would cause those costs to be capitalized or inventoried, and recovered under the normal cost recovery rules or at the time of disposition. The effect on taxpayer behavior of such repeal would generally depend on (1) the extent to which marginal investment choices are influenced by the special rules provided by current law and (2) the degree of neutrality achieved by the cost recovery rules replacing the special provisions.

1. Trademark and trade name expenditures. An investment in a trademark or trade name creates an intangible asset for which there is no reason to impute deductions for a decline in value over time. Accordingly, if such an investment were capitalized it would be recovered only upon disposition of the asset. Thus, the interest-free tax deferral which currently results from the tax treatment of trademark and trade name expenditures would be eliminated.

Nevertheless, the effect of repeal on business would be minimal. Unlike investments in plant and equipment, capitalized investments in trademarks and trade names generally do not vary with firm output. Rather, they are fixed capital costs which are relatively small compared to the initial investment in an enterprise, and constitute a declining proportion of total investment as firm output increases. Thus, the importance of trademark and trade name income tax deferral is initially small and is thereafter of diminishing significance to firms with average rates of growth.

2. **Certified pollution control facilities**. Pollution control facilities that are currently eligible for five-year amortization are for the most part comprised of equipment that, under a system more closely related to economic depreciation, would be depreciated over periods longer than five years. Since that system would reduce the relative tax benefit from investing in such equipment, compared to the tax consequences of investing in other means of controlling pollution, choices of pollution control methods would be based more on economic than on tax considerations. Since compliance with emission control standards is mandatory in most cases, the functional value of investments in pollution control facilities would not decline. However, under a more neutral cost recovery system, only the most cost-efficient pollution control methods would be used.

3. **Rehabilitation of low-income housing**. In the absence of five-year amortization of expenditures to rehabilitate low-income housing, such expenditures would be recovered in accordance with the normal rules for depreciating real property. Accordingly, repeal of this amortization provision would reduce to some extent the currently inflated after-tax return earned by investments in low-income housing rehabilitation. Nevertheless, the proposal is not expected to diminish the volume of low-income housing.

A tax preference for "rehabilitated" low-income housing directs private investment toward rehabilitation rather than new construction. New construction, however, even of housing for moderate- and high-income families, increases the stock of housing for low-income occupancy as tenants relocate. Thus, increased rehabilitation induced by tax subsidies largely displaces new construction. Accordingly, repeal of the subsidy would have little effect on the availability of low-income housing.

4. **Qualified railroad grading and tunnel bores**. In the absence of 50-year amortization of expenditures for railroad grading and tunnel bores, such expenditures should generally be capitalized as costs of land improvements, and recovered upon disposition of the improvements or the underlying land. This treatment would be consistent with the nature of the asset created by such expenditures, the value of which generally does not decline over time. In view of the fact that future improvements of and additions to railroad grading and tunnel bores are likely to be insubstantial in relation to

improvements and additions of track and rolling stock, repeal of 50-year amortization should not have an appreciable effect on the volume of railroad investment or on after-tax rates of return on such investment.

5. **Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures.** In the absence of special expensing rules for farmers' expenditures for clearing, conditioning, and conserving farmland, some of these expenditures would be capitalized as a cost of improving the land to make it suitable for farming and, as such, would be recovered under normal cost recovery rules (to the extent treated as the costs of land, such costs could be recovered only upon disposition of the land). To the extent that farmers who make such investments have significant marginal tax rates (generally large-scale operators and corporations), the loss of tax deferral would reduce the attractiveness of investments in land improvement relative to alternative investments, such as investments in farm machinery or in other industries. In addition to the resulting social gain from a better allocation of scarce private capital, eliminating this subsidy could result in a reduced level of Federal expenditures for price-support programs, since expansion of farm acreage would no longer be encouraged by the tax laws. Repeal of the expensing provisions should also improve the competitive position of those farmers, typically operating small or family farms, who do not receive full benefit from tax subsidies.

6. **Reforestation expenditures.** Repeal of seven-year amortization of qualified reforestation expenditures and the associated ten percent investment credit would have no measureable effect on the rate of investment in private forest lands. These incentives are structured so that they do not affect forest investment decisions; they apply only to the first $10,000 of reforestation investment, an amount far below the annual expenditures of a viable commercial forestry operation. The existing tax subsidies, however, also benefit farmers and other landowners who use tree planting to control wind-related soil damage or otherwise improve the value of their land. Since reforestation expenditures by such owners are much more likely to be $10,000 or less, repeal of the credit and amortization provisions could affect marginal investment decisions and decrease the total amount of reforestation expenditures by such owners. Absent the current subsidy, this type of tree planting probably would decline as investors selected other investment projects with higher market yields.

DENY RATE REDUCTION BENEFIT ATTRIBUTABLE TO EXCESS DEPRECIATION

General Explanation

Chapter 7.07

Current Law

Accelerated depreciation deductions are allowed under both the Accelerated Cost Recovery System ("ACRS") and pre-ACRS depreciation schedules based on useful lives. With respect to property placed in service before 1981, a taxpayer could generally elect to use either the straight-line method or an accelerated method such as the declining-balance method or the sum-of-the-years-digits method applied over the useful life of the property or over the class life of the property under the Class Life Asset Depreciation Range system. For purposes of computing their earnings and profits, corporations are required to use the straight-line method over the same useful life or class life used to compute depreciation deductions. Generally, for property placed in service after 1980, ACRS prescribes accelerated depreciation deductions over specified recovery periods. However, for purposes of computing earnings and profits, corporate taxpayers must use the straight-line method over longer recovery periods. Thus, in the early years of an asset's life, accelerated depreciation deductions under both ACRS and pre-ACRS law exceed straight-line depreciation deductions used to calculate a corporation's earnings and profits for tax purposes (E&P depreciation). Conversely, in the later years of an asset's life, accelerated depreciation deductions are less than E&P depreciation deductions; the year in which this first occurs may be referred to as the asset's "crossover point."

The top marginal rate for corporations was 48 percent for 1980 and 1981 and 46 percent for taxable years beginning after 1981. The top marginal tax rate for individuals was 70 percent for 1980 and 1981 and 50 percent for taxable years beginning after 1981.

Reasons for Change

The effect of using an accelerated depreciation method is that, relative to a calculation based on the straight-line method, taxable income is reduced in the years in which accelerated depreciation exceeds straight-line depreciation (i.e., years before the crossover point) and taxable income is increased in later years in which straight-line depreciation exceeds accelerated depreciation (i.e., in years after the crossover point). Thus, accelerated depreciation methods produce a deferral of tax liability relative to the time profile of tax liability that would result from the straight-line depreciation method.

As long as tax rates remain constant over the life of an asset, the amount of tax that is deferred as a result of accelerated depreciation is equal to the amount of tax that is repaid in later years. However, a reduction in tax rates for the later years produces an unexpected benefit for the taxpayer by reducing the tax that must be repaid relative to the tax that was deferred. This unexpected benefit is in addition to the intended benefit of interest-free deferral of the tax liability inherent in the acceleration of deductions.

The Administration proposals include a substantial reduction in tax rates effective on July 1, 1986. The top marginal rate would be reduced from 46 percent to 33 percent for corporations (a 13 percentage point reduction) and from 50 percent to 35 percent for individuals (a 15 percentage point reduction). Compared with the 48-percent and 70-percent rates in effect for corporations and individuals, respectively, prior to 1982, the rate reduction is even more substantial. Most taxpayers with substantial accelerated cost recovery deductions taken over the period 1980-85 will have been able to reduce tax at rates of 46 or 50 percent (48 or 70 percent for 1980-81). These taxpayers generally expected to repay their deferred tax liabilities attributable to accelerated depreciation at the currently applicable 46 or 50 percent rate. However, because of the proposed reduction in tax rates after July 1, 1986, the deferred tax liabilities of such taxpayers would generally be repaid at a 33-percent rate instead of a 46-percent rate for corporations (at a 35-percent rate instead of a 50-percent rate for top-bracket individuals). In the absence of a rule designed to recapture this unexpected benefit of the reduction in rates, part of the deferred tax liabilities attributable to accelerated depreciation deductions would effectively be forgiven. Taxpayers with deferred tax liabilities on July 1, 1986, would obtain an unintended windfall benefit, which had not been anticipated when investment decisions were made.

Proposal

In order to prevent taxpayers from obtaining the unexpected windfall benefit described above, 40 percent of a taxpayer's "excess depreciation" taken between January 1, 1980, and July 1, 1986, would be included in income over a three-year period. The excess depreciation over such period would be the excess of cumulative depreciation or amortization deductions over cumulative depreciation deductions that would have been allowed during such period using the straight-line method specified under current law for E&P depreciation (Code section 312(k)). For calendar-year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made to this schedule for fiscal-year taxpayers to put them on the same basis as calendar-year taxpayers.

Taxpayers whose total depreciation deductions taken between January 1, 1980, and December 31, 1985, are less than $400,000 would not be subject to the rate-reduction recapture rule. Such taxpayers would accordingly not have to make the excess depreciation calculation described above. Moreover, for those taxpayers who are subject to the rule, the first $300,000 of excess depreciation would be exempt from the rate-reduction recapture rule. If the taxpayer were in existence for only part of the 1980-85 period, the $400,000 threshold and $300,000 exemption would be adjusted accordingly.

For purposes of the rate-reduction recapture rule, any excess depreciation would be reduced by any net operating losses carried forward by the taxpayer from a year before 1986 to a taxable year beginning after 1985. The reduction of excess depreciation by such net operating losses would not reduce the amount of such losses that could be offset against taxable income. The proposed rate-reduction recapture rule would be applied at the level of individual partners, shareholders in an S corporation, or beneficiaries, not at the level of a partnership, S corporation, or trust. Amounts included in income under the rule that are attributable to foreign property would be treated as foreign-source income.

Effective Date

For calendar-year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made to this schedule for fiscal-year taxpayers to put them on the same basis as calendar-year taxpayers.

Property subject to the rate-reduction recapture rule would include all property placed in service on or after January 1, 1980, and before January 1, 1986, for which depreciation or amortization deductions were allowable under current law for any part of the period January 1, 1980, through June 30, 1986.

Transfers of property before July 1, 1986, in transactions where gain was not recognized would be disregarded in computing the transferor's liability under the rate-reduction recapture rule. Similar rules would be provided for transfers to related parties, with an appropriate adjustment for income recognized on the transfer. It is anticipated that the tax writing committees will provide any other transition rules necessary to prevent avoidance of the rate-reduction recapture. For example, the committees may wish to develop special rules for dispositions of real property in transactions where the gain attributable to excess depreciation is not fully subject to recapture under current law. No dispositions of property after June 30, 1986, would relieve the taxpayer of liability under the recapture rule, since such liability would be calculated as of that date.

Analysis

The proposal would prevent an unexpected windfall that would otherwise accrue to taxpayers who deferred tax liability by taking accelerated depreciation deductions at relatively high pre-reform tax rates, but would repay this deferred tax liability at lower post-reform tax rates. To reduce administrative complexity, the Administration proposal only approximates the rules that would be needed to eliminate the windfall precisely.

Ideally, the amount of the recapture tax on depreciable assets would be calculated as follows. The amount of excess depreciation on each asset placed in service prior to January 1, 1986, would be defined as the cumulative difference between accelerated and economic depreciation between the time the asset was placed in service and June 30, 1986. The tax would be equal to excess depreciation times the difference between the pre-reform and post-reform tax rates for the particular taxpayer, say, 13 percent. This tax would be assessed when the tax deferral associated with the accelerated deductions was repaid. That is, once the asset passed its crossover point, the taxpayer's annual tax burden would be increased by 13 percent of the amount of "deficient depreciation" in that year -- the amount by which economic depreciation exceeds accelerated depreciation -- until the full amount of the recapture tax was paid. Such a rule would ensure that tax deferrals that reduced income under the high pre-reform rate structure would be repaid at the expected time and at the expected tax rate, rather than at significantly lower post-reform rates.

The proposal contains a number of simplifying assumptions. E&P depreciation is used as a proxy for economic depreciation. This choice is made primarily for convenience, since most of the taxpayers subject to the proposal would be corporations that are currently required to compute E&P depreciation. In addition, no attempt is made to determine the appropriate tax differential for each taxpayer. Instead, the tax is assessed by including in income 40 percent of the cumulative excess depreciation taken prior to June 30, 1986, on assets placed in service between January 1, 1980, and December 31, 1985. This implies an effective recapture tax rate of 13.2 percent for large corporations that will experience a rate reduction from 46 to 33 percent; this rate is slightly below the 15 percent rate which should apply to corporate deductions taken at a 48 percent rate.

For top-bracket individuals, inclusion of excess depreciation in income at a 40 percent rate results in an effective recapture tax rate of 14 percent. This is slightly lower than the 15 percentage point reduction that would be appropriate for a top-bracket taxpayer who will experience a rate reduction from 50 to 35 percent; it is considerably below the 35 percent rate that should apply to individual deductions taken at a 70 percent rate. Virtually all individuals subject to the tax will be top-bracket taxpayers.

Similarly, no attempt is made to allocate the recapture liability across the years beyond the asset's crossover point as described above. Such a procedure would be exceedingly complex, as it would involve the calculation of the difference between accelerated and E&P depreciation for many years into the future for all assets subject to the rule. For certain assets, particularly long-lived property, determination of the amount of recapture liability with reference to the amount of excess depreciation taken prior to June 30, 1986, although correct in dollar terms, would overstate the liability in present value terms, since the additional tax liability would appropriately be assessed in later years. The proposed three year spread of the inclusion in income associated with the recapture rule would mitigate this problem, since it would reduce the present value of the rate-reduction recapture liability.

The recapture rule could be applied to all existing assets that would benefit from deferring tax liability at high pre-reform rates and repaying the deferred liability at lower rates. The limited scope of the provision is intended to reduce complexity, recognizing, for example, that most or all of deferred tax liability with respect to older depreciable assets will have been repaid by June 30, 1986.

The de minimis rule which exempts corporate and individual taxpayers with cumulative depreciation deductions over the 1980-1985 period of less than $400,000 from the rate reduction recapture rule would ensure that most taxpayers would not be subject to the rule and would not have to calculate their excess depreciation. Furthermore, taxpayers who may fall just above the $400,000 threshold would benefit from the exemption of $300,000 of excess depreciation from the rate-reduction recapture rule. Only about 150,000 individuals and 10 percent of corporations would be subject to the rule.

The recapture rule applies only to old capital and thus it has no effect on the cost of capital for new equipment.

CHAPTER 8

MEASURE INCOME PROPERLY

Significant strides were made in the Deficit Reduction Act of 1984 toward accurately reflecting the "time value of money" in measuring taxable income. This Chapter discusses proposals that would continue these improvements. Areas addressed in the 1984 legislation were generally not reevaluated.

The Administration proposals would require production costs to be capitalized on a more comprehensive basis, providing a more accurate matching of income and expenses. Accounting methods that mismeasure income, such as the cash method of accounting and the installment method, would be limited. Finally, the deductions for additions to bad debt reserves and to reserves for mining and solid waste reclamation and closing costs would be repealed.

REVISE ACCOUNTING RULES FOR PRODUCTION COSTS

General Explanation

Chapter 8.01

Current Law

In General

Where a taxpayer produces inventory or property that is not sold during the current year, the costs of production generally may not be currently deducted. Rather, these costs must be added to the taxpayer's basis in the property to which they relate. If the product is sold, the capitalized costs are recovered against the selling price. If the product is a durable good that is used in the taxpayer's business, the costs are recoverable as depreciation, amortization, or depletion deductions.

The general principle that production costs must be capitalized is not uniformly applied in all contexts. In some cases, production costs may be currently deducted. In others, where current tax accounting rules require production costs to be capitalized, the costs included within the definition of "production costs" vary substantially depending on the type of property produced and the method of production.

Production Costs Other than Interest

Inventories. In accounting for inventories of manufacturers or producers, costs must be collected according to the full absorption method of inventory accounting. All direct costs and certain indirect costs must be capitalized. Indirect costs that are not required to be included in inventoriable costs include, for example: depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported in the taxpayer's financial reports, and general and administrative expenses incident to and necessary for the taxpayer's activities as a whole.

The treatment of certain other indirect costs varies depending on how such costs are treated in the taxpayer's financial reports ("financial-conformity indirect costs"). These costs must be capitalized only if the taxpayer capitalizes them in its financial reports. Included in this category of indirect costs are: taxes, depreciation and cost depletion attributable to assets incident to and necessary for production; pension and profit-sharing contributions and other employee benefits; costs attributable to rework labor, scrap and spoilage; factory administrative expenses; salaries paid to officers attributable to services performed incident to and necessary for production; and insurance costs incident to and necessary for production.

Long-term contracts. Long-term contracts are building, installation, construction, or manufacturing contracts that are not completed within the taxable year in which they are entered into. Taxpayers using the completed-contract method of accounting for long-term contracts may not deduct contract costs until the contract is completed and income is reported. The rules for determining which costs must be treated as contract costs differ from the full absorption costing rules applicable to inventory. In addition, different rules apply depending on the duration of the contract.

For many long-term contracts the costs that must be capitalized generally track the full absorption regulations as they apply to a manufacturer that capitalizes in its financial reports the financial-conformity indirect costs. Differences are as follows: pension contributions and other employee benefits need not be capitalized; costs attributable to strikes, rework labor, scrap, and spoilage need not be capitalized; and research and experimental expenses directly attributable to particular contracts must be capitalized.

In the case of "extended-period long-term contracts," proposed regulations provide that taxpayers must capitalize certain additional long-term contract costs. With certain exceptions, extended-period long-term contracts are contracts that take more than two years to complete. The additional costs that must be capitalized include:

- all depreciation, amortization, and cost recovery allowances on equipment and facilities used in the performance of particular extended-period long-term contracts (tax depreciation in excess of depreciation reported on financial statements need not be capitalized in the case of non-extended-period contracts);

- depletion (whether or not in excess of cost) incurred in the performance of particular extended-period contracts;

- pension contributions and other employee benefits;

- rework labor, scrap, and spoilage incurred in the performance of particular extended-period contracts;

- expenses of successful bids; and

- certain direct and indirect costs incurred by any administrative, service, or support function or department to the extent allocable to particular extended-period contracts.

Proposed regulations set forth detailed rules for allocating administrative, service, and support costs to particular extended-period long-term contracts. The general test is whether a particular function or department of the taxpayer provides benefits to the extended-period long-term contracts, or merely benefits the overall management or policy guidance functions of the taxpayer.

Self-constructed assets. The costs of constructing or improving property having a useful life substantially beyond the taxable year must be capitalized and added to the basis of the property constructed. Existing regulations do not spell out which costs are to be capitalized when the taxpayer constructs property for its own use. The Supreme Court has held that depreciation on equipment used in such construction must be capitalized, and other courts have required certain indirect expenses, such as vacation pay, payroll taxes, certain fringe benefits, and certain overhead costs to be capitalized. Although administrative and judicial interpretations provide some guidelines, it is not clear in many self-construction cases whether particular costs may be deducted or must be capitalized.

Farming. Most farmers are not required to keep inventories for tax purposes, and thus do not capitalize the costs of producing crops. All of these costs may be deducted in the year when paid. The same is generally true of the costs of raising long-lived plants and animals, such as fruit and nut trees or breeding livestock. The costs of acquiring the seedlings or immature animals generally may not be deducted, however. The rule allowing a current deduction for most production costs originated from a concern that undue recordkeeping burdens not be imposed on farmers.

Some farmers are required to capitalize certain production costs. Under section 447, certain farming corporations must use an accrual method and inventory accounting in computing income, and accordingly are effectively denied a current deduction for production costs to the extent reflected in increased inventory. Section 447 does not apply to S corporations, corporations that are 50-percent owned by one family, or corporations with gross receipts of $1,000,000 or less. The provision is also inapplicable to certain corporations that were closely held to a requisite extent on October 4, 1976, and were engaged in farming on that date. In addition to requiring use of the accrual method and inventory accounting for tax purposes, section 447 requires the preproductive period expenses of raising long-lived plants and livestock to be capitalized. Preproductive period expenses are defined as any amount (other than interest and taxes) which is attributable to the preproductive period of crops, animals, or any other property having a crop or yield. In the case of property having a useful life of more than one year that will have more than one crop or yield, the preproductive period is the period before the disposition of the first marketable crop or yield. In the case of any other property having a crop or yield, the preproductive period is the period before the property is disposed of.

Farming syndicates engaged in developing a grove, orchard, or vineyard in which fruit or nuts are grown must capitalize the expenses of these activities under section 278(b). Instead of including the entire period before the disposition of the first marketable crop, the period during which expenses must be capitalized includes only the period before the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. Under proposed regulations, farming syndicates need not capitalize the following expenses: real estate taxes, interest, soil and water conservation expenditures that are deductible under section 175, and expenditures for clearing land allowable as a deduction under section 182.

Under section 278(a), expenses attributable to the development of any citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted must be capitalized. This provision is not restricted to farming syndicates. As under section 278(b), interest, taxes, soil and water conservation expenditures, and expenditures for clearing land need not be capitalized.

Timber. Some costs of producing timber are not deductible when paid or incurred, but may be recovered only when the timber is sold. These include planting costs (site preparation, seed or seedlings, labor and tool expenses, and depreciation on equipment) and costs of silvicultural practices incurred before the seedlings are established. All other production costs may be currently deducted, including carrying costs (such as property taxes), costs of silvicultural practices after establishment of the seedlings, costs of disease and pest control, fire protection expenses, insurance, and management costs (including labor and professional costs, costs of materials and supplies, and costs of timber cruises for management purposes, but not timber cruises in connection with the purchase of timber).

Capitalization of Construction-Period Interest

Real property construction-period interest and taxes may not be currently deducted, but must be amortized over ten years. If the property is sold before all the expenses are recovered, the unrecovered expenses are added to basis in determining gain on the sale. The provision does not apply to low-income housing, or to property that cannot reasonably be expected to be held in a trade or business or in an activity conducted for profit. Construction-period interest includes any interest expense that could have been avoided if construction expenditures had instead been used to repay indebtedness.

Construction-period interest relating to personal property may be deducted currently.

Reasons for Change

Current tax rules do not always match taxable receipts and deductions relating to production activities. This failure to match is of particular concern in the case of production that extends beyond one taxable year ("multiperiod production"), and becomes more significant with longer production periods. The mismatching of receipts and expenses permits deductions from these activities to offset income from other activities. A large number of tax shelters involve the so-called "natural deferral" industries, such as timber, extractive industries and vineyards.

Production expenses that relate to income to be produced in future periods should be matched with that income by capitalizing the production costs. Current tax accounting rules do not require comprehensive capitalization of costs. Most importantly, the current rules do not require the capitalization of interest paid with respect to the cost of carrying multiperiod production investments to completion. When these costs are not capitalized, the producer is able to shelter other income by deducting these costs, thus enjoying tax deferral.

Different rules regarding which production expenses must be capitalized apply to different types of activities. Long-term contracts, self-constructed assets, and inventories all have different capitalization rules. Replacement of the several different income tax accounting rules by uniform rules would make the income tax system more neutral and fairer.

Uniform capitalization rules would also eliminate tax distortions across activities. The current rules encourage a business to construct its own assets rather than to purchase them even when it is not the most efficient producer. The advantage given self-constructed assets is evidenced by comparing the basis of property in the hands of one who purchases with that of one who self-constructs. A seller prices goods by reference to all costs, including those deducted for tax purposes, plus a reasonable profit. The tax basis of a purchased asset, therefore, includes all costs of production, both direct and indirect, and these costs are recoverable by the purchaser only when sold or through depreciation, amortization, or depletion allowances. In contrast, the tax basis of a self-constructed asset includes only certain direct costs and perhaps a few indirect costs, while all other costs are deducted currently.

In addition to distorting investment decisions, the present rules cause serious unfairness. The benefits of tax deferral tend to be reflected in the prices of the products produced by multiperiod processes. Because the value of the tax deferral is related to the marginal tax rate of the investor, the attractiveness of these activities as tax shelters crowds out low-bracket individuals, as "shelter investors" bid-up the costs. Low tax rate individuals find they cannot earn a market after-tax rate of return at the price established by "shelter investors."

In sum, present law applies incomplete capitalization rules nonuniformly to different types of multiperiod production and applies rules that vary according to whether the output is sold or used in the producer's own business. These rules violate the principle of tax neutrality and should be modified.

Proposal

Capitalization of production costs other than interest. Uniform rules for capitalizing production costs would apply in all cases where the costs of producing or constructing real or personal property must be capitalized. The following types of production activities would be subject to the uniform capitalization rules:

- the production or manufacture of goods to be held in inventory or for sale to customers in the ordinary course of business;
- production under a long-term contract;
- the construction or other production of real or tangible personal property (including improvements to property) having a useful life beyond the taxable year, whether such property is to be used in the taxpayer's business or held for investment ("self-constructed assets"); and
- the growing of timber.

Special rules, described below, would apply to Federal government and cost-plus contracts and to farming. Current-law rules allowing expensing of certain development costs of oil and gas and other mineral property would remain unchanged; indirect costs would, however, be allocated to such development costs according to the rules set forth below.

The expenses of a particular production activity that would have to be capitalized would generally include all direct and indirect costs of production, as set forth in the rules applicable to extended-period long-term contracts, described in detail above. Major expenses that would not have to be capitalized as production costs include:

- marketing, selling, and advertising expenses;
- research and development expenses unrelated to particular production activities;
- expenses of unsuccessful bids and proposals; and
- general and administrative expenses other than those properly allocable to particular production activities.

General and administrative expenses attributable to certain cost-plus and Federal government contracts would have to be capitalized. This requirement would apply to all cost-plus contracts (i.e. not just contracts with Federal agencies) and to contracts with Federal agencies where the contractor is required by statute or regulation to submit certified cost data in connection with the award of the contract. Federal statutes generally require certified cost data to be submitted in connection with contracts the price of which is expected to exceed $100,000. This rule does not apply where the contract is awarded on the basis of sealed bids; where there is adequate price competition; or where the price is an established catalog or market price or is set by law. In the case of cost-plus contracts, only those types of general and administrative expenses that are reimbursed under the contract would have to be capitalized. General and administrative expenses required to be capitalized would not include marketing, selling, and advertising expenses, research and development expenses unrelated to particular contracts, or expenses of unsuccessful bids and proposals.

Special rules would apply to farmers. Except as provided below and in Ch. 8.03 (relating to cash accounting), farmers would not be required to keep inventories for tax purposes if not currently required to do so. With respect to preproductive period expenses, the rules of section 447 would continue to apply to the taxpayers currently covered by that provision (except in the case of property subject to section 278, revised as described below). Section 278, which deals with the capitalization of the development costs of fruit and nut orchards and vineyards, would be revised and extended to apply generally to any plant or animal, other than animals held for slaughter, whose preproductive period was two years or longer. The new provision would apply to all taxpayers, not just farming syndicates. In the case of plants, the preproductive period would begin with the time the plant or seed was first planted or acquired by the taxpayer, and would end with the time that the plant became productive or was disposed of. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the tree first bore fruit. In the case of animals, the preproductive period would begin at the time of breeding or embryo implantation (or at the time the taxpayer first acquired the animal), and would end when the animal became productive or was disposed of. An animal would be treated as productive when ready to perform its intended function, for example, when ready to be bred or to produce marketable quantities of milk. Animals held for slaughter would not be subject to these rules. If the preproductive period were two or more years long, the preproductive period expenses would have to be capitalized. The types of expenses that must be capitalized would be defined comprehensively as above. However, in lieu of capitalizing such expenses, taxpayers would be permitted to use inventory valuation methods such as the farm-price or unit-livestock-price method.

Capitalization of construction-period interest. Construction-period interest would have to be capitalized in the case of self-constructed property with a long useful life, and in the case of any property with a production period of two years or longer. With respect to self-constructed property, construction-period interest would have to be capitalized if it relates to property included in

CCRS Class 5, 6, or 7. In determining whether the production period is two years or longer, the period would generally begin with the commencement of construction or production and end with the time when the property is ready to be placed in service or held for sale. In the case of property produced under a long-term contract, the production period would end with contract completion. Interest attributable to the raising of plants or animals with a preproductive period of two years or longer would also have to be capitalized. The interest capitalization rule, however, would not apply to self-constructed assets to be used by the taxpayer for personal purposes (such as residential real estate).

Construction-period interest would be defined as any interest expense of the taxpayer that would have been avoided if production or construction expenditures had been used to repay indebtedness. Production or construction expenditures would be defined as equal to the cumulative production costs required to be capitalized. In effect, as under current-law rules defining construction-period interest, the taxpayer's interest cost would be deemed first allocable to production or construction activities. Indebtedness incurred specifically to finance construction would first be allocated to such construction. If construction-period expenditures exceed the amount of debt so allocated, interest on other debt of the taxpayer in the amount of such excess would be treated as construction-period interest. Where the taxpayer has outstanding debt with different rates of interest, the construction-period interest (other than interest specifically allocated to construction) would be computed according to the average interest rate on the taxpayer's debt. Appropriate related-party rules would be provided.

A customer of a contractor making progress payments or advance payments would be treated as self-constructing the property under construction by the contractor to the extent of such payments. Thus, payments and other advances by a customer would be treated as the customer's construction or production expenditures, and the contractor's construction or production expenditures would be reduced to this extent. The <u>customer</u> would have to capitalize interest attributable to such payments if the constructed property were in CCRS Class 5, 6, or 7, or if the construction period were two years or longer. To the extent of such advances by the customer, the <u>contractor</u> would not be treated as having incurred construction expenses, and would accordingly not have to capitalize construction-period interest. The contractor would have to capitalize construction-period interest on only the excess, if any, of its accumulated contract costs over the accumulated advances or progress payments it received.

In cases where interest is required to be capitalized, the interest would be added to the basis of the property being constructed. The basis of such property would be eligible for indexing, under rules similar to those set forth in Chapter 7.01, during the production period and thereafter. In the case of a contractor, contract costs up to the amount of advance payments made by the customer would not be eligible for indexing as far as the contractor is concerned, but would be treated as self-construction by the customer and eligible for indexing in the customer's hands.

Effective Date

Except as provided below, the proposed rules concerning production cost accounting and the capitalization of interest would be effective generally for costs and interest expense paid or incurred on or after January 1, 1986. The new rules would not apply to long-term contracts entered into before 1986. Production costs (including interest) attributable to timber that was planted before 1986 that are not required to be capitalized under present law would have to be capitalized under a ten-year phase-in. Thus, 10 percent of such costs paid or incurred in 1986 and 20 percent of such costs paid or incurred in 1987, etc., would have to be capitalized, until 100 percent was capitalized in 1995.

With respect to inventories, the new rules would apply for the taxpayer's first taxable year beginning on or after January 1, 1986. In order to minimize large distortions in taxable income, taxpayers subject to the new inventory cost accounting rules would be allowed to spread the adjustment that results from changing to the new method of accounting for production costs ratably over a period not to exceed six taxable years. This spread is in accordance with the usual rules for a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service.

Finally, the new rules would not apply to self-constructed assets where substantial construction had begun before 1986.

Analysis

Capitalization of production costs means that instead of being currently deductible, the costs are recovered when the produced property is sold or through depreciation, amortization or depletion deductions as the property is used in the taxpayer's business. When capital costs are not capitalized, deductible expenses are accelerated instead of being matched with the receipt of the taxable income they serve to produce. The acceleration of expenses allows other income to be sheltered by the deductions, and taxable income is correspondingly deferred until later years. The deferral of tax liability in this manner is the equivalent of the taxpayer receiving a subsidy, in the form of an interest-free loan from the Federal government.

Interest expense is a significant component of long-term production costs that generally is not required to be capitalized under current law. Because interest expense is a small portion of the total expenses incurred in short-term production activity, the proposal would generally require capitalization of interest only where production takes several years. Interest incurred in relatively short-term production of long-lived self-constructed assets would have to be capitalized, however, since a current deduction for such costs significantly accelerates deductions in comparison with capitalization. Because money is fungible, it is necessary to make certain assumptions as to the amount of interest attributable to production activities. Under the proposal, any debt outstanding would be attributed first to construction costs associated with the long-term production activity. The same rule applies in defining construction-period interest under current law.

Uniform rules for the capitalization of production costs would make the tax code more neutral in its application to various business activities. Uniform rules would also place all long-term production activities on a consistent tax accounting basis, and reduce tax-induced distortions in constructing and acquiring capital assets.

Special rules would recognize the special circumstances of certain industries. Thus, the current rules that do not require farmers to use inventories in computing income with respect to most crops would be retained, except as provided in Ch. 8.03, so as not to impose an undue recordkeeping burden. In the case of certain plants and animals that take a long time to mature, however, production costs would have to be capitalized, to avoid a significant deferral of tax liability.

The special rule requiring certain Federal contractors and cost-plus contractors to capitalize general and administrative expenses is appropriate because these contractors are paid for such overhead costs as part of the contract price. While it is generally not an easy matter to determine what portion of business overhead is properly allocable to a contract, the determination is not difficult where a contractor directly bills the customer for the overhead or relies on the allocated overhead in setting the contract price. Current law allows such contractors to be paid for overhead costs under the contract, but to treat such costs for tax purposes as period costs unrelated to the contract. Allowance of a current deduction for such costs defers tax by allowing a deduction in advance of recognition of the income to which it relates. The proposal would put Federal tax accounting on a consistent basis with contract cost accounting. The generosity of current accounting rules effectively subsidizes Federal government contracts, causing the actual cost of such contracts to the government to be understated. The budgetary process would be improved if this subsidy were removed and the full costs reflected in government outlays.

RECOGNIZE GAIN ON PLEDGES OF INSTALLMENT OBLIGATIONS

General Explanation

Chapter 8.02

Current Law

Income from an installment sale is reported as payments are received, rather than in the year of sale, unless the taxpayer elects otherwise. In general, an installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The gain recognized for any taxable year is the proportion of the installment payments received in that year which the gross profit to be realized when payment is completed bears to the total contract price ("gross profit ratio"). In general, the total contract price is the principal amount that will be paid to the seller. Treasury regulations provide analogous rules for installment method reporting by dealers in personal property.

Any indebtedness assumed by the buyer which is not "qualifying indebtedness" is treated as a payment in the year of sale or disposition. Qualifying indebtedness is treated as a payment in the year of sale only to the extent that it exceeds the seller's basis in the property. The term qualifying indebtedness means (1) a mortgage or other indebtedness encumbering the property, and (2) indebtedness incurred or assumed by the seller incident to the seller's acquisition, holding, or operation of the property in the ordinary course of business or investment.

If the seller disposes of an installment obligation, the tax that has been deferred on the installment sale generally becomes due. However, if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale.

Reasons for Change

The installment method was intended to alleviate liquidity problems that might arise if a taxpayer was required to pay tax on a sale when he had not received all or a portion of the sales proceeds. Nevertheless, under certain circumstances current law permits a taxpayer to defer his tax liability on an installment sale even though he has obtained cash by using the installment note as collateral for a loan. For example, assume that a taxpayer sells property for $100,000, payable in ten years with market-rate interest payable annually, and pledges the note as collateral for a loan of $90,000 from a bank. The interest payments received from the buyer on the installment obligation provide the taxpayer with funds to make interest payments on the $90,000 loan from the bank. Although the taxpayer has the use of $90,000 for ten years, current law permits him to defer tax on his gain from the sale until receipt of payment from the buyer in ten years. Moreover, such deferral may be permitted even if the buyer's note is secured by a bank letter of credit, so that the transaction is essentially riskless for the seller. In such circumstances, the taxpayer obtains the benefit of the profit element on the sale and has sufficient cash to pay the tax liability. There is no reason to permit such a taxpayer to continue to defer tax liability on the sale.

If instead of pledging the installment note after the sale of the property, the taxpayer had pledged the property for a loan prior to the sale and the buyer had assumed the taxpayer's indebtedness, the amount of the indebtedness (in the case of qualifying indebtedness, the excess over basis) would have been treated as a payment in the year of sale. Similar rules should apply regardless of whether the indebtedness is incurred before or after the sale.

Proposal

In general, the pledge of an installment obligation as security for a loan would cause recognition of all or a portion of the gain remaining to be recognized by the taxpayer with respect to the installment obligation. The following rules would control the recognition of such gain: In the case of an amount borrowed in the ordinary course of business and secured by an installment obligation received for the sale of property held by the taxpayer primarily for sale to customers within the ordinary course of business, gain on the installment obligation would be recognized to the extent of the excess of the amount borrowed over the basis of the obligation. In all other cases, gain on the installment obligation would be recognized to the extent of the amount borrowed (and secured by the installment obligation) multiplied by the gross profit ratio. Gain from an installment obligation which, but for this rule, would be recognized on subsequent payments on the obligation would be offset against the gain generated by the use of the installment obligation as security for indebtedness. Thus, in no case would the aggregate gain recognized by the taxpayer with respect to the installment obligation exceed the taxpayer's gross profit with respect to the installment obligation.

Exceptions would be provided for: an installment obligation which by its terms requires payment in full within a period not exceeding one year and which is received for the sale of property held by the taxpayer primarily for sale to customers in the ordinary course of business; a revolving credit plan which, by its terms and conditions, contemplates that all charges for each sale will be paid within a period not exceeding one year from the date of purchase; any indebtedness which by its terms requires payment in full within a period not exceeding 90 days from the date of issue, and which is not renewed or continued; and certain indebtedness owed to a financial institution and secured by a general lien on all of the borrower's

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trade or business assets. The general lien exception would not apply to a case, such as a financing subsidiary, where substantially all the borrower's assets are installment obligations.

Effective Date

The proposal would be effective for installment obligations pledged as security on or after January 1, 1986. In addition, any indebtedness outstanding on January 1, 1991 which is secured by an installment obligation which was pledged as collateral prior to January 1, 1986 would be treated as if the installment obligation was pledged on January 1, 1991.

Analysis

As shown in Table 1, the deferral of tax liability under the installment method can substantially reduce a taxpayer's effective tax rate. For example, when interest rates are eight percent, the deferral of tax for ten years by a taxpayer with a marginal tax rate of 50 percent reduces the effective tax rate to 23 percent. In effect, under the installment method, the Federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. The benefit of tax deferral under the installment method would be denied to taxpayers who have obtained cash by pledging an installment obligation.

In recent years, builders of commercial and residential real estate and sellers of equipment have issued bonds and debentures secured by their installment receivables. The volume of such borrowing by home builders alone has grown rapidly and is estimated to have exceeded $5 billion in 1984. The proposal would somewhat reduce the tax benefits of such transactions. To the extent that the proceeds from the bond or debenture exceed the taxpayer's basis in the installment obligations used as security, the taxpayer would recognize deferred gain from the installment sales. In such cases, the borrowing represents enjoyment of the profit element from the installment sales and should trigger recognition of income.

Certain dealers in personal property also have taken advantage of the ability to borrow against installment receivables by employing a single-purpose financing subsidiary, which has few assets other than installment obligations and incurs debt secured by a general lien on its assets. These transactions would be affected by the proposal unless they are within the exception for installment obligations with a term of one year or less, or the exception for certain revolving credit plans.

Finally, individual taxpayers have used installment obligations as security for indebtedness incurred for personal expenses. The proposal would eliminate the tax benefits of such transactions.

Table 8.02-1

Effective Tax Rate Per Dollar of Income Deferred by a 50 Percent Taxpayer for Different Deferral Periods and Interest Rates

Interest Rate	Deferral Period (in years)					
	1	3	5	10	20	30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

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LIMIT USE OF CASH METHOD OF ACCOUNTING

General Explanation

Chapter 8.03

Current Law

The Internal Revenue Code provides for the following permissible methods of accounting: (1) the cash receipts and disbursements method ("cash method"), (2) an accrual method, or (3) any other method or combination of methods permitted under Treasury regulations. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business of the taxpayer, provided that the method selected clearly reflects the taxpayer's income from such trade or business. A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to clearly reflect income.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. In contrast, the principles of the accrual method of accounting generally require that an item be included in income when all the events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual basis taxpayer when all events have occurred which determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and the economic performance that establishes the liability has occurred.

In general, taxpayers that are required to use inventories for a particular trade or business (other than farming) must use an accrual method of accounting for their purchases and sales. A taxpayer is required to use inventories in all cases in which the production, purchase, or sale of merchandise is an income-producing factor. Any other permissible method of accounting (including the cash method) may be used for other purposes in that trade or business or for other trades or businesses of the taxpayer.

A person engaged in the trade or business of farming generally may use the cash method of accounting for such business even though the farming business may involve the production and sale of goods. Use of the accrual method is required, however, for a corporation (other than S corporations and certain family-owned corporations) engaged in the trade or business of farming (or a partnership engaged in the trade or business of farming that has a corporation as a partner) that has gross receipts of more than $1 million in any taxable year beginning after December 31, 1975.

Reason for Change

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.

The relative simplicity of the cash method justifies its use for tax purposes by smaller, less sophisticated businesses, for which accrual accounting may be burdensome. Current law, however, permits many taxpayers that already use an accrual method for financial accounting purposes to use the cash method for tax purposes.

The cash method also produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual method taxpayer may deduct certain liabilities as incurred (even though not yet billed), such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until the amount is billed and cash payment thereon is made.

Proposal

A taxpayer would not be permitted to use the cash method of accounting for a trade or business unless it satisfied both of the following conditions: (1) the business has average (determined on a 3-year moving average basis) annual gross receipts of $5 million or less (taking into account appropriate aggregation rules); and (2) with respect to a trade or business other than farming, no other method of accounting has been used regularly to ascertain the income, profit, or loss of the business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries or for credit purposes. Consideration will also be given to taking into account the billing of clients for services in the use of the accrual method.

The above conditions would apply in addition to the current law limitation on use of the cash method with respect to a trade or business in which inventory accounting is required. The current rules requiring certain corporations to use accrual accounting for the trade or business of farming would also remain in effect in addition to the above rules.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to minimize large distortions in the taxable income of taxpayers who are required to change from the cash to the accrual method, the administrative rules generally applicable to changes in methods of accounting initiated by the taxpayer and approved by the Internal Revenue Service would be applied. Accordingly, taxpayers affected by the proposal would be allowed to spread the adjustment that results from the difference between the use of the cash and accrual methods of accounting ratably over a period not to exceed six taxable years.

Analysis

The proposed restriction on the use of the cash method of accounting would affect only a small percentage of firms. In 1981, approximately 103,000 corporations (eight percent of all corporations), 4,000 partnerships (one percent of all partnerships), and 1,800 sole proprietorships (including about 300 farmers) (less than one percent of all sole proprietorships) had receipts greater than the proposed $5 million limitation. Some of these businesses already use the accrual method of accounting for tax purposes. Accurate measurement of the income of these large firms is important to the integrity of the tax system, since they account for a significant share of business receipts.

The proposal would affect only businesses that are already using an accrual method of accounting in some part of their business or are sufficiently large to have access to professional accounting expertise. The primary industries that would be affected by the proposal would be banks that use an accrual method of accounting for financial reporting and large service organizations, such as accounting, law and advertising firms.

The virtue of the cash method's simplicity would be retained for those businesses, such as small farmers, that might be unduly burdened by a requirement that they use accrual accounting.

REPEAL RESERVE METHOD FOR BAD DEBT DEDUCTIONS

General Explanation

Chapter 8.04

Current Law

Taxpayers may deduct a business bad debt in the year in which it becomes worthless or, in the case of partially worthless debts, in the year in which part of the debt is charged off. In lieu of deducting specific bad debts, both cash and accrual method taxpayers may create a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the taxpayer may deduct an addition to the reserve sufficient to bring it to a reasonable level. The purpose of the reasonable reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that must be added to the reserve to restore it to an appropriate level. The deduction for additions to a bad debt reserve effectively allows a deduction for debts that become worthless during the year plus a deduction for future bad debts (attributable to the increase in the amount of receivables held at year-end).

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer of property in the ordinary course of its trade or business. In the case of certain taxpayers who were in existence in 1965, a suspense account arrangement prevents allowance of a double deduction by reason of a change in law which took place at that time.

Special rules govern the tax treatment of bad debts of depository institutions; these rules are dealt with in Ch. 10.01.

Reasons for Change

The reserve method for bad debt deductions allows taxpayers to deduct the bad debt losses in the current year and to deduct any net increase in the reserve. The deduction for the increase in the reserve represents a deduction for estimated future loan losses arising from an increase in the level of receivables on hand, without any discount for the present value of such losses. Moreover, the formula used to estimate such losses bears no necessary relationship to the future losses. The accelerated deduction for future losses defers taxable income and thereby reduces the effective tax rate of a business which experiences an increasing bad debt reserve.

In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income.

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

Proposal

The deduction for a reasonable addition to a reserve for bad debts would be repealed, although taxpayers would continue to be entitled to a deduction for debts that become worthless or are partially charged off. This proposal would also apply to the bad debts of financial institutions governed by Subchapter H.

The deduction for bad debts that become worthless would be conformed to the deduction for partially worthless debts. Thus, a deduction would not be allowed until a debt is charged off in whole or in part.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to prevent a double deduction for debts that become partially or wholly worthless after the effective date, a taxpayer's outstanding bad debt reserve at the close of the taxable year prior to the effective date would be includable in income ratably over a 10-year period.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. Because no market transaction occurs to fix the amount and timing of the loss for worthless or partially worthless debts, the most accurate method to determine the appropriate deduction for bad debts in a taxable year is to judge the loss that has occurred by examining the loan portfolio at the close of the year, based on all the facts known at that time.

In the contrast, any reserve system, even one based on generally accepted accounting principles, is based to some degree on expectations as to future losses. Such an ex ante approach would be inconsistent with the general principle that only realized losses are deductible. If reserves for future losses were allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Such a system would also require any divergences from the assumptions used in the present value calculation to be corrected. An accurate reserve system is not proposed because of the extreme administrative complexity that it would entail.

To illustrate the deferral allowed by the current reserve system, suppose a new firm, shown in Table 1, begins with $1,000 of accounts receivable and in the first year has $10 of bad debts (an experience rate of one percent). Under a reserve system where the allowable reserve equals the current year losses, the firm establishes a year-end reserve of $10. The allowable first year bad debt deduction is $20 -- $10 of actual losses plus $10 for the increase in the allowable reserve. As long as the firm's loss experience does not improve and its level of receivables does not decrease, the excess deduction is deferred indefinitely. If the firm prospers and accounts receivable increase in year two to $1,500 with the same loss experience rate of one percent, the allowable reserve increases to $15 and the company deducts $20 -- $5 more than the actual loan losses. In year three, if loans remain the same but the loss experience worsens to two percent, the company can deduct $45. Finally, if in the fourth year the company experiences a decrease in accounts receivable, its bad debt deduction is less than the loan losses that actually occurred. A net decrease in the bad debt reserve effectively brings excess deductions back into taxable income, thereby ending tax deferral on that amount. Table 1 in Ch. 8.02 shows the reduction in effective tax rate due to tax deferral for given deferral periods and interest rates.

Table 2 shows the discrepancy between bad debt deductions and actual loan losses due to the reserve method. The overstatement of losses and the amount of tax deferral depends on the growth rate of loans and the change in the loss experience rate. Credit growth over the past 10 years for domestic non-financial corporations was in excess of 20 percent annually. The change in the loss experience rate is not known, and is probably cyclical. Yet even with a constant loss rate, bad debt deductions overstated aggregate actual loan losses by 10 percent annually.

The modification of the rule governing when a worthless bad debt may be deducted would give taxpayers flexibility and would avoid penalizing them for failing to deduct a bad debt in the year in which it became worthless.

Table 8.04-1

Hypothetical Example of Excess Deductions with Reserve Method

	Year			
	1	2	3	4
Loss experience rate (percent)	1.0	1.0	2.0	2.0
Total loans or receivables	$1,000	$1,500	$1,500	$1,000
Actual losses	10	15	30	20
Beginning reserve	0	10	15	30
End reserve	10	15	30	20
Change in reserve	10	5	15	-10
Bad debt deduction [Losses plus change in reserve]	20	20	45	10
Excess deduction [Deduction minus actual losses]	10	5	15	-10
Accumulated excess deductions	10	15	30	20

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Table 8.04-2

Discrepancy Between Reserve Deductions 1/ and Actual Bad Debt Losses By Change in Total Loans and Loss Experience

(In Percent)

Annual Percentage Change in Loss Experience	Annual Percentage Change in Total Loans					
	-5	0	+5	+10	+15	+20
- 5	-11.2	-4.9	-0.2	3.3	6.0	8.0
0	-4.9	0.0	3.6	6.3	8.4	10.0
+ 5	-0.2	3.6	6.4	8.6	10.2	11.4
+10	3.3	6.3	8.6	10.2	11.5	12.5
+15	6.0	8.4	10.2	11.5	12.5	13.3

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1/ Assumes a six-year moving average experience method reserve. Shorter periods increase the discrepancy.

REPEAL MINING AND SOLID WASTE RECLAMATION AND CLOSING COST DEDUCTION

General Explanation

Chapter 8.05

Current Law

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. As a general rule, taxpayers using the cash method of accounting may deduct future expenses only when payment is made. Taxpayers using the accrual method of accounting generally may deduct future expenses only when the economic performance or activity giving rise to the expense has occurred. However, pursuant to a statutory exception to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. The amount that may be deducted in any year generally is the estimated future reclamation or closing costs attributable to production or mining activity during the taxable year. The estimate must be made on the basis of reclamation and closing cost prices prevailing in the taxable year. To obtain the deduction, no amount need be placed into a fund, but deducted amounts are added to a bookkeeping reserve maintained for tax purposes. In addition, interest on the additions to the reserve must be added to the reserve each year at a rate specified in the statute. When reclamation or closing occurs, the balance in the reserve is compared to the actual cost of closing or reclamation. If the total amount in the reserve, including interest, exceeds the reclamation or closing costs, further deductions are not allowed and the excess must be included in income. Amounts spent on reclamation or closing costs are charged against the reserve, and are deductible only to the extent the reserve is exhausted.

Expenses subject to the above rules include generally any expenses for land reclamation or closing activity pursuant to a reclamation plan under the Surface Mining Control and Reclamation Act of 1977 or similar law. Also included are expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site conducted in accordance with the Solid Waste Disposal Act or other similar law. Expenses attributable to property which is disturbed after being listed in the national contingency plan established under the Comprehensive Environmental, Compensation, and Liability Act of 1980 are not, however, included.

Reasons for Change

The special rules for strip mining and waste disposal closing and reclamation costs allow a current deduction for future costs without recognition of the fact that economic performance will occur, and the cost will be paid, in the future. The requirements to increase the reserve by an interest charge and to recapture reserves limit the extent to which the present value of the reserve is overstated. Nevertheless, the deduction generally is overstated in real terms and results in a reduced effective tax rate for those companies that find the special tax treatment to be advantageous for them.

The preferential tax treatment reduces the production costs of companies engaged in surface mining and companies generating solid waste. By reducing the costs of the products of these companies, the tax system encourages production processes that cause environmental damage. Regulations already in place require the environmental damage to be corrected. The tax system should not be employed to subsidize the costs of compliance. Such costs generally should be borne (through higher product prices) by the users of the products whose production damages the environment, rather than by all taxpayers. If it is determined that certain of these costs are of such societal importance as to justify a Federal subsidy, that subsidy should be provided through the appropriations process, not the tax system.

The current reserve system is substantially more complicated than a system requiring deduction of the future expenses when they occur. Future expenses must be estimated; records must be kept of previously deducted amounts; interest must be imputed on this amount on a cumulative basis; and excess amounts in the account must be recaptured, requiring a re-estimate of future costs each year. Further, as reclamation or closing costs are incurred, the costs must be allocated to particular properties, since reclamation and closing can be taking place on several sites at the same time.

Proposal

The special rules for mining and solid waste disposal reclamation and closing costs would be repealed. Accordingly, such costs would generally be deductible only as the sites were closed or the land reclaimed.

Effective Date

The proposal would be effective for mining or production activity occurring on or after January 1, 1986.

Analysis

The proposal would eliminate the indirect Federal subsidy for mining and solid waste reclamation and disposal costs. Under existing law, companies are allowed to accelerate deductions for future expenses, thus reducing their effective tax rates through tax deferral. This preferential tax treatment reduces the costs of companies incurring such expenses. The elimination of the tax preference can be expected to raise by a small amount the price of the affected products, which for the most part involve production processes that cause environmental damage. A small shift in consumption away from such products would result.

CHAPTER 9

REVISE TAXATION OF ENERGY AND NATURAL RESOURCES

The tax law has long been used to subsidize the exploration, development and production of natural resources. While subsidies for particular activities generally lead to inefficiencies and misdirect investment capital, the subsidies applied to national resource development have also been important in maintaining a viable domestic energy industry. Accordingly, these subsidies would be modified under the Administration proposals in order to establish greater neutrality in the taxation of various commercial activities, while retaining those incentives believed necessary to maintain exploration and development of domestic mineral resources.

REPEAL ENERGY TAX CREDITS

General Explanation

Chapter 9.01

Current Law

A. Business Energy Tax Incentives

Special tax credits are available for business firms to encourage investments in conservation and renewable energy technologies and to encourage production of alternative fuels. These incentives can be grouped into three major categories:

1. Energy Investment Tax Credits. Solar, wind, geothermal property and ocean thermal property qualify for a 15 percent energy investment tax credit. Certain hydroelectric generating property qualifies for an 11 percent credit. Qualified intercity buses and biomass property are eligible for a ten percent energy credit. These energy credits terminate on December 31, 1985.

A ten percent energy investment tax credit was available for certain other types of energy property but this credit generally expired on December 31, 1982. However, if such energy property qualifies under "affirmative commitment" rules, the credit continues to be available until December 31, 1990. Under these rules, projects requiring two or more years for completion will continue to be eligible if (a) all engineering studies were completed and all necessary permits filed before January 1, 1983, (b) binding contracts for 50 percent of specially designed equipment are entered into before 1986, and (c) the project is completed and placed in service before 1991. In addition, in the case of hydroelectric generating property, the credit is available through December 31, 1988, if an application has been filed with the Federal Energy Regulatory Commission before January 1, 1986.

2. Production Tax Credits. A credit of up to $3 per barrel of oil equivalent is available for certain qualifying fuels. In general, the credit is available for qualifying fuels produced from facilities placed in service after December 31, 1979, and before January 1, 1990, and sold after December 31, 1979, and before January 1, 2001. The credit phases out as the average wellhead price of domestic crude oil rises from $23.50 to $29.50 per barrel. The maximum credit and the phaseout range are adjusted for inflation. Qualifying fuels include (a) oil produced from shale and tar sands, (b) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, (c) synthetic fuels produced from coal, (d) fuel from qualified processed wood, and (e) steam from solid agricultural byproducts.

3. **Alcohol Fuels Credit and Excise Tax Exemptions.**

a) **Alcohol fuels mixtures**. Present law provides a six cents per gallon exemption from the nine cents excise tax on gasoline and a similar six cents per gallon exemption from the 15 cents diesel fuel excise tax if the taxable products are blended in a mixture with at least ten percent alcohol ("gasohol"). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). The provision terminates after December 31, 1992.

b) **Alcohol fuels**. Present law provides a nine cents per gallon exemption from the excise tax on special motor fuels for a fuel consisting of at least 85 percent alcohol derived from a source other than petroleum or natural gas and a four and one-half cents per gallon exemption if the source is natural gas. The provision terminates after December 31, 1992.

c) **Alcohol production credit**. A 60 cents per gallon income tax credit is provided for alcohol used in gasohol mixtures with gasoline, diesel fuel, and special motor fuels. A like credit is allowed for alcohol used as a fuel other than in a qualified fuels mixture. A lesser credit of 45 cents per gallon is provided for alcohol of at least 150 proof but less than 190 proof. The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). This credit terminates on December 31, 1992, and may be carried forward for 15 years, but not to a tax year beginning after December 31, 1994. If a production credit is claimed with respect to alcohol, the exemption from the gasoline and special fuels excise taxes is not allowed.

d) **Taxicabs refund**. A four cents per gallon exemption from the excise tax on gasoline, diesel fuel and special motor fuels is provided if used in certain taxicabs that are rated at above-average fuel economy. The exemption expires on September 30, 1985.

B. Residential Energy Tax Credits

Under current law there are two categories of residential energy tax credits:

1. **Conservation credits**. A 15 percent credit is available to individuals for the first $2,000 of expenditures for certain energy conservation equipment, such as insulation or storm windows and doors, for a maximum credit of $300.

2. **Renewable energy credits**. A 40 percent credit is available to individuals for the first $10,000 of expenditures for solar, wind or geothermal energy property, for a maximum credit of $4,000.

To be eligible for the residential energy tax credits, expenditures must be with respect to the taxpayer's principal residence. In the case of the residential conservation credits the residence must have been in use before April 20, 1978. The credits expire on December 31, 1985. Unused credits may be carried over through 1987.

Reasons for Change

Congress enacted the energy credits because oil and gas price controls understated the replacement cost of energy. Because of price controls, consumers did not have the incentive to invest in energy conservation and alternative fuels. The absence of free-market prices created an economic rationale for energy tax incentives. Since these incentives were enacted, however, crude oil prices have been decontrolled and natural gas prices are being decontrolled. As a result, these tax credits are no longer needed.

Proposal

The energy tax incentives would be allowed to expire or would be terminated on December 31, 1985.

Effective Dates

A. Business Energy Tax Incentives

1. Renewable Energy Investment Tax Credits. All renewable energy investment tax credits would be allowed to terminate on December 31, 1985. Unused credits may be carried forward or backward. However, for hydroelectric generating property the present law affirmative commitment rules will continue to apply.

2. Energy Investment Tax Credits. All conservation and other alternative source energy investment tax credits would terminate on December 31, 1985. However, present law affirmative commitment rules would continue to apply.

3. Production Tax Credits. All production tax credits would terminate on December 31, 1985. However, eligible fuel produced from a well drilled, or from facilities completed, before January 1, 1986, and sold before January 1, 1990, would continue to be eligible for the credit.

4. Alcohol Fuels Credit and Excise Tax Exemptions. The credit for alcohol fuels would be available for eligible alcohol fuels produced from facilities completed before January 1, 1986, and sold before January 1, 1993. All excise tax exemptions would terminate on December 31, 1985. The qualified taxicab refund that is scheduled to terminate on September 30, 1985, would not be renewed.

B. Residential Energy Tax Credits.

The residential energy tax credits would be allowed to expire on December 31, 1985, and would not be renewed. Carryovers of unused credits would continue to be available through 1987 as under current law.

Analysis

The energy tax credits implement questionable energy policies. Subsidies provided for alternative fuels, for example, are significantly in excess of the price that should be paid for replacement of crude oil. With an alcohol fuel production credit at 60 cents per gallon, the Federal government is paying a subsidy of $25.20 (in addition to the price paid by the consumer) in order to save a barrel of oil currently valued at under $30.

The energy tax credits also add to the complexity of our tax laws and impose additional administrative burdens upon the Internal Revenue Service. A taxpayer compliance study with respect to individual income tax returns for taxable year 1979 disclosed that of $473 million of taxpayer claims for energy tax credits, $126 million in claims would have had to be disallowed had the Internal Revenue Service been able to fully audit all returns. Taxpayers failed to claim only $26 million in credits that they were otherwise entitled to claim. Thus, by Internal Revenue Service estimates, more than one-quarter of the amount of energy credits claimed by taxpayers for 1979 should not have been allowed. The high error rate resulted from confusion over dollar limitations, qualification of equipment for credit, as well as improper carryovers. According to another study, in the case of the geothermal credit, nearly 95 percent of claimed credits were invalid because of an apparent massive misunderstanding of the applicable rules.

The residential energy credits, particularly the renewable energy credits, tend to favor middle- and upper/middle-income households, and cannot be justified on the ground that they are necessary to help low-income persons adjust to higher energy prices. For example, in 1982, households with adjusted gross income in excess of $30,000 accounted for about 60 percent of all renewable energy expenditures eligible for tax credits, but accounted for only 51 percent of total adjusted gross income.

Finally, many of the conservation improvements subsidized by the residential energy credits would have been made without the tax credits because of decontrol and the increase in world oil prices in 1979. Thus, in many cases, tax credits have served merely to reduce the tax burden of middle- and upper-income households, rather than to encourage additional energy conservation efforts.

REPEAL PERCENTAGE DEPLETION

General Explanation

Chapter 9.02

Current Law

The design of cost recovery rules for the extractive industries is complicated by the fact that the quantity of reserves and the rate of production vary widely for different deposits. Moreover, production may be prolonged through the application of various enhanced recovery techniques. Thus, unlike ordinary depreciation methods, which may reasonably be applied to generic categories of investment in plant and equipment, the rate of cost recovery for mineral properties is appropriately determined on a property by property basis.

Under current law, recovery of capital investment in mineral properties is generally determined under the cost depletion or the percentage depletion method. Under cost depletion, a deduction is allowed each year equal to the product of the unrecovered costs and the ratio of the quantity of minerals sold during the year to the quantity of minerals estimated to be available as of the beginning of the year. By taking into account a property's cumulative production record, cost depletion permits a more accurate allocation of costs incurred to individual time periods than methods employing a fixed service life or rate of recovery.

Under percentage depletion, a deduction is allowed based on a statutory percentage of the gross income from the property. The percentage of gross income that may be claimed is generally 15 percent for oil, gas and geothermal, and ranges from 5 to 22 percent for other minerals. The allowance is limited to 50 percent of the net income from the property, and certain additional limitations apply in the case of oil and gas. Unlike all other cost recovery systems, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire or develop the property have been recovered.

Taxpayers with an economic interest in a mineral property must claim the greater of percentage depletion or cost depletion. Percentage depletion generally is not allowed in the case of oil and gas production. However, natural gas producers with long-term contracts and certain independent producers and royalty owners (i.e., taxpayers that do not refine or market more than specified quantities of product) are allowed to claim percentage depletion. Independent producers and royalty owners may claim percentage depletion only on production up to 1,000 barrels of crude oil (or, in the case of natural gas, crude oil equivalents) per day. This quantity limitation must be allocated between different properties, and, at the taxpayer's election, between oil and gas production. In the case of coal and iron ore, corporate taxpayers must reduce such deductions by 15 percent of the amount in excess of the basis of the property. Taxpayers denied percentage depletion, such as integrated oil companies, may only use cost depletion.

The excess of percentage depletion over the adjusted basis of the property is a tax preference item for the corporate minimum tax and the noncorporate alternative minimum tax.

Reasons for Change

Percentage depletion allows deductions to be claimed in excess of a taxpayer's investment, and thus is more accurately viewed as a general production subsidy than as a method of cost recovery. The subsidy provided by percentage depletion, however, does not provide an efficient incentive for resource production. Because of the relatively lengthy interval between the acquisition of a property and initial production (if, in fact, the property is ever productive), percentage depletion encourages development of existing properties rather than exploration for new deposits. Moreover, because the allowance is limited to 50 percent of the property's net income, the subsidy is cut back for developers of marginally profitable properties. Thus, the greatest benefits are provided where a subsidy is least needed, i.e., to the developers of the most prolific or highly concentrated deposits.

Even if percentage depletion allowances were limited to a taxpayer's investment, percentage depletion would not be an appropriate cost recovery method. The rate of cost recovery would depend on the volume of production, and thus would favor owners of deposits that can be produced more rapidly over owners of less productive properties (even if such production might represent a smaller fraction of total reserves). Percentage depletion also provides faster cost recovery when mineral prices rise, and less rapid recovery when prices fall. These factors are unrelated to the appropriate rate of cost recovery.

Although percentage depletion is inappropriate as a general method of cost recovery, its total repeal could have a significant adverse effect on a segment of the domestic oil and gas industry. Recent sharp declines in oil and gas prices have strained the profitability of certain marginal producing properties. These so-called "stripper wells" (i.e., wells producing less than 10 barrels per day) comprise about 15 percent of domestic oil production. A change in existing law to deny percentage depletion could make many stripper wells unprofitable on an after-tax basis and result in their early abandonment. A significant decline in stripper well production could, in turn, increase the country's dependence on foreign energy, exacerbate the problem of the trade deficit, and again make the U.S. vulnerable to concerted political or market action by foreign producers. The clear national security interest in maintaining energy independence supports current retention of percentage depletion for oil and gas stripper well production.

The rationale for retaining percentage depletion with respect to stripper well production does not extend to owners of royalty interests in stripper wells. The treatment of the stripper well royalty owner has no direct bearing on the operator's decision to maintain production, and thus such owners should be subject to the generally applicable cost recovery rule, i.e., cost depletion. Royalty owners would, of course, benefit from royalties earned from continued stripper production as well as from the lower marginal tax rates that would be provided under the Administration proposals.

Proposal

Percentage depletion would generally be repealed for all minerals. Percentage depletion would be phased out over a five year period beginning on January 1, 1986, by reducing the applicable percentage depletion rates by 20 percent each year. In the case of oil and gas stripper wells, however, percentage depletion would continue to be available for independent producers (but not royalty owners). For this purpose, stripper well status is to be determined on a well by well basis.

Taxpayers unable to claim percentage depletion would use cost depletion to recover their adjusted basis in the property, if any, indexed for inflation. To the extent that percentage depletion is available, the excess of percentage depletion over the deduction allowable for cost depletion would be treated as a tax preference item for purposes of the corporate and noncorporate alternative minimum taxes. See Chs. 13.03, 13.04.

Effective Date

The phase out of percentage depletion would be effective for production beginning on or after January 1, 1986.

Analysis

In general, the subsidy provided by percentage depletion is inefficient and should be terminated. Given the decline in mineral prices over recent years, however, immediate termination of percentage depletion could create significant dislocation. A phase-out of percentage depletion over several years should permit producers to continue in production until the industry adjusts.

In addition, percentage depletion has had the effect of maintaining production from many marginal oil and gas wells. In order that domestic energy production not be significantly impaired, percentage depletion for stripper well production by independent producers should be retained.

REVISE MINIMUM TAX ON INTANGIBLE DRILLING COSTS

General Explanation

Chapter 9.03

Current Law

Intangible drilling costs ("IDCs") are those costs of drilling and preparing oil, gas, and geothermal wells that generally are not incurred for the purchase of tangible property. These intangible costs include not only amounts paid for labor, fuel, materials, and technical services necessary for the actual drilling, but also site preparation costs (which may require the construction of man-made islands from which to drill or the digging of canals to move drilling rigs and other equipment) and costs incurred in the transportation and installation of drilling rigs, production casing, and wellhead equipment (but generally not the cost of the rigs, casing, or equipment).

Under current law, taxpayers have the right to elect to expense IDCs as incurred or to capitalize them. They may also elect to expense only the IDCs on unsuccessful wells ("dry holes") and to capitalize the IDCs on productive wells. If capitalized, the costs are recovered through depletion or depreciation. IDCs are subject to recapture upon disposition of the property with respect to which they are deducted. Corporate taxpayers are allowed to expense only 80 percent of their IDCs; the balance must be capitalized and amortized over 36 months.

The amount of "excess" IDCs is an item of tax preference for the alternative minimum tax for noncorporate taxpayers. The "excess" is calculated by subtracting from IDCs paid or incurred (other than costs of dry holes) (1) the IDCs that would have been allowable had such IDCs been capitalized and amortized over 10 years, and (2) the taxpayer's net income from oil, gas, and geothermal properties during the taxable year. IDCs are not subject to the corporate minimum tax (except for personal holding companies).

Reasons for Change

Intangible drilling costs are a major portion of the costs necessary to locate and develop oil and gas reserves. IDCs associated with successful wells contribute to an asset that has productive value over more than a single year; from a tax accounting perspective, conventional matching of income and expense would require that they be recovered over their full productive period. Expensing of IDCs, as permitted under current law, thus departs from ordinary accounting principles and is appropriately viewed as an implicit incentive for domestic energy production.

A change in the treatment of IDCs, however, from the expensing allowed under current law to recovery over their full productive life would dramatically alter the taxation of oil and gas production. Moreover, the change in tax burden would be concentrated on exploratory and developmental activities, leaving the tax treatment of existing producing properties largely unaffected. The downturn in oil prices in recent years has already caused a substantial decline in oil drilling activity. In this climate, a lengthening of the period over which IDCs are recovered could cause a significant further decline and thus reduce domestic oil production. Any such reduction would increase the country's dependence on foreign energy, exacerbate the problem of the trade deficit, and again make the U.S. vulnerable to concerted political or market action by foreign energy producers. The clear national security interest in maintaining energy independence thus supports retaining cost recovery rules for IDCs that provide an incentive for domestic energy production.

At the same time, taxpayers should not be able to eliminate their tax liabilities through excessive use of the option to expense IDCs. Accordingly, it is appropriate that a portion of IDCs be treated as a minimum tax preference item for both corporate and noncorporate taxpayers. The portion of IDCs so treated should reflect the extent to which the present value of the taxpayer's deduction for IDCs exceeds the present value of the deductions for such costs that would be allowed under generally applicable accounting rules. Furthermore, for purposes of the minimum tax, no distinction should be made between taxpayers who are engaged in the oil and gas business and other taxpayers incurring IDCs. Accordingly, the current law rule under which net oil and gas income reduces the amount of IDCs treated as a minimum tax preference item should be repealed.

Proposal

The current law option to expense IDCs would be retained. However, eight percent of the IDCs paid or incurred on successful wells in a taxable year would constitute a tax preference for purposes of the proposed corporate and noncorporate minimum taxes. See Chs. 13.03 and 13.04. The percentage of IDCs included as a preference item would not be reduced by the taxpayer's net oil and gas income.

Effective Date

The inclusion of IDCs in the individual and corporate minimum tax would be effective for costs paid or incurred on or after January 1, 1986.

Analysis

The Administration proposal would reduce the potential for corporate and noncorporate taxpayers engaged in the production of oil and gas to escape income taxation as a result of the election to expense IDCs. Eight percent of IDCs represents the difference between the present value of expensing and the present value of the deductions that would be allowed if the taxpayer capitalized the IDCs and depreciated them as CCRS class 3 property (the same as tangible drilling costs; see Ch. 7.01). The additional tax liabilities incurred because of this proposal should not significantly affect continued development of the nation's energy resources.

REVISE ROYALTY TAXATION

GENERAL EXPLANATION

Chapter 9.04

Current Law

Royalty income received by the owner of a retained economic interest in coal or iron ore production is eligible for treatment as long-term capital gain under section 1231 of the Internal Revenue Code. In order to receive capital gain treatment, the taxpayer must have been an owner of an interest in the coal or iron ore in place for at least six months, and must dispose of the ore under a contract by which he retains an economic interest therein. Under such contract, the taxpayer treats the difference between amounts received and the adjusted cost depletion basis of the coal or iron ore disposed of as long-term capital gain or ordinary loss under section 1231. No percentage depletion allowance may be claimed with respect to such income. In order to prevent operating owners from benefiting from these provisions, related party rules limit the availability of capital gain treatment.

Royalty income received by the owner of a royalty interest in timber qualifies for long-term capital gain treatment under rules similar to those applicable to coal and iron ore royalties. In addition, an owner of timber or a contract right to cut timber may elect to treat the cutting of timber (for sale or for use in the taxpayer's trade or business) as a sale or exchange of timber eligible for long-term capital gain or ordinary loss treatment under section 1231.

Reasons for Change

The special tax treatment of income from certain interests in timber, coal and iron ore is unjustified. Royalty income from these natural resources should be subject to tax on the same basis as royalty income from other investments. In addition, if items of a resource are held for sale to customers in the ordinary course of business or for use in a trade or business, income from disposition of such items should be treated on the same basis as income from other property held for the same purposes.

Proposal

The provisions establishing special tax treatment for timber, coal and iron ore royalty income would be repealed, along with the provisions permitting elective sale or exchange treatment for owners of timber or contract rights to cut timber. In addition, timber, coal and iron ore held for sale in the ordinary course of business or for use in a trade or business would not be eligible for long-term capital gain treatment. See Ch. 7.03.

Effective Date

Capital gain treatment for royalty income from timber, coal and iron ore and capital gain treatment for cut timber eligible for elective sale or exchange treatment would be repealed effective January 1, 1989. However, between January 1, 1986, and January 1, 1989, capital gain treatment would be phased out. For corporations, capital gains from timber, coal and iron ore would be taxed at a 30 percent rate in 1986 and the rate would increase by one percent in 1987 and 1988. For individuals, the exclusion rate on capital gains from timber, coal and iron ore would be reduced to 30 percent in 1986, 20 percent in 1987 and 10 percent in 1988.

Analysis

The Administration proposal to repeal the special treatment of timber, coal and iron ore royalty income would cause all royalty income, from whatever source, to be taxed on the same basis as ordinary income.

The Administration proposal to repeal the elective sale or exchange treatment for owners of timber tracts or of contract rights to cut timber would defer the realization of gain or loss on those assets under generally applicable realization rules for property held for sale or use in a trade or business or held for investment. The character of such gain or loss would depend upon whether the interest in timber constitutes ordinary income property or a capital asset in the hands of a particular taxpayer. To provide a reasonable transition period for the timber industry, capital gain treatment for timber would be phased out over a five-year period.

CHAPTER 10

REFORM TAXATION OF FINANCIAL INSTITUTIONS

Part A. Commercial Banks and Thrift Institutions

This Part discusses proposals to conform special rules relating to the taxation of banks and thrift institutions to the general rules for the taxation of corporate income. The special bad debt reserve deduction for banks and thrift institutions would be repealed. Interest allocable to tax-exempt obligations held by banks, savings and loans, and certain other thrift institutions would be nondeductible. The tax exemption of credit unions would be repealed in the case of large credit unions. Finally, special rules concerning reorganizations of certain thrift institutions and net operating losses of depository institutions would be repealed.

REPEAL SPECIAL RULES FOR DEPOSITORY INSTITUTION BAD DEBT DEDUCTIONS

General Explanation

Chapter 10.01

Current Law

In general, taxpayers may deduct bad debts in the year in which they become wholly or partially worthless or may create a bad debt reserve and deduct a reasonable addition to the reserve each year. Although subject to this general rule, commercial banks and thrift institutions are also permitted to deduct additions to reserves for bad debts using methods unrelated to their actual loan loss experience. These methods for computing additions to reserves for tax purposes bear no relationship to regulatory requirements for bad debt reserves or to the present value of the expected future loan losses.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a tax reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Loans which become wholly or partially worthless during a taxable year are charged against the reserve. This charge reduces the reserve and, under the percentage of eligible loans or experience methods, increases the amount that must be added to the reserve to restore it to an appropriate level.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

The deduction for additions to a bad debt reserve essentially allows a deduction for debts that become worthless during the taxable year and a deduction for any net increase in the tax reserve. The deduction for the increase in the tax reserve represents a deduction for future loan losses, without any discount for the present value of such losses. A deduction for future losses defers taxable income, which either increases depository institutions' after-tax income or enables then to offer lower loan rates.

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. The experience reserve method favors fast-growing banks and banks with worsening loss experiences. The percentage of eligible loans method favors fast-growing banks and banks with low loan loss experience. Moreover, the methods permitted depository institutions for computing additions to tax reserves bear no necessary relationship to actual loan losses.

This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortgage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loans method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Administration proposals would require generally that bad debt losses be deducted only as they occur. See Ch. 8.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. To prevent a double deduction for debts that become partially or wholly worthless after the effective date, depository institutions would generally be required to include existing tax reserves in income ratably over ten years, starting with the first taxable year beginning on or after January 1, 1986. Alternatively, a depository institution could elect to include existing tax reserves in income in the first taxable year beginning on or after January 1, 1986. A special transition rule would be provided for thrifts with existing tax reserves determined in whole or in part under the percentage of taxable income method. Thrifts would recapture only the greater of the tax reserve computed under the experience or percentage of eligible loans methods. Any existing excess tax reserves would not be recaptured.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. Any reserve method for computing bad debt deductions is based on expectations as to future losses to some degree. If tax reserves for future losses were allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Thus, it is proposed that for all taxpayers the deduction for a reasonable addition to a reserve for bad debts would be repealed. Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 8.04.

Under current law, deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is either to increase the after-tax income of depository institutions or to enable depository institutions to offer loans at artificially low rates. The proposal would eliminate these distortive effects.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loans reserve method permits a bank to maintain a tax reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from $1.41 billion in 1979 to $0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are a significant subsidy for depository institutions and substantially distort the measurement of their income.

Depository institutions must establish reserves to meet regulatory requirements. Regulatory agencies properly seek to preserve the safety and soundness of depository institutions by requiring conservative levels of actual reserves. Historically, the tax rules for computing deductions for additions to tax reserves have been unrelated to reserve requirements imposed by regulatory agencies. Under current law, deductions for additions to a bad debt reserve do not reflect additions to actual reserves, only a reduction in tax liability. The tax accounting rules for bad debts should be designed to measure income accurately. Thus, depository institutions, as with other taxpayers, should be restricted to deducting losses when they occur.

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Existing tax reserves reflect previous deductions for future losses. If the reserves are not brought back into income and deductions are allowed, then some loan losses would be deducted twice. The portion of the thrifts' tax reserves in excess of what they would have taken under the commercial bank method is not brought back into income because it was a special subsidy for investments in residential mortgages. The proposed transition rule draws down existing tax reserves over a 10-year period. This rule is substantially more favorable than requiring future loan losses to be charged against the reserve until the reserve is exhausted.

Finally, in response to the original Treasury Department proposal, some commentators suggested that the deduction for bad debts be based on the additions to the reserve maintained for financial accounting and regulatory purposes. Such a reserve, based on generally accepted accounting principles ("GAAP"), is said to reflect economic income more accurately than the specific chargeoff method because, it is argued, additions to a reserve based on GAAP reflect current diminutions in the value of the loan portfolio while the specific chargeoff method delays the deduction until a time after the loss has actually occurred. The suggestion to recognize reserves based on GAAP was not adopted because any reserve system is inevitably based to some extent on expectations as to future losses. The more accurate method to determine the amount and timing of the appropriate deduction for bad debts in a taxable year is to judge the loss which has occurred by examining the loan portfolio at the close of the taxable year based on the facts and circumstances known at that time. It is also important to note that, if a deduction were permitted based on additions to a GAAP reserve, an interest charge on recoveries attributable to loans for which an addition to the reserve was made might be appropriate.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

General Explanation

Chapter 10.02

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations) incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. For this purpose, a statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Brokers and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example, if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. As under current law, the prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on the transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent (9 x [1 - (.46 x .8)]) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Together with the reduction in marginal tax rates, this proposal would tend to reduce demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Administration proposals, however, would have the opposite effect on the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of nongovernmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by State and local governments.

Table 10.02-1

Distribution of Tax-Exempt Securities and Loans -- 1983

	Outstanding Tax-Exempt Bonds	
	Amount (In Billions)	Percent
Households	$ 173.8	35.9 %
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$ 484.6	100.0 %

Office of the Secretary of the Treasury May 28, 1985

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83.

REPEAL TAX EXEMPTION FOR LARGE CREDIT UNIONS

General Explanation

Chapter 10.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. The tax-exempt status of credit unions has enabled them to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Since 1962, credit unions have enjoyed a 13 percent annual growth rate in financial assets, compared with an 11.1 percent rate for savings and loan associations, 9.4 percent for commercial banks, and 7 percent for mutual savings banks. Due to expanded powers and faster growth, credit unions accounted for 10.8 percent of total consumer credit (not including mortgages) in 1983 compared with 6.6 percent in 1962.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions thus should generally be subject to tax on the same basis as other financial institutions.

These arguments apply with particular force to large credit unions, which are substantially equivalent to commercial banks and thrifts. Most credit unions, however, are relatively small. Over 80 percent of all credit unions have less than $5 million of gross assets. Revoking the tax-exempt status of small credit unions would impose a significant administrative burden for a relatively small revenue increase.

Proposal

The tax exemption for credit unions with assets of at least $5 million would be repealed. Such large credit unions would be subject to tax under the same rules that apply to other thrift institutions. Credit unions with assets less than $5 million would continue to be exempt from tax.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows customer/owners in credit unions to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for such credit unions to retain, rather than distribute, current earnings.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. The proposal is limited to credit unions with assets of at least $5 million because, while approximately 82 percent of all credit unions (13,020 out of a total of 15,877 credit unions) in 1983 had assets less than $5 million, the credit unions above this threshold accounted for approximately 80 percent of retained earnings for all credit unions.

The proposal would subject large credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, large credit unions would have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, large credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

REPEAL REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

General Explanation

Chapter 10.04

Current Law

Certain acquisitions of the stock or assets of one corporation by another qualify as tax-free reorganizations under current law. In general, the shareholders of a corporation that is acquired in a reorganization may exchange their stock for stock of the acquiring corporation on a tax-free basis. In addition, a corporation acquired in a reorganization may exchange its assets on a tax-free basis for stock of the acquiring corporation.

Corporate acquisitions generally do not qualify as tax-free reorganizations unless they satisfy the "continuity of interest" requirement. Stated generally, an acquisition will satisfy the continuity of interest requirement only if the shareholders of the acquired corporation receive a significant, continuing equity interest in the acquiring corporation.

Special rules enacted in 1981 permit the acquisition of a "financially troubled" thrift institution to qualify as a tax-free reorganization without regard to the continuity of interest requirement. The continuity of interest requirement would generally pose an obstacle in such an acquisition because depositors are the only persons holding interests in the financially troubled thrift who would receive an interest in the acquiring corporation. Because of their insured position, however, the depositors in the failing thrift generally will not accept an equity interest in the acquiring corporation with its attendant risk of loss. For this reason, the acquiring corporation ordinarily will assume the failing thrift's liabilities to its depositors. In the absence of the special waiver, an interest as a depositor would not satisfy the continuity of interest requirement.

For the special rule to apply, the Federal Savings and Loan Insurance Corporation ("FSLIC"), Federal Home Loan Bank Board ("FHLBB"), or, where neither has supervisory authority, an equivalent State authority, must certify that the transferor thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. In addition, the transferee must acquire substantially all of the transferor's assets and must assume substantially all of its liabilities. If an acquisition of a failing thrift institution satisfies these rules, the acquiring corporation succeeds to the tax attributes of the failing thrift, including its net operating losses and a carryover basis in its assets.

In addition to the special reorganization rule, present law provides an exclusion from income for payments by the FSLIC to a thrift institution in connection with a reorganization. Such payments are not included in the thrift's gross income and do not reduce the thrift's basis in any of its assets.

Reasons for Change

The special rules governing reorganizations of financially troubled thrift institutions were enacted in 1981 to facilitate mergers and reorganizations of the ailing thrift industry. In such acquisitions, a profitable financial institution typically agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses and assume the thrift's basis in its assets, which typically consist primarily of mortgage loans with a book value substantially in excess of market value.

Thrift institutions and their shareholders should be subject to tax on the same basis as other business enterprises. The special rules for reorganizations of financially troubled thrift institutions are essentially in lieu of increased assessments by the FSLIC on all thrifts for deposit insurance and effectively shift some of the burden of thrift losses to the Federal government. If such subsidization of thrifts is necessary, it should be effected through direct appropriations. This would permit the appropriate regulatory agency to determine the need for and amount of a subsidy on a case-by-case basis.

Proposal

The special reorganization rules for acquisitions of financially troubled thrifts and the exclusion from income of FSLIC payments to thrift institutions in connection with a reorganization would be repealed.

Effective Date

The repeal of the special reorganization rules would be effective for acquisitions occurring on or after January 1, 1991. The repeal of the exclusion for certain FSLIC payments would apply to taxable years beginning on or after January 1, 1991; payments made on or after January 1, 1991, pursuant to an agreement entered into before that date would be exempt.

Analysis

The special reorganization rules are in lieu of increased assessments of the thrift industry for deposit insurance and, thus, are an inappropriate subsidy for a particular industry. In addition, Federal assistance provided through special tax rules hides the total subsidy cost and is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations.

Nevertheless, the Administration recognizes that the thrift industry has not fully recovered from the economic conditions which prompted Congress to enact the special reorganization rules in 1981. Moreover, the FSLIC will require a transition period within which to seek authorization to charge sufficient premiums for deposit insurance. Therefore, repeal of the special rules is not proposed to be effective until January 1, 1991. In the interim period, most of the below market loans currently jeopardizing the financial stability of many thrifts will be repaid and the FSLIC may seek authority to assess more realistic deposit insurance premiums. Increased assessments will place the burden of thrift losses on the industry, rather than on taxpayers generally.

REPEAL SPECIAL RULES FOR NET OPERATING LOSSES OF DEPOSITORY INSTITUTIONS

General Explanation

Chapter 10.05

Current Law

Taxpayers may generally carry net operating losses ("NOLs") back to the three taxable years preceding the loss year and forward to the succeeding fifteen taxable years. Commercial banks and thrift institutions, however, may carry NOLs back ten taxable years and forward to the five succeeding taxable years. The extended carryback period makes it more likely that a NOL of a depository institution will result in a current refund.

Reason for Change

The underlying premise of allowing a corporation to offset a NOL incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system. No justification exists, however, for distinguishing between NOLs of depository institutions and NOLs of other businesses.

Proposal

The special carryback and carryover rules for banks and thrifts would be repealed.

Effective Date

The proposal would be effective for NOLs incurred in taxable years beginning on or after January 1, 1986. Losses incurred in taxable years before the effective date would be subject to the rules of current law.

Analysis

Losses incurred by depository institutions should be treated in the same manner as losses of other taxpayers. Under current law, a depository institution is more likely to obtain a current benefit from a NOL than other taxpayers. There is no reason of tax or economic policy for granting favorable treatment in this regard to depository institutions.

Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return on the investment portion of such products than is available on investments whose income is fully taxed on a current basis. The Administration proposals would do away with this special treatment. Deferral of tax on the investment income earned on a life insurance policy (other than a term insurance policy) would be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance company deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE INSURANCE INSIDE BUILD-UP

General Explanation

Chapter 10.06

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns income for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as investment income is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the policy have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance for past periods. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment products offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment product, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Earnings on comparable investment products generally are not tax free or tax deferred. Instead, income credited on such investments generally is subject to tax whether or not the income is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures, and on investment income from mutual funds even if the income is credited in the form of additional fund shares.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside build-up encourages individuals to save through life insurance companies rather than other financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies (other than variable life insurance policies) would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy. In the case of variable life insurance policies, the policyholder would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable policy. The policyholder thus would not be taxed on the unrealized appreciation of assets underlying a variable policy. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all inside build-up credited on or after January 1, 1986 to policies issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. Inside build-up would continue to be free from tax in the case of policies issued before the date of Committee action to the extent that the death benefit of the policy does not exceed the death benefit on the date of Committee action plus any additional death benefit required for the policy to continue to satisfy the definition of life insurance under current law.

Analysis

Taxing the inside build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Taxation of inside build-up also would eliminate the need under current law for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred income earned on life insurance and annuity policies in 1983 is estimated at $3,050 for families with income greater than $200,000 and less than $200 for families with income less than $30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 10.06-1

Distribution of Ownership of Cash-Value Life Insurance Policies and the Annual Inside Interest Build-up 1/ By Economic Income - 1983

Family Economic Income	Percentage of Families with Cash-Value Life Insurance Policies	Average Annual Inside Buildup 2/
$ 0 - 9,999	13 %	$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42 %	$ 355

Office of the Secretary of the Treasury May 28, 1985

1/ Includes annuities.

2/ For those with policies.

IMPOSE CURRENT TAXATION ON DEFERRED ANNUITY INVESTMENT INCOME

General Explanation

Chapter 10.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposit and investment income from mutual funds is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts ("IRAs"). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller and more easily avoided withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts (other than variable contracts) would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract. In the case of variable deferred annuity contracts, the contract owner would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. The owner thus would not be taxed on the unrealized appreciation of assets underlying a variable contract. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all investment income credited on or after January 1, 1986 to contracts issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. In the case of contracts outstanding before the date of Committee action, investment income credited to the contracts would continue to be untaxed until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions from contracts issued on or after the date of Committee action. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would encourage the efficient flow of long-term savings.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 10.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Ch. 10.06, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an account yielding an investment return. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy.

This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to pay to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserve for any contract generally would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). A special rule would be provided for current annuity contracts that may not be surrendered for cash.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Ch. 10.06, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 10.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base of competing financial institutions. Enactment of comprehensive tax reform affecting all financial institutions and reducing the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective maximum marginal tax rate to 36.8 percent. The Administration proposals would lower the top corporate rate to 33 percent. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate.

Small life insurance companies would be placed on a par with all other small corporations. Elimination of preferential tax rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor sales of life insurance through small firms.

Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty ("P&C") insurance companies. The system of reserves for unpaid losses would be revised to assure correct treatment of the underwriting and investment income earned by P&C companies. Special provisions that reduce the effective tax rate on P&C companies would be eliminated. Specifically, the deduction for contributions to a protection against loss account would be repealed. Special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

REVISE TREATMENT OF LOSSES BY PROPERTY AND CASUALTY INSURANCE COMPANIES AND ALLOW DEDUCTION TO CERTAIN OF THEIR POLICYHOLDERS

General Explanation

Chapter 10.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a reserve deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under normal tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future. Moreover, the reserve does not grow over time to reflect the investment income earned on the reserve. A company is also permitted to set up an unearned premium reserve for premiums received during one taxable year that relate to coverage to be provided in subsequent years.

In the case of taxpayers who sustain losses, the tax treatment of the losses depends upon a number of factors, including whether the loss is a business or a personal loss, whether the loss is to the person or property of the taxpayer or is a tort or other liability to a third party, and whether the loss is covered by insurance. First, most personal losses are nondeductible. For example, individual taxpayers can claim a deduction for casualty losses to personal property only to the extent the losses exceed ten percent of the individual's adjusted gross income; deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. Second, otherwise deductible tort and similar liabilities to a third party generally are not treated as incurred (and hence are not deductible) until payment is made to the third party. Third, although certain uninsured losses sustained by a taxpayer are deductible at the time the loss is incurred, no deduction is allowed at this time if the loss is insured. In general, no account is taken of the taxpayer's loss of the time value of money resulting from any delay between the time the loss is incurred and the time the insurance claim is paid.

Often, as part of the settlement of a liability to make payments for personal injury damages, a property and casualty company or an uninsured defendant will agree with the injured party to assign the liability to make periodic settlement payments to another person, such as an affiliate of a life insurance company, who will fund the "structured settlement" by purchasing an annuity contract. Third-party assignees who assume other persons' liabilities to make periodic payments as personal injury damages or settlements may exclude from gross income amounts received in consideration for such assumptions, to the extent such amounts are invested in annuity contracts to fund the liabilities. The third-party assignees' basis in the annuity contracts is reduced by the amount of excluded income. Third-party assignees recognize income as they receive payments on the annuity contracts but may deduct periodic payments to the injured parties.

Reasons for Change

The deduction by P&C companies of reserves for claims to be paid in the future, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for reserves are allowed, either the allowable reserves are discounted for the expected future investment earnings on the reserve funds (as is the case with life insurance reserves) or the investment income earned on the reserve is added to the reserve (as is the case with nuclear decommissioning trust funds).

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by a self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

With respect to persons sustaining losses covered by insurance, current law is inaccurate in failing to recognize the effect of a delay between the time a loss is incurred and the time an insurance claim for such loss is paid. Even a taxpayer who suffers a loss of property that is fully insured for its current fair market value suffers an uninsured loss measured by the loss of the value of the property during the period the incurred loss remains unreimbursed. If the current system of taxing P&C companies were changed without correcting this defect, the tax system would discourage the purchase of insurance with respect to losses that would otherwise be deductible (primarily business property losses and large personal casualty losses).

Finally, in the case of third-party assignees, the current tax treatment of amounts received from assignors and amounts paid to injured parties effectively exempts from tax the investment income on the amount assigned. This exemption is not warranted nor is it required by the exclusion from injured parties' income of periodic payments received as personal injury damages pursuant to structured settlements. That is, the rationale for the tax treatment of injured parties is not to allow them tax-free investment of damage awards, but rather to remove a tax disincentive to injured parties who accept payment in the form of a structured settlement as an alternative to a lump sum. Just as injured parties are taxed on income from the investment of damage awards once received, third-party assignees should be taxed on income from the investment of funds prior to payment to injured parties.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" ("QRA") method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year. This account would take the place of the current separate reserve accounts for unearned premiums, incurred but not reported ("IBNR") losses, and reported claims.

The initial amount deductible with respect to a given reserve account could not exceed the combined statutory unearned premium reserve, IBNR reserve, and claims reserves on policies covered by that account. Beyond this, the company would not be subject to federally prescribed rules in establishing the reserve account.

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The after-tax rate of return for a company during a given taxable year would be equal to the total net investment income of the company (including tax-exempt income) for that year, reduced by taxes attributable to that income, divided by the average total surplus and reserves of the company for the year. Thus, in effect, the QRA proposal would prorate the taxable and tax-exempt income among all the reserves and surplus of the company. To the extent a P&C company is able to increase its after-tax income through investment in tax-exempt securities, its reserves would grow more quickly. This would require the company either to take smaller initial reserve deductions or realize greater income from the release of reserves when claims are paid.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it determined was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid a bunching of income in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

This proposal would also apply to reserves for unpaid losses not included in life insurance reserves held by life insurance companies. Thus, a life insurance company issuing accident and health policies would be required to use the QRA method to account for unpaid losses on such policies.

Taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. In other words, electing taxpayers would be allowed to deduct the loss in the taxable year the loss is incurred as if the loss were uninsured. Insurance proceeds would be taxable income when received, but an exclusion would be given equal to the amount of any portion of the loss that was not deductible. Current law would continue to apply to nonelecting taxpayers.

Third-party assignees of liabilities to make personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component thereof. The assignee would be permitted to elect either to treat the purchase of an annuity used to fund its liabilities to an injured party as a deductible expense at the time of the purchase or to treat each payment to the injured party as deductible at the time the payment is made.

Effective Date

The proposal would be effective for all losses incurred in taxable years beginning on or after January 1, 1986 that are insured under policies issued on or after January 1, 1986. The proposal on third-party assignments of personal injury liability would be effective for all assignments entered into on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The QRA method, however, would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving produced by the deduction. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000. If a fund of $1,000 is set aside and deducted, it is appropriate to recognize the growth of that fund to $1,262.48 and to include the excess amount of $262.48 in income when the claim is paid.

The system of qualified reserve accounts does not require the discounting of reserves. This feature of the proposal avoids the difficult problem of choosing a mandatory discount rate in an environment where investment returns vary widely from company to company and from year to year. Companies are free to discount reserves using any set of assumptions as to future interest rates (e.g., the assumptions used in pricing the policies) or even to establish undiscounted reserves. This flexibility is possible because the QRA method assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. The company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return on investment assets. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

This feature of the QRA method is not present in a system that requires <u>pre-tax</u> discounting of reserves and grants additional deductions for investment income earned on reserves. Such a system, while clearly an improvement over present law, would penalize a company for underestimating the amount of a claim or overestimating the length of time until payment of the claim. Conversely, a company would receive a windfall on any claim that was overestimated or whose payment was delayed. More significantly, such a system would continue to undertax P&C companies since investment income on reserves held by P&C companies would not be taxed. Such a system thus fails to tax the entire income of P&C companies and continues the distortionary effect of current tax law that favors third-party insurance over self-insurance.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business property losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. To the extent losses would be deductible by the person suffering the loss if uninsured, the proposal would allow a deduction for insured losses and insurance proceeds would be included in income when received. This would achieve a far more accurate result than the "rough justice" arguably afforded by present law, since the taxpayer actually suffering the loss is made whole. Under the current system, a taxpayer suffering the loss is penalized while the policyholders not suffering losses have a windfall to the extent the P&C company passes through its tax benefits in the form of lower premiums. The P&C company also has a windfall to the extent it does not pass through the tax benefits.

The combination of the QRA reserve proposal and the proposed change in the tax treatment of third-party assignees assures that the investment income on amounts set aside to fund structured settlements would be subject to tax. This change would make the tax system a neutral consideration in the choice between structured settlements and lump-sum payments while preserving the current rule that plaintiffs should not have to pay tax on any personal injury damage awards.

The P&C industry may argue that the QRA proposal is not appropriate for an industry with large underwriting losses (-\$11.0 billion in 1983). However, the large underwriting losses occur primarily because P&C companies lower premiums (discount) for the future investment income expected to be earned prior to the payment of claims, while the statutory reserves used in calculating underwriting income are not discounted. Total net income is the appropriate

Table 10.10-1

Time Pattern of Loss Payments by Major Lines of Business of Property and Casualty Insurance Companies - 1975 to 1983 Experience

Time Between Payment and Loss	Payments as Percent of Losses Incurred by Line of Business 1/					
	All Policies	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred 2/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

Office of the Secretary of the Treasury — May 28, 1985

1/ As an example of how to read this table:
81.6 percent of total losses and loss expense incurred on all policies in 1980 were paid by the end of 1983 (36.7 + 26.1 + 10.5 + 8.3). Only 73.3 percent of total losses and loss expense incurred on all policies in 1981 were paid by the end of 1983 (36.7 + 26.1 + 10.5). Assuming constant payment streams across years, 8.3 percent of losses and loss expense incurred are paid in the third year following the year in which the loss was incurred.

2/ The payment stream discounted at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because the payments eight years or later are discounted for only eight years, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

Source: Unpublished tabulations from Schedule P of the insurance companies' annual statement from A. M. Best Company.

measure of company profitability, not underwriting income. Moreover, even in times of overall net losses, the tax system should limit tax losses to properly measured economic losses and should tax profitable enterprises on their properly measured economic income.

The QRA would be only a bookkeeping entry. The QRA reserve system would increase the tax liabilities of P&C companies and affiliated companies but, as described above, the proposal would simply eliminate the deferral of tax liability allowed under current law or impose an appropriate interest charge on the deferral. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The QRA system would not affect State law requirements for reserves to protect policyholders against company insolvency. The amount of tax reserves would be different than the amount of statutory reserves but, because the QRA method does not require the discounting of reserves, tax reserves would not necessarily be lower than statutory reserves. State law presumably would continue to require adequate funding of statutory reserves.

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REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 10.11

Current Law

Most mutual property and casualty ("P&C") insurance companies are allowed deductions for net contributions to a protection against loss ("PAL") account. A deduction is generally allowed for contributions to the account in an amount equal to one percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies that have a high percentage of risks relating to windstorms, hail, flood, earthquakes, or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing one percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of losses to be paid in the future. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 10.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty ("P&C") insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other small corporations. Elimination of preferential rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 10.13

Current Law

In general, stock and mutual property and casualty ("P&C") insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Dividends paid by stock P&C companies to their shareholders are not deductible by the company and are includable in the gross income of the recipient.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The different tax treatment of income distributed in the form of policyholder dividends by mutual P&C companies and shareholder dividends paid by stock P&C companies provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would reduce the distortion caused by the deduction and by the policyholders' treatment of the dividends as price rebates.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law. Additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual P&C companies and to set the appropriate deduction limitation.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.

CHAPTER 11

REFORM TREATMENT OF STATE AND LOCAL GOVERNMENT DEBT AND INVESTMENTS

This Chapter discusses proposals to limit the tax exemption of interest on State and local obligations to its proper scope -- the financing of governmental activities, such as schools and roads for State and local governments. Future issues of nongovernmental bonds would not be exempt from Federal income tax. Restrictions on arbitrage with respect to tax-exempt obligations would be tightened, and advance refundings would be prohibited. Finally, the general stock ownership corporation provisions would be repealed as deadwood.

REPEAL TAX EXEMPTION FOR NONGOVERNMENTAL BONDS

General Explanation

Chapter 11.01

Current Law

Interest on State and local obligations generally is exempt from Federal income tax. In many cases, proceeds from the issuance of tax-exempt bonds are made available for use by private businesses, certain tax-exempt organizations, homeowners and students, as well as for use by State and local governments.

Industrial development bonds. State and local government obligations are classified as industrial development bonds ("IDBs") if the bond proceeds are to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on the bonds is derived from or secured by money or property used in a trade or business. Interest on IDBs as a general rule is taxable, but interest on two categories of IDBs is tax exempt: (1) IDBs that qualify as exempt small issues, and (2) IDBs issued to finance certain exempt activities.

Exempt small issue IDBs can be issued in amounts of $1 million or less to assist any principal user in the acquisition, construction or improvement of land or depreciable property located in any one city or county. The $1 million limitation may be increased to $10 million if the aggregate amount of capital expenditures of the principal users in the particular jurisdiction do not exceed $10 million over a six-year period. Current law also provides an exemption for interest on IDBs used to finance certain specific exempt activities. Any land, buildings or other property that is functionally related and subordinate to the exempt facility also may be financed through tax-exempt bonds.

Mortgage subsidy bonds. State and local governments may issue mortgage subsidy bonds to finance mortgages on owner-occupied residences. There are two categories of mortgage subsidy bonds that are tax-exempt: (1) qualified mortgage bonds, and (2) qualified veterans' mortgage bonds. Qualified mortgage bonds provide mortgage financing for qualified homebuyers. Qualified veterans' mortgage bonds provide mortgage financing for certain veterans, but may be issued only by States with programs in place before June 22, 1984.

Other nongovernmental bonds. Tax-exempt obligations may be issued for certain tax-exempt organizations such as nonprofit hospitals and educational institutions. Tax-exempt student loan bonds may be issued to finance educational and related expenses by nonprofit corporations or public agencies or instrumentalities of a State. Finally, other tax-exempt bonds that are not IDBs may be used to provide financing to nongovernmental entities, businesses and individuals.

Reasons for Change

The exemption from Federal income tax of interest on State and local government obligations exists as a matter of comity between the Federal government and State and local governments. This tax exemption lowers the cost to State and local governments of financing public facilities, such as schools, roads and sewers. Increasingly, however, State and local governments have used their tax-exempt financing privilege to obtain funds for use by nongovernmental persons. Thus, State and local tax-exempt obligations are now commonly used to provide financing for private businesses, residential mortgages, nonprofit corporations and student loans. Table 1 shows the volume of long-term tax-exempt bond issues from 1975 to 1983 by type of activity. A total of $58 billion of such nongovernmental bonds was issued in 1983, accounting for 61 percent of all long-term tax-exempt bonds issued that year.

Tax-exempt nongovernmental bonds have caused serious erosion in the Federal income tax base, lowering tax receipts and forcing increases in the tax rates on nonexempt income. The revenues lost as a result of tax-exempt nongovernmental bonds represent an indirect Federal subsidy program, based in the tax code, and thus significantly free of the scrutiny that attaches to direct Federal expenditures. In many cases, the issuer of nongovernmental bonds would not spend its own revenues to support the activities that are Federally subsidized through tax-exempt nongovernmental bonds.

The Federal subsidy provided through tax-exempt bonds is inefficient because the subsidy is filtered through high-income investors. Because part of the subsidy is captured by these investors, the revenue loss to the Federal government is approximately 33-50 percent higher than the benefits received by the borrower.

Tax-exempt nongovernmental bonds also have anti-competitive and distortive effects on the economy. Activities receiving tax-exempt financing have a significant advantage over their competitors, which must raise capital with higher-cost taxable obligations. Yet, the availability of tax-exempt financing for nongovernmental persons depends upon which jurisdictions have the necessary programs in place and upon the ability of persons to negotiate through obstacles of State and local law and procedure. These factors have little relation to the value or efficiency of particular activities, and ought not to influence the allocation of capital among sectors of the economy.

Table 11.01-1

Volume of Long-Term Tax-Exempt Bonds by Type of Activity, 1975-1983

(In billions of dollars)

	Calendar Years								
	1975	1976	1977	1978	1979	1980	1981	1982	1983
Total issues, long-term tax exempts 1/	30.5	35.0	46.9	49.1	48.4	54.5	55.1	84.9	93.3
Nongovernmental tax exempts	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1
Housing bonds	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0
Single-family mortgage subsidy bonds	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0
Multi-family rental housing bonds	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3
Veterans general obligation bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7
Private exempt entity bonds 2/	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7
Student loan bonds	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3
Pollution control industrial development bonds	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5
Small-issue industrial development bonds	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6
Other industrial development bonds 3/	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0
Other tax-exempt bonds 4/	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2

Office of the Secretary of the Treasury May 28, 1985

Note: Totals may not add due to rounding.

* $50 million or less.

1/ Total reported volume from Credit Markets (formerly the Bond Buyer) adjusted for privately placed small-issue IDBs.

2/ Private-exempt entity bonds are obligations of Internal Revenue Code Section 501(c)(3) organizations such as private nonprofit hospitals and educational facilities.

3/ Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

4/ Some of these may be nongovernmental bonds.

Finally, the volume of tax-exempt nongovernmental bonds has worked to the detriment of bonds issued to provide financing for State and local governments. As a result of the issuance of these additional securities, tax-exempt interest rates must rise in order to attract additional capital. This increases costs for State and local governments, with no corresponding increase in the level of government services provided. Moreover, these increased costs are borne by all State and local governments, not simply those issuing nongovernmental bonds.

Proposal

Interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government. Generally, use of a facility financed with proceeds of tax-exempt obligations would be considered to be use of those proceeds. The proposal would preserve the tax exemption for obligations issued to finance ordinary government operations, such as tax anticipation notes, as well as those issued to finance the acquisition or construction of government buildings.

Under an exception to the general rule, use of tax-exempt financed facilities by a nongovernmental person would be permissible if the facilities were available for use by the general public on the same basis. Use of or access to a facility by a nongovernmental person on a basis other than that available to the general public could be shown by a formal or informal agreement with the nongovernmental person or by locating a facility at a site to which the general public does not have ready access. For example, extension of a road, sewer or other system serving the general public to a newly constructed house or business could be financed on a tax-exempt basis. On the other hand, construction of an airstrip adjacent to a business that would be its primary user could not be financed through the issuance of tax-exempt bonds. Use of a facility by a nongovernmental person would not qualify for the exception simply because there was also some use of the facility by the general public. Thus, an airport terminal leased to an airline that ultimately provides service to the public could not be financed on a tax-exempt basis, since the airline's use of the terminal is on a basis different than that available to the general public.

In addition, a de minimis exception would allow use of tax-exempt financed facilities by a nongovernmental person pursuant to a short-term (one year or less) management contract. Thus, for example, a solid waste disposal facility serving the general public could be financed with tax-exempt obligations if it were owned by a city and operated by the city or by a private manager under a short-term management contract. If the proceeds of the financing were made available to a nongovernmental person to construct a privately-owned solid waste disposal facility, however, the bonds would not be tax-exempt.

In general, the lease of all or part of a government-owned facility to a nongovernmental person would disqualify the portion so leased for tax-exempt financing. This rule would not apply to leases for a brief interim period, i.e., leases of one year or less for the period immediately after the facility was substantially completed.

Allocation rules would permit tax-exempt financing for a proportionate share of the cost of a facility used in part for governmental and in part for nongovernmental purposes. For example, a government-owned and operated electric generating facility which by contract sold 10 percent of its output over its entire life to an investor-owned utility, and supplied its remaining power directly to the general public, could have 90 percent of its costs financed on a tax-exempt basis.

Finally, an exception to the nongovernmental use rule would permit bond proceeds to be (a) used to fund a reasonably required reserve fund, (b) invested for the initial temporary period before use for the governmental purpose of the borrowing, or (c) deposited in a bona fide debt service fund.

The proposal would extend to all tax-exempt bonds the IDB reporting requirements, and would retain certain other existing restrictions, including the prohibition against Federal guarantees, arbitrage restrictions, registration requirements and limitations on bonds granted tax-exemption by Federal law other than the Internal Revenue Code. Most other provisions of Internal Revenue Code section 103 would be repealed. Since State and local governments would no longer be entitled to issue mortgage subsidy bonds under the proposal, the mortgage credit certificate program would be terminated.

Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986. A transition rule would be provided for current refundings of outstanding obligations if the refunding does not extend the weighted average maturity date of the obligations outstanding at the time of the refunding or exceed the outstanding amount of the refunded obligation.

Analysis

The proposal would replace the standard for tax-exemption in current law, which grants tax-exempt status to obligations on the basis of their qualifying as student loan bonds, mortgage subsidy bonds, veterans' mortgage bonds, small issue IDBs, exempt activity IDBs or other tax-exempt non-IDBs, with a new standard for determining the tax-exempt status of obligations. The proposal would virtually eliminate (rather than limit through a volume ceiling) the Federal subsidy currently made available to nongovernmental persons through tax-exempt financing. State and local governments would, however, retain the ability to finance projects with tax-exempt obligations if the proceeds are not used by nongovernmental persons.

Under any given set of tax rates, elimination of nongovernmental tax-exempt bonds would cause the spread between tax-exempt and taxable interest rates to increase, due to a lower volume of tax-exempt obligations. Thus, the value of the Federal subsidy provided to governmental activities financed with tax-exempt bonds would increase. The proposal would, of course, increase financing costs for nongovernmental persons currently receiving tax-exempt financing. Such increase, however, would simply restore parity among all nongovernmental persons in the competition for capital.

LIMIT TAX ARBITRAGE AND ADVANCE REFUNDING FOR TAX-EXEMPT BONDS

General Explanation

Chapter 11.02

Current Law

Interest on State and local obligations generally is exempt from Federal income tax. An issuer of tax-exempt bonds may borrow at tax-exempt rates and earn "arbitrage" by investing the borrowed amounts in obligations that pay higher returns. Current law denies tax-exempt status to interest on bonds issued with the expectation that the proceeds will be used to earn arbitrage in excess of specified amounts.

Restrictions on Arbitrage. Treasury regulations apply different arbitrage restrictions to different types of obligations acquired with bond proceeds. "Acquired purpose obligations" are obligations acquired to carry out the purpose of the bond issue. Permissible arbitrage on acquired purpose obligations generally is limited to a spread between the yield on the bonds and the yield on the acquired purpose obligations of 0.125 percent plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying and repaying the bonds, the underwriter's discount, and the costs of acquiring, carrying, redeeming or selling the obligation of the bond user. All obligations other than acquired purpose obligations acquired with bond proceeds are "acquired nonpurpose obligations." The arbitrage spread for investments of bond proceeds in acquired nonpurpose obligations is restricted to 0.125 percent plus certain costs. There are two principal exceptions to these rules. First, unlimited arbitrage is permitted on bond proceeds invested for a temporary period prior to use, without regard to whether such proceeds are held by the user or the issuer. The temporary period is generally three years for new money financings and up to two years for a refunding transaction. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percent plus allowable costs with respect to obligations subject to yield restrictions. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund ("4R fund"). Additional arbitrage restrictions apply to other types of tax-exempt obligations, as discussed below.

Calculation of Yield. The limitations on permissible arbitrage earnings under current law require a comparison of the yield on the bonds and the yield on the acquired obligations. In computing yield, current law permits various costs to be taken into account that either increase bond yield or decrease acquired obligation yield. The result is to increase the amount of permissible arbitrage that issuers may earn. One court has held that bond yield is the discount rate at which the present value of all payments of principal and interest on the bonds equals the net proceeds of the issue after deducting the costs of issuing the bonds. Permitting issuance costs to reduce net proceeds results in a corresponding increase in the bond yield. The effect of calculating bond yield in this fashion is that the bond issuer is permitted to earn an amount equal to issuance costs out of arbitrage. This method of calculating bond yield does not apply for mortgage subsidy bond rebate purposes, where bond yield is based on the initial offering price to the public (excluding bond houses and brokers). In addition, premiums paid to insure a bond issue are treated as additional interest on the issue (to the extent that the present value of the premiums does not exceed the present value of the interest savings) with a resulting increase in the yield on the bond issue. Similarly, the yield on acquired purpose obligations is calculated by excluding from the payments to be received with respect to such obligations a portion of the payments having a present value equal to the costs of issuing, carrying or repaying the bonds, the underwriter's spread and the costs of purchasing, carrying, redeeming or selling acquired purpose obligations. The bond issuer cannot use the same cost to both increase bond yield and decrease yield on acquired obligations.

Advance Refundings. Current law permits the advance refunding of certain tax-exempt bonds. For this purpose, an advance refunding generally is defined as the issuance of bonds to retire another bond issue on a date after the issuance date of the refunding bonds. Advance refundings of industrial development bonds and mortgage subsidy bonds are generally prohibited. For industrial development bonds and mortgage subsidy bonds, however, an advance refunding is defined as the issuance of bonds to retire another bond issue more than 180 days after the issuance date of the refunding bonds. Permissible arbitrage on advance refunding issues, in addition to that earned during any applicable temporary period, basically is limited to interest on $25,000 at the bond rate, plus an amount sufficient to recover reasonable administrative costs.

Special Arbitrage Rules for Certain Bonds. Current law applies special arbitrage rules to certain types of tax-exempt bonds. Mortgage subsidy bonds are permitted to earn an arbitrage spread of 1.125 percent on acquired purpose obligations (the mortgages). Arbitrage earned on nonpurpose obligations must be paid to the mortgagors or to the United States. The amount of bond proceeds that can be invested in nonpurpose obligations at a yield above the bond yield is limited to 150 percent of annual debt service for the bond year. Certain industrial development bonds issued after December 31, 1984, are subject to an arbitrage rebate requirement and a limitation on investment in nonpurpose obligations similar to those imposed on mortgage subsidy bonds. Student loan bonds and other obligations issued in connection with certain governmental programs are generally permitted an arbitrage spread of 1.5 percent plus reasonable administrative costs on the acquired purpose obligations. Interest subsidies paid by the Department of Education can be excluded in determining yield on the acquired purpose obligations (student loans) for student loan bond issues.

Reasons for Change

Under current law, the exclusion from Federal income tax of interest on State and local government obligations provides two separate benefits to State and local issuers. The basic benefit is the reduction in interest cost for the financing. The additional benefit, however, is the ability of the issuer to invest bond proceeds to earn arbitrage. Arbitrage consists of the amounts directly permitted as arbitrage spread and amounts earned when yield restrictions do not apply. By virtue of the definition of yield, the spread includes issuance costs and bond insurance premiums.

Current law is overly generous in that it allows issuers or bond users to retain the economic benefit of all permissible arbitrage, even though many of the rules permitting arbitrage (those for temporary periods and 4R funds, for example) are intended only to reduce the complexity of the arbitrage restrictions. Moreover, because the current rules generally prevent only the issuance of bonds that are expected to earn arbitrage and do not prohibit the retention of arbitrage ultimately earned, issuers and bond users often are rewarded with substantial amounts of "unexpected" arbitrage.

Arbitrage has two undesirable results. First, it may be used for activities ineligible for tax-exempt bond financing, since arbitrage is not subject to the use limitations applicable to proceeds of tax-exempt bonds. Second, arbitrage also increases the volume of tax-exempt bonds. This increase in volume occurs for several reasons. First, the availability of arbitrage makes feasible bond issues that otherwise would be uneconomical. For example, since issuance costs for advance refundings can be recovered out of arbitrage, such bonds may be issued even though issuance costs dwarf the economic benefit to the issuer or the bond user. Bond counsel and underwriters benefit from the resulting lack of motivation on the part of the issuer to restrain costs. Second, the arbitrage encourages issuers to sell more bonds than are necessary in order to invest the excess proceeds in higher yielding investments. Finally, the arbitrage encourages issuers to sell bonds earlier or keep them outstanding longer than is necessary in order to invest the proceeds to earn the arbitrage. For example, it was recently reported that New York City will earn $3 million in legal arbitrage simply by extending the maturity of its tax anticipation notes five months beyond the date on which the taxes will be collected.

Advance refundings of tax-exempt bonds also have the undesirable effect of increasing the volume of tax-exempt bonds. Advance refundings result in twice as many bonds being outstanding as are required for a given project.

Increased bond volume brought about by arbitrage and advance refundings increases the Federal revenue loss associated with tax-exempt bonds, thereby causing taxpayers all over the country to pay additional taxes to support this subsidy of selected governmental issuers. Furthermore, additional volume in the tax-exempt bond market raises the interest rates that must be paid to finance State and local government projects. This expansion also results in pressure for additional Federal aid for those projects from more jurisdictions because of the increased cost of providing the governmental services.

Proposal

Issuers of tax-exempt bonds would be required to rebate to the United States all arbitrage on acquired nonpurpose obligations (adjusted for gains and losses on the obligations and earnings on the gains and on the arbitrage). Investments in acquired nonpurpose obligations would be limited to 150 percent of annual debt service with exceptions for the initial temporary period and for bona fide debt service funds.

Yield on the bond issue would be determined without regard to the underwriter's discount, costs of issuance, credit enhancement fees or other costs. Calculation of yield on acquired obligations also would be changed to prevent any reduction for costs.

The reasonable expectations test would be clarified to provide explicitly that it only protects inadvertent errors and not intentional acts to create arbitrage. For example, any fund that will be used to pay debt service on an issue will be subject to the rebate requirement regardless of whether its creation or its arbitrage was anticipated at the time of the tax-exempt bond issuance.

Temporary period rules permitting unlimited arbitrage until bond proceeds are used would be made more strict than the current rules. There would be no temporary period for bond issues to finance acquisitions. The temporary period for construction projects would terminate when the project is substantially completed or when an amount equal to bond proceeds has been expended on the project and would in all cases be limited to three years. The right to waive the temporary period and earn a yield exceeding the bond yield by 0.5 percent would be repealed.

Early issuance of bonds for a project would be prohibited. The issuer would be required to spend a significant part of the bond proceeds within one month and spend all bond proceeds (excluding proceeds in a 4R fund) within three years of issuance.

Advance refundings would be prohibited for all tax-exempt bonds. Refundings would be permitted only if the proceeds of the refunding bonds are used immediately to retire the prior bond issue.

Effective Date

The proposal would be effective for obligations issued on or after January 1, 1986.

Analysis

The proposal's rebate requirement would eliminate most of the economic motivation to issue tax-exempt bonds to earn arbitrage. In addition, arbitrage earned on obligations that are issued for governmental functions would not result in a windfall profit for the issuer. Proposed changes in the method of calculating yield and in the reasonable expectations test are necessary to implement the rebate requirement properly.

The prohibition of advance refundings would result in a reduction in the aggregate volume of tax-exempt obligations being issued. Individual bond issues would be limited in size by the proposal's restriction on the amount of investments in acquired nonpurpose obligations. In addition, the period during which bonds may be outstanding would be limited by the proposal's restrictions on temporary periods and early issuance. The reductions in both the overall volume and individual size of bond issues would reduce the Federal revenue cost of tax-exempt bonds and would also reduce the interest costs to issuers of obtaining financing for governmental functions.

State and local governments would continue to fulfill necessary governmental functions. Governmental facilities and services could still be financed on a tax-exempt basis. Issuers, however, would not obtain the unnecessary "double dipping" provided by arbitrage in addition to the basic benefit of reduced interest cost.

The proposal would eliminate many complex provisions in the Code and in the Treasury regulations interpreting the Code. The rules on advance refundings would be unnecessary and those dealing with yield computation would be simplified. The special arbitrage rules for certain bonds under current law also would be unnecessary because these bonds would not be exempt under the proposal for repeal of tax exemption for nongovernmental bonds.

REPEAL GENERAL STOCK OWNERSHIP CORPORATION PROVISIONS

General Explanation

Chapter 11.03

Current Law

Current law authorizes a State to establish a General Stock Ownership Corporation ("GSOC") for the benefit of its citizens. A GSOC meeting certain statutory requirements and making an appropriate election is exempt from Federal income tax. Instead, the shareholders of the GSOC are taxable on their daily pro rata share of the GSOC's taxable income. The GSOC computes its taxable income in the same manner as a regular corporation, but is not eligible for the dividends-received deduction. Losses of a GSOC do not flow through to its shareholders, but the GSOC is allowed a 10-year net operating loss carryforward.

Current law permits such corporations to be chartered after December 31, 1978, and before January 1, 1984.

Reasons for Change

No GSOC has been organized under this law and the period during which they may be formed has expired.

Proposal

The proposal would repeal the law permitting creation of GSOCs.

Effective Date

The proposal would be effective as of January 1, 1984, the sunset date for creation of GSOCs.

Analysis

The complex provisions governing organization and operation of GSOCs have never been utilized. Repeal of these provisions would simplify the Code and have no economic effect. There would be no impact on revenues or expenditures as a result of implementing this proposal.

CHAPTER 12

MODIFY OTHER SPECIFIC SUBSIDIES

The Administration proposals would repeal various tax subsidies for particular businesses, including the rehabilitation tax credit, the merchant marine capital construction fund provisions, and special rules for book, magazine, and discount coupon income. The research and experimentation credit would be retained, but modified to improve its efficiency. The possessions tax credit would be replaced with a wage credit. Various tax incentives designed to encourage employee stock ownership would be revised to better carry out their purposes.

REPEAL TAX CREDIT FOR QUALIFIED REHABILITATION

General Explanation

Chapter 12.01

Current Law

A special investment tax credit (the "rehabilitation credit") is provided for qualified expenditures incurred in connection with the rehabilitation (but not enlargement) of certain old or historic buildings. The credit rate is equal to (a) 15 percent for qualified expenditures incurred in connection with buildings at least 30 years old but less than 40 years old, (b) 20 percent for qualified expenditures incurred in connection with buildings at least 40 years old, and (c) 25 percent for qualified expenditures incurred in connection with certified historic structures of any age. The regular investment tax credit and the energy investment tax credit do not apply to any portion of an expenditure which qualifies for the rehabilitation credit.

The rehabilitation credit is limited to expenditures incurred in connection with buildings that will not be used for lodging (except in the case of certified historic structures), and is available only if the taxpayer elects to use the straight-line recovery method with respect to the expenditures. A rehabilitation must be substantial to qualify for the credit. In general, this requirement is met if rehabilitation expenditures incurred over a 24-month period exceed the adjusted basis of the property at the beginning of that period. In addition, at least 75 percent of the building's external walls must be retained in place.

The 25 percent credit for rehabilitations of certified historic structures is subject to certain additional requirements. In general, the 25 percent credit is not available unless the rehabilitation is certified by the Secretary of the Interior as being consistent with the historic character of the building or the district in which the building is located. Certified historic structures include only (a) buildings listed in the National Register and (b) buildings located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

In the case of a qualified rehabilitation of a certified historic structure, the basis of the rehabilitated building is reduced by 50 percent of the amount of the credit. The reduction is 100 percent of the credit in the case of other qualified rehabilitations. If a rehabilitation credit is subsequently recaptured, corrective basis adjustments are made (and treated as occurring immediately before the recapture event).

Reasons For Change

As enacted in 1962, the investment tax credit was unavailable for buildings and their structural components. In limiting the credit to tangible personal property, Congress was primarily concerned about the greater average age and lower efficiency of domestic machinery and equipment in comparison with the facilities of major foreign producers.

In 1978, Congress observed a decline in the usefulness of existing, older buildings, primarily in central cities and older neighborhoods, and extended the regular investment tax credit to older buildings for the purpose of promoting stability and economic vitality in deteriorating areas. No special credit was provided for certified historic structures, although the credit was made available for rehabilitation of such structures only if the Secretary of the Interior certified the rehabilitation as appropriate.

In 1981, Congress enacted the Accelerated Cost Recovery System ("ACRS"), and noted that ACRS had the unintended effect of reducing the relative attractiveness of the original (ten percent) credit for rehabilitating older buildings. Accordingly, Congress replaced the original rehabilitation credit with the three-tier credit contained in current law. The three-tier system had the effect of (1) increasing the amount of the credit available for all qualified buildings, (2) further increasing the credit for buildings more than 30 years old, and (3) providing a special increased credit for certified historic structures.

The current rehabilitation tax credit is flawed in several respects. First, the credits are embedded in a complicated matrix of tax rules which, taken as a whole, result in widely varying after-tax returns for investments in different types of assets. There is no evidence that the combined tax benefits granted to rehabilitators of older buildings, when compared to the tax benefits available to constructors or rehabilitators of newer buildings, are an appropriate incentive for investment in older buildings. Moreover, since the amount of the credit for any qualified rehabilitation is generally a function only of (1) the age of the existing structure, and (2) the cost of the rehabilitation, the incentive effects of the credit are not limited to investment in deteriorating areas, as opposed to modernization of older structures in stable areas.

In addition, the 25 percent credit for certified historic structures is effectively administered by an agency without budgetary responsibility for the revenue cost. The Secretary of the Interior is given sole authority to determine whether a structure meets the requirements for the credit, but the subsidy is not included in the Interior Department's budget. Thus, in determining the availability of the credit, the sole reviewing agency has no direct incentive to compare probable costs and benefits.

Proposal

The rehabilitation credit would be repealed.

Effective Date

Repeal would be effective for expenditures incurred on or after January 1, 1986. Expenditures incurred on or after the effective date would be aggregated with expenditures incurred prior to the effective date for purposes of determining whether the earlier expenditures were incurred in connection with a "substantial" rehabilitation.

Analysis

In the absence of investment tax credits for rehabilitation expenditures, the full amount of such expenditures would be recovered through normal cost recovery rules.

REPEAL SPECIAL RULES FOR BOOK, MAGAZINE, AND DISCOUNT COUPON INCOME

General Explanation

Chapter 12.02

Current Law

Magazine, Paperback, and Record Returns. An accrual basis taxpayer that distributes magazines, paperbacks, or sound recordings for resale may elect (irrevocably) to exclude from gross income for the taxable year certain amounts attributable to the sale of such items if the purchaser fails to resell the items and returns them within a specified period after the end of the taxable year (2-1/2 months in the case of magazines, and 4-1/2 months in the case of paperbacks and recordings). The exclusion applies only if, at the time of sale, the taxpayer has a legal obligation to adjust the sales price if the items are not resold, and the exclusion is limited to the amount of price reductions for returns that are actually made within the prescribed periods.

An election to take advantage of this exclusion triggers the application of special transitional adjustment rules designed to prevent the "bunching" of deductions in the first year of the election. In the case of an election relating to magazines, the decrease in income resulting from the bunching of deductions in the first year is spread over a five-year period. In the case of an election relating to paperbacks or records, however, the decrease is placed in a suspense account. Adjustments to this suspense account permit additional exclusions from income in subsequent taxable years only to the extent the taxpayer's adjustments from post-year returns decline over time. In general, the effect of the suspense account is to defer deduction of the transitional adjustment until the taxpayer ceases to be engaged in the trade or business of publishing or distributing paperbacks or records.

Redemptions of Qualified Discount Coupons. An accrual basis taxpayer that issues discount coupons with respect to merchandise marketed by unrelated retailers may irrevocably elect to deduct in the taxable year the cost of redeeming qualified coupons that are returned within six months after the end of the taxable year. A shorter period may be used at the taxpayer's election.

In the case of an election under this provision, the decrease in income resulting from the "bunching" of deductions in the first year is not allowed but is placed in a suspense account. Adjustments to this suspense account permit additional deductions in subsequent taxable years only to the extent the taxpayer's qualified discount coupon redemptions decline over time. If such redemptions do not decline, the suspended amounts may be deducted only when the taxpayer ceases to be engaged in the business.

Reasons for Change

The primary purpose of the special provisions for magazine, paperback, and record returns, and redemptions of qualified discount coupons, is to enable taxpayers to conform their tax accounting to their financial accounting. In both cases, the exclusion or deduction is designed to approximate decreases in adjusted gross income that would have accrued at the end of the taxable year if the amount of the taxpayer's price-adjustment or redemption obligation were known at that time.

On the other hand, there is a general standard for accrual of liabilities in the taxable year -- occurrence of all events sufficient to establish the existence and amount of the liability. The cases covered by the current rules do not satisfy this standard, since the events establishing the taxpayer's liability for the adjustment -- return of magazines, paperbacks, or records, or presentment of coupons -- have not occurred as of the end of the year.

Repeal of these rules would also simplify the tax code and would make it unnecessary to determine the correctness of taxpayers' claims that post-year price adjustments and redemptions are made pursuant to obligations or coupons that were outstanding prior to the end of the taxable year.

Proposal

The elections (a) to exclude from income certain adjustments relating to magazines, paperbacks, and record returns, and (b) to deduct costs of redeeming qualified discount coupons, would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1986. Affected taxpayers would be permitted to deduct the balances of their suspense accounts or suspended amounts in the first taxable year in which the proposal is effective.

Analysis

Taxpayers would be adversely affected by repeal of these special accounting rules only to the extent of amounts prematurely deducted in prior years. Under the proposal, affected taxpayers would compute their income on the same basis as others using the accrual method. Adversely affected taxpayers also would gain a compensating benefit from the proposed general reductions in tax rates.

EXTEND AND MODIFY RESEARCH AND EXPERIMENTATION CREDIT

General Explanation

Chapter 12.03

Current Law

A 25 percent nonrefundable tax credit is allowed for the portion of a taxpayer's qualified research expenses which is equal to the lesser of (1) the excess of such expenses in the current year over the average amount of such expenses for the prior three years or (2) 50 percent of qualified research expenses in the current year. Special rules apply to aggregate qualified research expenses of certain related persons to ensure that the credit is available only for real increases in qualified research expenditures.

"Qualified research expenses" generally include only research and development costs in the experimental or laboratory sense. Qualified research expenses that are eligible for the credit include (1) expenses paid or incurred for qualified research conducted directly by the taxpayer, (2) 65 percent of any amounts paid or incurred to another person for qualified research (i.e., "contract research" expenses), and (3) in the case of corporate taxpayers, 65 percent of any amounts contributed to universities and other qualifying organizations for the conduct of basic research.

The credit is available only for research expenses paid or incurred in connection with an ongoing trade or business of the taxpayer. Employee wages are treated as qualified research expenses to the extent paid to an employee for engaging in (1) the actual conduct of qualified research, (2) the immediate supervision of qualified research activities, or (3) the direct support of such activities. Payments for supplies used in the conduct of qualified research and amounts paid for the right to use personal property in the conduct of qualified research also constitute qualified research expenses.

Expenses of (1) research conducted outside the United States, (2) research in the social sciences and humanities, and (3) funded research are specifically excluded from qualified research expenses eligible for the credit.

Credits that are not used in a taxable year may be carried back three years and forward 15 years. The credit will not be available for expenses paid or incurred after December 31, 1985.

Reasons For Change

The existing credit for research and experimentation activities is intended to create an incentive for technological innovation. The benefit to the country from such innovation is unquestioned, and there are reasonable grounds for believing that market rewards to those who take the risks of research and experimentation are not sufficient to support an optimal level of such activity. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

Although the credit for research and experimentation is justified in concept, the existing definition of eligible activities is overly broad. Some taxpayers take the view that the costs of any trial and error procedure are eligible for the credit even though there may be little doubt about the outcome of the procedure.

The definition of qualifying expenses for purposes of the credit should identify clearly those innovative research activities which merit government support. This definition also should incorporate standards that are sufficiently objective to permit taxpayers, in planning their activities, to determine with reasonable certainty whether the credit will be available. A definition that satisfies these two criteria would be more effective in encouraging taxpayers to undertake innovative research and experimental activities.

Proposal

The credit for increases in research and experimentation expenditures would be extended for an additional three years (until December 31, 1988), and the definition of qualified research would be revised to target those research activities likely to result in technological innovations.

Effective Date

The revised definition of qualified research would be effective for expenses paid or incurred after December 31, 1985.

Analysis

The definition of expenses qualifying for the research credit should target private research activities designed to lead to technological innovations in products and production processes. At the same time, the definition must be phrased in terms that permit taxpayers to know with reasonable certainty what research activities qualify for the credit.

A useful definition incorporating both principles is found in the Senate amendment to H.R. 4170 (enacted as the "Tax Reform Act of 1984"). Although the conference committee agreed to defer consideration of the research credit, the Senate definition targets technological innovation and provides taxpayers with relatively objective rules.

The Senate definition focuses on new or technologically improved products and processes and provides that research qualifies for the credit only if it relates to a process of experimentation encompassing the evaluation of alternatives that involve a serious degree of uncertainty as to whether the desired result can be achieved. This requirement is designed to ensure that the credit is available only for research activities intended to lead to technological innovation. In addition, the Senate definition excludes a number of activities, such as reverse engineering and debugging, that, by their nature, will not result in technological innovation.

Further refinements in the Senate definition, such as identifying additional exclusions from the scope of qualifying research, may be appropriate to ensure that the credit does not subsidize private research activities that are not innovative. In addition, the revenue loss resulting from the extension of the credit must be considered in redefining the scope of qualifying expenses.

Other legislative proposals, such as a separate credit for contributions to fund basic university research or an enhanced charitable deduction for contributions of scientific equipment to universities, are typically associated with the research credit. Although the Administration proposal does not address these related issues, they would be considered in the context of legislative efforts to extend the research credit.

REPEAL MERCHANT MARINE CAPITAL CONSTRUCTION FUND PROVISIONS

General Explanation

Chapter 12.04

Current Law

The Merchant Marine Act provides special tax treatment for U.S. citizens and domestic corporations owning or leasing certain vessels operated in the foreign or domestic commerce of the United States or in U.S. fisheries. The vessel must have been constructed or reconstructed in the United States and must be documented under the laws of the United States.

In general, a taxpayer that qualifies for this treatment receives a deduction for amounts deposited in a capital construction fund pursuant to an agreement with the Secretary of Transportation or, in the case of U.S. fisheries, the Secretary of Commerce. The deductible amount is limited to the portion of the taxable income of the owner or lessee that is attributable to the qualified operation of the vessel covered by the agreement ("eligible agreement vessel"). In addition, nondeductible deposits may be made up to the amount of depreciation on such vessel for the year. Earnings on all amounts in the fund are exempt from Federal income tax liability.

The tax consequences of a withdrawal from such a fund are determined by reference to three accounts. The capital account represents deposits that were not deductible as well as the fund's tax-exempt income (that is, income exempt from tax without regard to the fund's special exemption). The capital gain account represents accumulated net long-term capital gain income of the fund. The ordinary income account represents deductible deposits and accumulated taxable income of the fund (that is, income that would have been taxable if the fund were not exempt).

The tax treatment of a withdrawal depends on whether it is "qualified." A withdrawal is qualified if used to acquire, construct, or reconstruct "qualified agreement vessels," or barges and containers which are part of the complement of such vessels, in accordance with the terms of the applicable agreement, or to repay principal on debt incurred with respect to such acquisition, construction, or reconstruction.

A qualified withdrawal is not currently taxable, and is deemed to come first out of the capital account, then out of the capital gain account, and finally out of the ordinary income account (after the other accounts have been exhausted). Amounts withdrawn from the ordinary income or capital gain accounts reduce the taxpayer's basis in its investment in the qualified vessels (only in part in the case of capital gain account withdrawals). A taxpayer may, however, compute its investment tax credit with respect to a qualified vessel by including at least one-half of its qualified withdrawals in basis. Accordingly, the taxpayer is entitled to at least a partial investment tax credit on investments made with fund withdrawals, even though its basis attributable to withdrawals is zero for purposes of computing depreciation. A qualified withdrawal out of the ordinary income or capital gain account made to retire debt requires a reduction in the basis of vessels, barges, and containers owned by the person maintaining the fund.

Nonqualified withdrawals are deemed to come first out of the ordinary income account, then out of the capital gain account, and finally out of the capital account. A nonqualified withdrawal treated as made out of the ordinary income account must be included in taxable income. To the extent the withdrawal comes out of the capital gain account it is taxed as long-term capital gain; a withdrawal out of the capital account is not taxable. Interest on the tax liability attributable to the withdrawal is payable from the time for payment of tax for the year in which the item was deposited into the fund.

Reasons for Change

The current rules for taxation of merchant marine capital construction funds are a gross departure from generally applicable principles of taxation. The special rules generally exempt from tax earnings on deposits in such funds. Moreover, they permit an eligible taxpayer to expense capital investments made with fund withdrawals as well as claim an investment tax credit on an asset in which it has a zero basis.

The special tax treatment of capital construction funds originated, along with a direct appropriations program, to assure an adequate supply of shipping in the event of war. It was thus feared that because of comparative shipbuilding and operating cost disadvantages, peacetime demand for U.S.-flag vessels would not reflect possible wartime needs.

A national security justification for subsidies of U.S. maritime construction is today unclear. U.S. citizens own or control large numbers of ships registered in Panama, Liberia, and Honduras that would be available to the United States in an emergency, and most U.S. allies possess substantial fleets of oceangoing cargo ships that would be available in any common emergency. Largely for this reason, direct appropriations for maritime construction (the construction differential and operating differential subsidies) are being phased out.

A similar fate is appropriate for the special tax rules applicable to capital construction funds. Even if a capital construction fund subsidy is justified, it would more appropriately be provided in the form of a direct spending or regulatory program that

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is subject to review by the congressional committees and agencies concerned with maritime policy. Basing such a subsidy in the tax laws complicates tax administration and has a differential impact on different taxpayers depending on their other tax attributes. A direct subsidy would be more straightforward and would reflect the costs of the subsidy in the budget of the appropriate agency. Such an approach would also avoid problems of coordination and excessive bureaucracy due to administration of a program by two agencies (the IRS and MARAD).

Similar considerations apply to the allowance of capital construction funds for fishing vessels. To the extent that a subsidy is justified for reasons relating to foreign competition, it would be better provided outside the tax system.

Proposal

The rules providing special tax treatment for capital construction funds would be repealed.

Effective Date

No further tax-free contributions to capital construction funds could be made after 1985, except with respect to qualified agreement vessels that the taxpayer owned on January 1, 1986, or qualified agreement vessels with respect to which the taxpayer had performed (or had caused to be performed) a substantial amount of construction or reconstruction before January 1, 1986. To the extent that fund assets exceeded amounts designated under the agreement to be used with respect to such qualified vessels, earnings on such excess attributable to the period after December 31, 1985, would be subject to tax. Any withdrawals from a fund on or after January 1, 1986, other than with respect to such qualified vessels, would be treated as nonqualified withdrawals, except that no interest charge would apply with respect to such withdrawals. Any amounts remaining in a capital construction fund on January 1, 1996, would be treated as withdrawn at that time.

Analysis

Repeal of the special tax treatment for capital construction funds would promote neutrality by ensuring that capital investments are made only when justified by economic rather than tax considerations.

REPLACE POSSESSIONS TAX CREDIT WITH A WAGE CREDIT

General Explanation

Chapter 12.05

Current Law

Section 936 provides a special credit for certain income of qualifying corporations operating in Puerto Rico and possessions of the United States other than the Virgin Islands. A section 936 corporation is generally subject to tax on its worldwide income in a manner similar to any other U.S. corporation. However, it may claim a tax credit equal to the U.S. tax on business and qualified investment income from the possessions, regardless of whether any tax is paid to the government of the possessions. The effect of this treatment is to exempt from U.S. tax the income from business activities and qualified investments in the possessions and the income from disposition of a possessions business. (Rules having similar effect, but through a different mechanism, apply for the Virgin Islands.) All other income of section 936 corporations is taxed currently, subject to the usual credit for foreign taxes paid on foreign source income. To avoid a double credit against U.S. taxes, no credit is allowed under section 901 for foreign taxes paid on income subject to the section 936 credit, and no deduction is allowed for such taxes.

Any domestic corporation which elects to be a section 936 corporation may receive the section 936 credit if it satisfies two conditions. First, 80 percent or more of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within a possession (or possessions). Second, for tax years beginning after 1984 at least 65 percent of its income for that period must be from the active conduct of a trade or business within a possession (or possessions).

Puerto Rico has complemented the section 936 credit with incentives of its own. Puerto Rico grants tax exemptions of up to 90 percent for income of certain approved enterprises for specified periods of time (generally 10 to 25 years). In addition, Puerto Rico exempts from tax certain passive income. The combination of the section 936 credit and the Puerto Rican incentives means that qualifying corporations pay little tax on their Puerto Rican-source income.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") made two changes designed to reduce the revenue cost of section 936 due to (a) the attempted allocation of intangible income to possessions in order to claim exemption for such income, and (b) the exemption of passive income. The problem of intangible income was addressed by adding a very complex set of allocation rules to section 936 for tax years beginning after 1982. The revenue cost of exempting passive income was addressed by increasing the active trade or business percentage requirement from 50 percent in 1982 to 65 percent in 1985.

As a rough corollary to section 936 (and to section 934(b) for Virgin Islands operations), section 957(c) provides that a corporation organized in a possession (including Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands) shall not be considered a controlled foreign corporation (the Subpart F income of which would otherwise be taxed currently to its controlling U.S. shareholders) if 80 percent of its gross income is derived from sources in the possession and 50 percent of its gross income is derived from the active conduct within the possession of certain specified trades or businesses.

Reasons for Change

The stated purpose of section 936 is to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." However, despite the fact that inflation-adjusted tax-exempt income of corporations which have elected the benefits of section 936 has more than doubled since 1972, employment levels (both overall and in the manufacturing sector) have been flat. The credit rewards generating income in the possessions; it provides no direct incentive to generating employment. Even after TEFRA, much of the benefit of the existing credit accrues to income of intangible assets which have been developed in the United States and attributed to a possessions corporation for purposes of determining possession-source income. As an example, for pharmaceutical companies operating in Puerto Rico, profits are frequently 60 percent of their sales.

The existing credit is very costly and inefficient. The average tax benefit per employee for all section 936 corporations was more than $22,000 in 1982, more than 50 percent more than the average wage of possessions corporations' employees of $14,210. Fourteen corporations received tax benefits in excess of $100,000 per employee. Those fourteen companies accounted for 4 percent of the section 936 corporations for which employment data was available and derived 29 percent of the combined tax benefits. (The fourteen companies accounted for 3 percent of all section 936 corporations and 26 percent of the total tax benefits of all such corporations.)

The TEFRA changes were designed to reduce the revenue cost and income distortions associated with this program. However, an examination of available 1983 returns (post-TEFRA), representing companies which claimed 25 percent of the possessions tax credits in 1982, indicates that the credit claimed in 1983 actually increased slightly, rather than declining sharply as had been expected, even though the previously predicted decline in cost had taken expected growth into account. This increase in the possessions credits is particularly disturbing because it took place when there appears to have been a substantial decline in qualified interest income, due to the decline in average interest rates in 1983 and to repatriation of earnings by the companies. In the absence of the decline in interest income, the credits would have increased much more.

Moreover, the TEFRA changes are exceedingly complex. As a result, they will be very difficult for the IRS to administer.

In addition, there remains no direct incentive under current law to increase employment in the possessions; the incentive continues to be to attribute income to the possessions. Even with the TEFRA rules, section 936 fails to provide any incentive to increase employment or economic activity in the possessions beyond the minimum business presence required to qualify for the special income allocation rules introduced by TEFRA.

The exemption from controlled foreign corporation status available to possession-chartered corporations under section 957(c) is similarly poorly targeted to the creation of employment-producing investments in the possessions. That provision permits the exemption of tax-haven income from the Subpart F classification without any significant justification.

Proposal

The current income-based credit would be repealed and replaced by a permanent wage credit. A U.S. corporation could elect a wage credit equal to 60 percent of wages, up to the Federal minimum wage amount, paid to persons employed in the possessions by an establishment engaged in manufacturing, plus 20 percent of such wages paid above the Federal minimum wage amount, subject to an overall wage cap per employee of four times the Federal minimum wage amount. Corporations electing the wage credit would be required to reduce their otherwise allowable deduction for wages paid by the amount of the wage credit claimed. At the present annual minimum wage amount of $6,968, and with a 33 percent corporate tax, the maximum net credit would be $5,602 per employee (67 percent of the maximum gross credit of $8,362).

The wage credit could be used to offset the U.S. tax on any income, without regard to whether such income may have arisen from sources in a possession. The credit would not be refundable, but could be carried forward for 15 years. United States corporations with manufacturing operations in the Virgin Islands would be entitled to elect the wage credit on the same basis as U.S. corporations with operations in any other eligible possession. Thus, the parity that exists under current law between U.S. corporations doing business in the Virgin Islands and those doing business in other possessions would continue.

Corporations electing the wage credit would not be entitled to claim a foreign tax credit for taxes paid to the possessions, but they would be allowed a deduction for such taxes, regardless of whether they otherwise claim a credit for taxes paid to other countries. This rule allowing a deduction for possessions taxes and a foreign tax credit for other foreign taxes compensates for the denial of the foreign tax credit for possessions taxes and is consistent with the approach taken under the proposed per-country limitation on the foreign tax credit. Also, for possessions corporations that elect the wage credit rather than the foreign tax credit for possessions taxes, the introduction of the per-country limitation eliminates any need that might otherwise arise to adopt special rules for possessions-source income to prevent such corporations from using that low-tax income to increase their foreign tax credit limitation on other categories of income.

Dividends paid by corporations electing the wage credit would be subject to the general rules with respect to dividends-received deductions for dividends from U.S. corporations. The electing corporations would be required to be included in the consolidated tax returns filed by affiliated corporations, thereby effectively achieving the equivalent of a 100 percent dividends-received deduction.

Section 957(c) would be repealed, thereby eliminating the deferral of U.S. tax on the Subpart F income of possessions-chartered corporations that fall into the category of controlled foreign corporations.

For purposes of applying the rules of the proposed Capital Cost Recovery System ("CCRS") to property purchased by a domestic corporation on or after January 1, 1986 and used predominantly in a U.S. possession, such property would be treated as foreign property only to the extent such corporation elects to claim the benefits of the income-based credit under section 936, as that section currently applies, during the grandfather period described below.

Effective Date

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. However, corporations which have validly elected possessions corporation status for a taxable year beginning before January 1, 1986 would be entitled to grandfather protection. Such corporations would be allowed to continue to use the existing income-based credit for their first five taxable years beginning on or after January 1, 1986, but only with respect to products which they had validly designated as possessions products for their last taxable year beginning before January 1, 1986. (If they had validly elected possessions corporation status but had not designated a possessions product, they would be allowed to use the income-based credit during the grandfather period only with respect to products which they were "manufacturing" in the same possession during their last taxable year beginning before January 1, 1986, as determined in a manner similar to the significant business presence test transition rules in the proposed section 936(h) regulations issued after TEFRA.) In addition, such corporations could continue to use the income-based credit during the grandfather period with respect to qualified possessions-source investment income from such grandfathered activities and from their existing qualifying passive investments. Existing possessions corporations could elect to claim either the wage credit or the current section 936 credit during the grandfather period, but once they have elected the wage credit they could not return to use of the income-based credit. Related corporations operating in the possessions would not be permitted to make different elections.

Domestic corporations doing business in the Virgin Islands which have validly qualified for the benefits of section 934(b) for their last taxable year beginning before January 1, 1986 would be entitled to elect to use the income-based credit during the five-year grandfather period to achieve exemption of their qualifying Virgin Islands-source income from U.S. taxation under rules similar to those applying to existing possessions corporations.

The repeal of section 957(c) would apply to taxable years of possessions-chartered corporations beginning on or after January 1, 1986 and to taxable years of U.S. shareholders within or with which these taxable years of the possessions-chartered corporations end. For purposes of applying the controlled foreign corporation rules to such corporations, earnings and profits for taxable years beginning before January 1, 1986 and property acquired before January 1, 1986 would be excluded from the operation of the controlled foreign corporation provisions.

Analysis

The current system is complicated, expensive, and inefficient. The rules for determining possessions source income are among the most complex in the tax law. Because section 936 is not targeted toward increasing employment, the average revenue cost per job has exceeded 150 percent of the average total compensation per employee of section 936 corporations, without producing any clearly identifiable and readily measurable improvement in employment levels. Furthermore, the TEFRA changes do not appear to have limited the level of credits claimed to any significant extent.

The Administration recognizes its special obligations toward, and supports the goal of encouraging increased employment and economic growth in, the possessions. The Administration also recognizes a special interest in the economic health of the Caribbean region. Thus, notwithstanding the inefficiency of the present system, a subsidy is maintained for operations in the possessions. The subsidy for the possessions would be restructured as a wage credit, however, for the reasons discussed herein. The Administration is aware of the proposals being developed by interested parties that seek better to benefit Puerto Rico and countries participating in the Caribbean Basin Initiative. It is recognized that there may be other ways to encourage employment in the possessions in a cost-effective way, or that there may be ways to restructure the wage credit to make it more efficient. The Administration looks forward to receiving further comments and suggestions in this regard from the governments of the possessions and other interested persons.

The objective of the proposal is to encourage employment in the possessions in a cost-effective way. The simplest and most direct and efficient way to do so is through a wage subsidy. The proposed credit is permanent, to provide an ongoing incentive to investors.

The proposed wage credit is more generous than it may at first appear. The amount of the credit is 60 percent of the annual Federal minimum wage plus 20 percent of wages above that level up to the ceiling amount of four times the annual Federal minimum wage. The proposed formula for the wage credit primarily offsets the costs of employing a worker at the Federal minimum wage level, but it also gives corporations an incentive to employ more highly skilled, highly paid workers, thereby encouraging the development of a technology-oriented labor force in the possessions. Linking the credit to the minimum wage also provides an element of automatic indexing when that amount is adjusted for inflation. At the current minimum wage level and with a 33 percent corporate rate, the maximum net credit per employee (after reducing the deduction for wages paid by the amount of the credit) is $5,602, that credit would eliminate the tax on $16,975 of taxable income per employee. In 1983 the pre-tax corporate profit per employee in U.S. manufacturing was about $3,600. Even assuming a substantial increase since then as a result of the economic recovery, the availability of a wage credit of the type proposed would have meant a very large increase in the after-tax return on capital. For example, after-tax profits would have much more than doubled in the electronics, instruments, fabricated metals and food industries and would have significantly increased even in the chemical and allied products industries. This result is not surprising, considering the importance of labor costs in manufacturing. For U.S. manufacturing, labor compensation accounts for 70 percent of the value-added on average, somewhat less (about 60 percent) in the manufacture of nondurable goods and somewhat more (nearly 80 percent) in the manufacture of durables. Thus, the proposal should be attractive to a broad class of industries. At the same time, the grandfather protection and the wage credit's extra incentive for highly paid workers should make it attractive to existing companies as well.

Another way in which the proposed credit is generous is that it may be used to offset U.S. tax on any income (including income of affiliated companies filing as a consolidated group). Thus, the benefit is not limited to companies able to generate large profits in the possessions. Even an operation in a possession with a relatively low profit margin would provide tax benefits to a company with other taxable income. This aspect of the proposal will also simplify present law. Any U.S. corporation may elect the credit and may use it to offset U.S. tax on any income; the excessively complex eligibility tests and income allocation rules will no longer be necessary.

Despite the problems inherent in the existing law, the Administration recognizes that the proposed wage credit may be less attractive than the existing income-based credit for certain corporations, primarily those in industries such as pharmaceuticals and electronics which have lower than average employment levels and higher intangible income, and that immediate repeal of the existing credit could cause undesirable short-term economic dislocation in the possessions. The proposed grandfather protection is designed to allow existing firms a generous transitional period to recover their existing investments and restructure their operations. Available data indicate that possessions corporations are able to recover their investments quickly under existing law. For example, in 1982 the ratio of pre-tax operating income to operating assets (including inventories and net accounts receivable as well as property, plant and equipment) was 57 percent for all possessions corporations, this implies that that investments can be fully recovered in about 1 3/4 years. For pharmaceuticals and the electrical and electronic industries, the ratios were 79 and 68 percent, respectively, which imply a recovery periods of about 1 1/4 years for pharmaceuticals and about 1 1/2 years for the electrical and electronic firms. Accordingly, the five-year period should be more than adequate to allow tax-free recovery of investment in existing assets. In addition, a grandfather period of any longer than five years would heighten the need for a re-examination and amendment of the income allocation rules of the existing section 936 to reduce existing abuses during the transition period.

The banking sector of the possessions' economies currently benefits from that aspect of the income-based credit which exempts qualifying possessions-source investment income from tax. Available data indicate, however, that the accumulation of section 936 funds has had little positive impact on real investment in the possessions. The proposal would have little adverse impact on the Puerto Rican banking system, even in the absence of the grandfathering provision, due to the system's high liquidity.

REVISE RULES FOR LEVERAGED ESOPS

General Explanation

Chapter 12.06

Current Law

An employee stock ownership plan ("ESOP") is a qualified retirement plan designed to invest primarily in employer securities. Such plans generally are either "tax credit ESOPs" or "leveraged ESOPs." Both types of plans receive significant tax subsidies.

A corporate employer is entitled to a tax credit for contributions to a tax credit ESOP of cash or employer securities not in excess of 0.5 percent of the compensation paid or accrued with respect to employees participating in the ESOP. The employer also receives a tax credit for the costs of establishing and administering the plan, within certain limits.

In a leveraged ESOP, the plan borrows to purchase employer securities and the corporation obligates itself to contribute amounts sufficient for the ESOP to make payments on the debt. The employer generally may deduct these contributions to the ESOP currently without regard to the limits on employer contributions to other types of qualified plans. A special exception to the prohibited transaction rules applicable to qualified plans permits a sponsoring corporation and its ESOP to engage in this transaction if the loan is primarily for the benefit of participants and certain other requirements are satisfied.

Employees are not taxed on employer contributions to an ESOP or accumulated income of the trust until securities are distributed. A tax credit ESOP must hold employer securities for at least seven years before the securities can be distributed to employees; a leveraged ESOP generally must hold employer securities for at least two years before they can be distributed to employees. Typically, however, in both types of plans, participants do not receive a distribution of securities until they separate from service. When a distribution is made, the participant may "put" the securities to the employer and receive cash, unless the securities are traded on an established exchange.

An ESOP must pass through voting rights on employer securities allocated to the accounts of participants; this requirement, however, is substantially limited if the employer has no registration-required class of securities. An ESOP may pass dividends through to participants on shares allocated to participants' accounts; dividends on unallocated shares are retained by the trust.

Congress provided certain additional incentives for employee ownership through qualified plans in the Tax Reform Act of 1984: (1) banks, insurance companies and other commercial lenders may exclude half of the interest paid or accrued on a loan used by a leveraged ESOP to purchase qualified securities; (2) corporations may deduct dividends actually paid to employees with respect to employer stock held in an ESOP and allocated to participants' accounts; (3) taxpayers are permitted to sell securities in a corporation to an ESOP or eligible worker-owned cooperative, purchase securities in a second corporation and defer recognition of gain on the sale; and (4) an ESOP may assume the estate tax liability of a decedent if the decedent's securities are transferred to the ESOP.

Reasons for Change

Many argue that employees who own stock in their employer are more productive because, as part owners of the business, they have a stake in seeing the enterprise become more profitable. Current law has in many respects embraced this argument, since it contains a variety of provisions aimed at encouraging employee ownership. Despite the intentions behind such provisions, they represent a confused mix of incentives and requirements which fails to encourage direct employee ownership.

Employee ownership of employer securities through a qualified plan defers significant incidents of ownership for employees until distribution of the securities. In most ESOPs, employees must wait until they separate from service before they receive a distribution. Furthermore, since employees are entitled to put nontraded securities to the employer following distribution, employees may never directly own any employer securities despite years of participation in an ESOP.

ESOP participants receive only a small portion of the dividends paid on the employer securities that are eventually distributed to them. This results from the fact that an ESOP may pass through dividends only with respect to shares actually allocated to the participants' accounts. Similarly, voting rights with respect to employer securities are passed through to participants only in limited circumstances and only with respect to shares allocated to participants' accounts.

To the extent the full benefits of owning employer securities are deferred for ESOP participants, the intended incentive for employee ownership is diminished. Indeed, if participation in the ESOP is in lieu of current compensation, such deferral may actually lessen employees' overall incentive to increase productivity.

Finally, ESOPs should be recognized and treated as vehicles to encourage employee ownership rather than as an alternative form of qualified retirement plan. Relying on ESOPs to provide retirement benefits is poor retirement policy. Qualified retirement plans are generally required to invest in a diversified portfolio to insure that anticipated benefits will be available when a participant retires. A retirement benefit entirely dependent on market fluctuations in a single, often unmarketable asset provides an employee little certainty that adequate retirement security will be provided. This concern is particularly acute where employers reduce or eliminate contributions to pension or profit sharing plans because of required contributions to an ESOP. In addition, applying to ESOPs the rules for qualified retirement plans, such as vesting requirements and contribution and distribution limits, unnecessarily restricts the ability of an employer to provide the benefits of owning employer securities to its employees.

Proposal

The tax credit for contributions to an ESOP would be permitted to expire as scheduled and the special deduction limits for contributions to leveraged ESOPs would be repealed. Also, the special exception to the prohibited transaction rules for leveraged ESOPs would be repealed.

An employer with 15 or more employees that borrows funds from an unrelated lender to purchase outstanding "employer securities" with a fair market value equal to the principal amount of the loan would be permitted to deduct principal payments made each year with respect to the indebtedness provided that (1) the employer contributes the securities to an "employee stock ownership trust" and (2) the loan agreement requires either (i) annual principal payments not greater than 20 percent or less than 8.3 percent of the original principal balance or (ii) equal annual payments and a term of ten years or less. In addition, an employer would be precluded from deducting principal payments for any year in excess of 25 percent of eligible employees' aggregate compensation for such year. Nondeductible payments would be deductible in a subsequent year, subject to the same 25 percent limit. For this purpose, "employer securities" would constitute either the stock of the employer or of any related corporation which is traded on an established securities exchange or, if no stock of the employer or of any related corporation is so traded, the securities of the employer or of any related corporation having the greatest voting and dividend rights. The employer would be required to employ an independent fiduciary to value nontraded employer securities.

The employee stock ownership trust generally would be required to distribute annually a portion of the securities held by the trust (in proportion to the scheduled principal repayments for the year) as well as dividends paid during the year on securities held by the trust. Alternatively, the trust agreement could provide that the trust would retain nominal ownership of the employer securities allocated to employees; a trust agreement so providing, would be required to provide employees with all rights of direct ownership in the securities, including the right to dividends paid with respect to the securities, the right to vote and the right to transfer the securities.

In addition, the trust agreement for an employee stock ownership trust would be required to provide that the securities distributed or allocated during a year and dividends on undistributed securities be apportioned among employees on the basis of each employee's compensation for the year not in excess of $50,000. The trust agreement could provide that only employees with at least 1,000 hours of service during the year would receive a distribution or allocation of securities or dividends on unallocated securities. The trust agreement would also be required to provide that employees be able to vote unallocated securities with respect to a corporate matter requiring more than a majority vote of outstanding employer securities; the trustee could grant the right to vote unallocated securities in such cases to employees eligible to receive distributions from the trust in any reasonable manner. In addition, the trustee of the trust holding the employer securities would be subject to the fiduciary responsibility provisions of Title I of ERISA.

Employees would realize no income on the distribution or allocation of securities from an employee stock ownership trust. Employees could freely enter into voting trust arrangements or buy-sell agreements with respect to such securities, but the employer could not impose any restrictions on the exercise of voting rights or transferability of the securities. The employer would be required to grant employees the right to put distributed or allocated securities to the employer at their fair market value three years after receipt or allocation of the securities; the put right would be required to be available during a specified period every year thereafter (through the year following separation from service). Upon sale or disposition of securities, employees would recognize income equal to the full amount of the proceeds from the sale or disposition; the portion of such proceeds not in excess of the employer's principal payments with respect to the stock would be characterized as ordinary income, and the excess would be capital gain.

The current rule allowing deferral of gain on a sale of employer securities to an ESOP or eligible worker-owned cooperative would be retained, but would be revised to permit deferral of gain only on sales of employer securities to an employee stock ownership trust. The exclusion of one-half of the interest paid on a loan used by a leveraged ESOP to purchase employer securities would be retained, but revised to apply to loans to employers in connection with an employee stock ownership trust. The current rule permitting a deduction for dividends paid on stock held in an ESOP would be retained, but revised to require an employer to make an additional nondeductible payment to any employee who receives a dividend with respect to employer securities distributed or allocated to the employee. This additional payment would be an amount equal to the tax saving available to the employer for the taxable year on account of the deductible dividend. The provision permitting an ESOP to assume certain decedents' estate tax liabilities would be repealed.

Effective Date

An employer's deduction for ESOP contributions with respect to securities acquisition loans outstanding on December 31, 1985, and the status of such loans under the prohibited transaction rules would continue to be governed by current law. See Ch. 14.03. The repeal of the rule relating to the assumption of estate tax liability would apply beginning January 1, 1986.

The proposal for an employee stock ownership trust would apply to securities acquisition loans made on or after January 1, 1986. The amendment to the dividends paid deduction would apply to dividends paid on or after January 1, 1986. The amendment of the interest exclusion would apply to loans made on or after January 1, 1986.

Analysis

The proposal is designed to provide a subsidy equivalent to that provided under current law for leveraged ESOPs, but in a manner that will encourage direct ownership by employees. Under current law, an employer is entitled essentially to a current deduction for principal payments on a loan used to acquire employer securities, while an employee is generally not required to include such amounts in income until he or she receives a distribution from the ESOP, usually upon retirement or other separation from service. Under the proposal, the employer would be entitled to claim current deductions for principal payments, but employees, while receiving the employer securities as the loan is repaid, would recognize no income until the securities are sold.

Tax subsidies for employee ownership should encourage direct ownership of employer stock. Direct ownership of employer securities, with the attendant rights and benefits, is far more likely to be an incentive for employee productivity than a speculative benefit to be realized only upon separation from service. Moreover, employees are fully capable of exercising all of the rights of direct stock ownership, including the right to vote and to determine whether to dispose of or hold employer securities.

The tax law should not foster arrangements, such as those existing under current law, which purportedly vest the incidents of ownership of employer securities in employees, but which actually defer and, in certain respects, deprive employees of the rights and responsibilities of stock ownership. For example, if one of the goals of tax incentives for employee ownership is to give employees some voice in the affairs of the employer corporation, employees must be entitled to vote the shares which have been allocated to them. To vest this right in a third party, such as the trustee of an ESOP (who may be an officer of the employer), deprives employees of a valuable right of stock ownership.

Similarly, if an employer chooses to compensate employees by giving employees shares of its stock, employees should receive the benefits of owning the stock currently, including the right to decide whether the employer securities are an appropriate investment, rather than being required, as under current law, to maintain an investment in the employer through the ESOP. If ownership of employer securities is a sound investment, the employees will readily agree to continue that tax deferred investment and work to enhance its value. On the other hand, if the employer stock is a bad investment, employees should enjoy the same freedom to dispose of it as any other rational investor. Employees are poorly served where the tax law overrides their own judgments.

The proposal is also designed to remove the subsidy for employee ownership from the requirements applicable to qualified retirement plans. These requirements are needlessly restrictive in the context of an incentive for employee ownership. Moreover, benefits provided in the form of employer securities should not be viewed as a substitute for plans established to provide a more secure retirement benefit.

CHAPTER 13

CURTAIL TAX SHELTERS

Current rules limiting the deduction of investment interest are inadequate to curtail tax shelter abuses. This Chapter proposes a comprehensive limitation on the deduction of nonbusiness interest. In addition, the special exceptions to the at-risk limitations for real estate would be repealed, so that the at-risk rules would apply more uniformly to all activities. Finally, the individual and corporate minimum taxes would be revised and expanded.

General Explanation

Chapter 13.01

Current Law

In general, interest paid or incurred on indebtedness is fully deductible from income. This general rule is subject to exceptions for interest on indebtedness incurred to generate certain tax-preferred income. Thus, for taxpayers other than certain financial institutions, no deduction is allowed for interest on indebtedness incurred to purchase or carry obligations that generate tax-exempt income. In addition, for noncorporate taxpayers, interest on debt incurred to acquire or carry investment property ("investment interest") is deductible only to the extent of the sum of (i) $10,000 ($5,000 for married persons filing separately), (ii) "net investment income," and (iii) certain deductions attributable to net-leased property. Amounts disallowed under this limitation for a taxable year are carried forward and treated as investment interest in the succeeding taxable year.

Interest on debt incurred to acquire or carry personal-use property or business property is ordinarily deductible currently, even if that property does not produce taxable income or is likely to appreciate substantially (resulting in deferred capital gains). (See Ch. 8.01 for a discussion of circumstances in which interest costs must be capitalized when incurred in connection with certain production or manufacturing activities.)

Reasons for Change

Clear reflection of income for tax purposes requires that the costs of generating income be matched with the income actually earned. If a current deduction is allowed for the cost of producing income that is exempt from tax or includable in income on a deferred basis, the current deduction will offset other taxable income and thus eliminate or defer tax. Such "tax arbitrage" occurs, for example, when an investor deducts interest on indebtedness incurred to acquire or carry assets that yield tax-exempt income such as personal-use property or assets held in an Individual Retirement Account. It also occurs, though with less predictability, where indebtedness is incurred to acquire or carry interests in business property that experiences real appreciation over time.

Current law permits taxpayers to deduct the interest costs of generating certain tax-exempt or tax-deferred income. Although interest incurred to acquire or carry tax-exempt bonds is nondeductible, interest incurred to produce analogous forms of tax-preferred income is deductible without limitation. Thus, "consumer interest," i.e., interest incurred to acquire personal assets, such as a car or vacation home, is fully deductible, even though such assets do not generate taxable income. Similarly, current law limits the deductibility of "investment interest," but interest incurred in a trade or business is fully deductible, even if the investor is not actively engaged in the management of the business and much of the return from the business is expected to be deferred. The current deductibility of interest is an important feature of real estate tax shelter investments structured as limited partnerships.

The unlimited deduction for consumer and "passive" business interest also undermines existing limitations on investment interest and interest incurred to acquire tax-exempt bonds. Since money is fungible, the identification required under current law of the purpose for which indebtedness is incurred is difficult at best. The general deductibility of all consumer and business interest complicates the task of determining whether debt was incurred for a nondeductible purpose.

Proposal

Interest subject to the current investment interest limitation would be expanded to include: (a) all interest not incurred in connection with a trade or business (other than interest on debt secured by the taxpayer's principal residence, to the extent such debt does not exceed the fair market value of the residence), (b) the taxpayer's share of all interest expense of S corporations (other than S corporations in which the taxpayer actively participates in management), and (c) the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. Interest on indebtedness incurred to carry or acquire business rental property used by the taxpayer for personal purposes for part of a taxable year would generally be treated as business interest (and thus not subject to limitation) in the same proportion that the number of days the property is rented at a fair rental bears to the number of days in the taxable year.

Interest subject to the limitation would be deductible only to the extent of the sum of (a) $5,000 ($2,500 in the case of a married person filing a separate return), and (b) the taxpayer's net investment income. In general, net investment income for this purpose would have the same meaning as under current law, except that it would include the taxpayer's share of all income of S corporations not managed by the taxpayer and the taxpayer's distributive share of all income of limited partnerships in which the taxpayer is a limited partner. Any interest deduction disallowed for the taxable year under this limitation would be treated as interest expense subject to the limitation for the succeeding taxable year.

Effective Date

Subject to two phase-in rules, the proposal would be effective for interest expense paid or incurred in taxable years beginning on or after January 1, 1986. Under the first phase-in rule, for taxable years beginning before January 1, 1988, interest subject to limitation would continue to be deductible to the extent of $10,000 plus net investment income (determined under the new rules). Thereafter, the proposed limitation of $5,000 plus net investment income would apply. Under the second phase-in rule, for taxable years beginning on or after January 1, 1986, an increasing percentage of interest expense that is treated as investment interest under the expanded definition but that is not subject to the investment interest limitation of current law would become subject to the proposed expanded investment interest limitation. That is, in taxable years beginning in 1986, 10 percent of newly limited investment interest (e.g., consumer interest, interest passed through a limited partnership or a passive subchapter S corporation) would be subject to the limitation; in taxable years beginning in 1987, 20 percent of newly limited investment interest would be subject to the limitation; and in each subsequent taxable year, the percentage would be increased by 10 percentage points until fully phased in. For purposes of the proposed limitation, the expanded definition of net investment income would be phased in on a similar basis.

Analysis

Because the expanded limitation on interest deductions would not apply to mortgage interest deductions on the taxpayer's principal residence or to the first $5,000 of any additional interest expense, the vast majority of taxpayers would not be affected by the proposal. Interest expenses attributable to a trade or business in which the taxpayer actively participates also would not be subject to the limitation. Thus, sole proprietors, owner-operators of farms, general partners, and shareholder-managers of S corporations would continue to treat their business interest expenses in the same manner as under current law. However, taxpayers with substantial tax shelter interest expense would be prevented, in many cases, from using that interest expense to offset business and employment income.

EXTEND AT-RISK LIMITATION TO REAL ESTATE

General Explanation

Chapter 13.02

Current Law

In general, in the case of individuals and certain closely held corporations, current law limits the loss a taxpayer may deduct from an investment to the amount the taxpayer has at risk with respect to such investment. This "at-risk" limitation on deductible losses is applied on an "activity-by-activity" basis. The at-risk rules extend to all activities conducted by taxpayers to whom the rules apply, other than (1) real estate activities and (2) most business activities actively conducted by closely held corporations. Accordingly, an investor in real estate, a closely held corporation actively conducting a business activity, or a widely held corporation investing in any activity, may generally deduct for tax purposes losses from the investment that exceed the investor's maximum possible economic loss from the investment.

For purposes of the at-risk rules, a taxpayer is generally at risk in an activity to the extent that the taxpayer has contributed money or property (to the extent of its basis) to the activity, or is personally liable to repay borrowed funds used in the activity. A taxpayer is not considered to be at risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop loss or similar arrangements. Losses which are disallowed for a taxable year under the at risk rules are carried forward indefinitely and are allowed in a succeeding taxable year to the extent that the taxpayer increases the amount at risk in the activity giving rise to the losses.

Reasons for Change

The at-risk rules of current law reflect the fact that, as an economic matter, an investor cannot lose more than the amount that he or she has directly invested plus any additional amount for which the investor is liable. This principle is no less true for investments in real estate or corporate activities than it is for the activities to which the current at-risk rules apply.

However, the purpose of the at-risk rules is generally to restrict the use by individual taxpayers of limited-risk transactions to shelter artificially their income from other sources. The use of limited-risk financing in the public corporate sector has not generally been viewed as abusive. Similarly, the use of limited-risk financing in the closely-held corporate sector has not been viewed as abusive where loss activities are conducted as substantial active businesses; in such situations, the likelihood that loss activities are utilized for the purpose of sheltering other income of the corporate owners is diminished.

On the other hand, the exclusion of real estate activities from the at-risk rules is not similarly justified. Due to this exclusion, individuals investing in real estate may offset current taxable income from other activities (e.g., wages) with tax losses that will never be matched by economic losses.

The allowance of such noneconomic losses for tax purposes is a necessary basis for many tax-sheltered real estate investments. Front-loaded tax losses that have no economic basis permit the investor to reduce or eliminate tax on his other income. The resulting deferral of tax liability guarantees a return to the investor that may make an otherwise noneconomic investment plausible. Tax-driven noneconomic investment activity diverts capital from more productive uses, causes overinvestment in the tax-preferred activities and thus distorts prices and capital costs throughout the economy.

Tax shelter activity also invites disrespect for the tax law. Whether legally justified or not, the use of tax shelters by high-income, well advised individuals is viewed with confusion and skepticism by ordinary taxpayers. These perceptions undermine the voluntary compliance that is crucial to the income tax system.

Proposal

The at-risk rules would be extended to real estate activities. The at-risk rules would continue to be applicable only to individuals and certain activities of closely held corporations.

Effective Date

The proposal would be effective for losses attributable to property acquired on or after January 1, 1986.

Analysis

Extending the at-risk rules to real estate activities would not inhibit the leveraged acquisition of properties expected to yield a market rate of return. The proposal, however, would require that investors in real estate activities evaluate the economic risk of loss associated with investments in those activities as well as their tax benefits and income potential. The proposal thus would leave real estate investments subject to the same market discipline as currently applies to investments generally. The enhanced neutrality among investment alternatives would improve resource allocation and reduce overinvestment in currently tax-preferred real estate activities. This, in turn, should lead to overall productivity gains.

It is possible that the laws of some States that preclude the use of recourse debt in connection with the acquisition of certain real estate could prevent certain investors in those States from receiving full tax benefits from leveraged real estate investments. It is anticipated that any such States would act quickly to permit business investments in real estate to employ recourse indebtedness.

Some have argued that the proper goal of the at-risk rules is not, as indicated above, to prevent taxpayers from sheltering income with artificial losses, but to police the use of limited-risk financing to inflate artifically value and thus recoverable basis in property acquired by purchase. Under this view, the at-risk rules should be restructured to limit a taxpayer's basis in property financed with limited risk debt. Since the focus of such a rule would be on artificially inflated values, limited-risk financing from unrelated institutional lenders would presumably be free of the basis restriction. Such rule generally would not disturb limited-risk transactions lacking the indicia of abuse, but would limit cost recovery deductions from abusive transactions to a greater extent than current law. Under the Administration proposal, the at-risk rules would continue to serve the broader function of loss limitation that their current structure implies. At the appropriate time, Congress may wish to consider whether the at-risk rules place sensible limitations on artificial losses, or could be targeted instead to restrict abusive transactions.

REVISE ALTERNATIVE MINIMUM TAX FOR NONCORPORATE TAXPAYERS

General Explanation

Chapter 13.03

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" that may increase their overall tax liabilities. For noncorporate taxpayers, such minimum taxes are imposed in the form of an "alternative minimum tax" ("AMT").

Noncorporate taxpayers whose regular tax liabilities are substantially reduced by tax preferences are, in effect, subject to the AMT in lieu of the regular income tax. The AMT is equal to 20 percent of the excess of the taxpayer's "alternative minimum taxable income" ("AMTI") over an exemption amount.*/ A taxpayer's AMTI is computed by (a) adding tax preferences back to adjusted gross income, (b) subtracting the "alternative tax itemized deductions," and (c) making adjustments for net operating loss carryovers and certain trust distributions included in income under the so-called "throwback rules." The alternative tax itemized deductions include (a) casualty losses and certain wagering losses, (b) charitable contributions, (c) deductible medical expenses, (d) certain interest expenses (including interest on debt incurred to acquire the taxpayer's principal residence), and (e) estate taxes attributable to income in respect of a decedent. The exemption amount for the AMT is (a) $40,000 for a joint return or a surviving spouse, (b) $30,000 for a single taxpayer or head of household, and (c) $20,000 for other noncorporate taxpayers.

Items of tax preference generally include:

(a) Dividends excluded from gross income.

(b) The excess of accelerated over straight-line depreciation for each item of real property and leased personal property (other than recovery property).

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*/ The statutory term "alternative minimum tax" actually refers to the excess of (1) 20% of AMTI less the exemption amount over (2) the regular income tax. This excess is imposed in addition to the regular tax. For convenience, however, the terms "alternative minimum tax" and "AMT", as used herein, will refer to the sum of the true alternative minimum tax and the regular income tax.

(c) In the case of an item of recovery property (but only if it is leased property, 18-year real property, or low-income housing), the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated under the straight-line method over prescribed recovery periods.

(d) The net capital gain deduction.

(e) The excess of amortization deductions for each pollution control facility over depreciation deductions that would otherwise be allowable for the facility in the absence of special amortization.

(f) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.

(g) In the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties.

(h) The excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a three-year period.

(i) In the case of circulation expenditures, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a three-year period.

(j) With respect to each depletable property, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.

(k) In the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value of the stock over the option price.

Reasons For Change

The alternative and corporate minimum taxes were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by

Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

Since the Administration proposals contain incentive provisions that depart from the measurement of economic income, some high-income individuals would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income individuals paying little or no tax threatens public confidence in the system. Consequently, a minimum tax designed to limit the number of high-income low-tax returns should be retained.

Proposal

Under the proposal, the minimum tax for noncorporate taxpayers would continue to be structured as an alternative tax, with a rate of 20 percent. Alternative minimum taxable income would be computed by adding to adjusted gross income the excess of preference items over $10,000 ($5,000 for married persons filing separately), and subtracting (a) allowable itemized deductions, (b) personal exemptions, and (c) a threshold exemption amount. The threshold exemption amount would be $15,000 for joint returns ($7,500 for married persons filing separately), $12,000 for heads of households, and $10,000 for single persons.

Allowable itemized deductions generally would include all itemized deductions, with the exception of the deduction for non-business interest (other than mortgage interest with respect to the taxpayer's principal residence) in excess of net investment income.

Items of tax preference subject to the alternative minimum tax would include the following:

(a) The tax preference, as defined under current law, with respect to each item or real property placed in service before 1981 and each item of recovery property which is 15-year real property, 18-year real property, or low-income housing.

(b) For each item of real property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

(c) The tax preference, as defined under current law, with respect to each item of leased personal property placed in service before 1981 and each item of leased recovery property which is not 15-year real property, 18-year real property, or low-income housing.

(d) For each item of leased personal property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

(e) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction that would otherwise be allowable in the absence of special amortization.

(f) The net capital gain deduction.

(g) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.

(h) In the case of intangible drilling and development costs of oil, gas, and geothermal properties (other than dry holes), eight percent of the amount of such costs paid or incurred in the taxable year.

(i) With respect to each depletable property placed in service before January 1, 1986, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.

(j) With respect to each depletable property placed in service on or after January 1, 1986, the excess of the deduction allowable for the taxable year for percentage depletion over the amount that would have been allowable for the taxable year had capitalized costs been recovered through cost depletion.

(k) With respect to each item of contributed property for which a charitable contribution deduction is allowed, the excess of the deduction allowed over the donor's basis in the property.

(l) The excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a ten-year period.

(m) In the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value of the stock over the option price.

The deduction for circulation expenditures would not be treated as an item of tax preference under the proposal.

Effective Date

The revised alternative minimum tax would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would minimize the number of high-income individuals who pay little or no tax as a result of heavy utilization of the tax preferences included in the alternative minimum tax base, and would thus improve the fairness of the tax system. Due to the exclusion of a taxpayer's first $10,000 of preferences from alternative minimum taxable income, only individuals using substantial amounts of tax preferences would need to compute the minimum tax. The threshold amounts would ensure that no individual would be subject to a minimum tax liability greater than the regular tax liability computed by adding preferences to the regular tax base. For analysis of the treatment of IDCs as an item of tax preference, see Ch. 9.03.

REVISE CORPORATE MINIMUM TAX

General Explanation

Chapter 13.04

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. For corporations, a minimum tax is imposed in the form of an "add-on" minimum tax.

In general, the corporate minimum tax is equal to 15 percent of the amount by which the taxpayer's items of tax preference exceed the greater of (a) $10,000 or (b) the regular corporate income tax for the taxable year (without regard to the accumulated earnings tax or personal holding company tax, if any, and reduced by most allowable tax credits).

Items of tax preference generally include:

(a) The excess of accelerated over straight-line depreciation for each item of real property (other than recovery property) and, for personal holding companies, each item of leased personal property (other than recovery property).

(b) In the case of each item of recovery property that is 18-year real property or low-income housing (and, for personal holding companies, each item of leased recovery property other than 18-year real property or low-income housing), the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated under the straight-line method over prescribed recovery periods.

(c) The amount of income effectively untaxed due to the preferential rate of tax applied to capital gains.

(d) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction that would otherwise be allowable in the absence of special amortization.

(e) In the case of mining exploration and development costs with respect to a mine or other natural deposit of a personal holding company, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.

(f) In the case of intangible drilling and development costs of oil, gas, and geothermal properties of personal holding companies, the amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties.

(g) In the case of circulation expenditures of personal holding companies, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a three-year period.

(h) In the case of research and experimental expenditures of personal holding companies, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a ten-year period.

(i) The excess of a financial institution's allowable deduction for bad debt reserves over the deduction that would have been allowable had the institution maintained its reserves on the basis of actual experience.

(j) With respect to each depletable property, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.

Reasons For Change

Since the Administration's tax reform proposals contain incentive provisions that depart from the measurement of economic income, some high-income corporations would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system. Consequently, a minimum tax designed to limit the number of high-income, low-tax returns should be retained.

The add-on corporate minimum tax under current law is poorly designed for this purpose. The add-on tax may be imposed on preferences used by a corporate taxpayer even though the taxpayer is taxed at an effective rate higher than the minimum tax rate. An "alternative" minimum tax, imposed only to the extent a taxpayer's regular effective tax rate falls below a minimum acceptable level, is better designed to achieve the purposes of a minimum tax.

However, an alternative minimum tax limited to the tax preferences applicable to corporations under current law would be insufficient to prevent many corporations from eliminating their regular tax on economic income. Additional preferences should thus be taken into account. Although the Administration proposals generally would allow accelerated depreciation as an incentive for capital formation, a debt-financed acquisition of depreciable assets may reduce the effective tax rate on such investment substantially below the effective tax rate on similar investments that are equity financed.

The full deductibility of interest, without adjustment for the extent to which interest payments are compensation for the effects of inflation rather than a cost of borrowing money, results in significant mismeasurement of income. This mismeasurement is more serious where the investment itself receives preferential treatment. Since the low effective tax rates for debt-financed investment in depreciable property are unnecessary to encourage capital formation, the minimum tax should apply to corporations that substantially reduce their regular tax liabilities through such debt-financed investments.

In addition, corporations engaged in oil and gas activities may eliminate or substantially reduce tax liabilities through excessive use of the election to expense intangible drilling costs ("IDCs"). Although the election to expense IDCs is provided as an incentive for domestic energy production, the value of the incentive is appropriately an item of tax preference for purposes of the corporate minimum tax.

Proposal

Under the proposal, the minimum tax for corporations would be repealed and replaced with an alternative minimum tax, similar in structure to the alternative minimum tax for noncorporate taxpayers. The alternative minimum tax rate would be 20 percent. Alternative minimum taxable income would generally be computed by adding to taxable income (or loss) the excess of preference items over $10,000, subtracting a threshold exemption amount of $15,000, and making adjustments for net operating loss carryovers attributable to preference items. The foreign tax credit generally would be allowed to offset minimum tax liability.

Items of tax preference subject to the alternative minimum tax would include the following:

(a) The tax preferences, as defined under current law, with respect to each item of real property placed in service before 1981 and each item of recovery property which is 15-year real property, 18-year real property, or low-income housing.

(b) For each item of real property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

(c) In the case of personal holding companies, the tax preference, as defined under current law, with respect to each item of leased personal property placed in service before 1981 and each item of leased recovery property which is not 15-year real property, 18-year real property, or low-income housing.

(d) In the case of personal holding companies, for each item of leased personal property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

(e) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction for that facility that would otherwise be allowable in the absence of special amortization.

(f) The amount of income effectively untaxed due to the preferential rate of tax applied to capital gains.

(g) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.

(h) In the case of intangible drilling and development costs of oil, gas, and geothermal properties (other than dry holes), eight percent of the amount of such costs paid or incurred in the taxable year.

(i) With respect to each depletable property placed in service before January 1, 1986, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.

(j) With respect to each depletable property placed in service on or after January 1, 1986, the excess of the deduction allowable for the taxable year for percentage depletion over the amount that would have been allowable for the taxable year had capitalized costs been recovered through cost depletion.

(k) With respect to each item of contributed property for which a charitable contribution deduction is allowed, the excess of the deduction allowed over the donor's basis in the property.

(l) Twenty-five percent of the deduction for interest expense for the taxable year (reduced by taxable interest income for such year), but not in excess of the amount (if any) by which the deduction allowed under CCRS for the taxable year for each item of personal property placed in service on or after January 1, 1986 (but, in the case of personal holding companies, only if such property is not subject to a lease), exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

(m) In the case of personal holding companies, the excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a ten-year period.

The deduction for circulation expenditures would not be treated as an item of tax preference under the proposal.

Effective Date

The proposed alternative minimum tax would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would minimize the number of high-income corporations paying little or no tax as a result of heavy utilization of the tax preferences included in the alternative minimum tax base, and would thus improve the fairness of the tax system. Due to the exclusion of a corporation's first $10,000 of preferences from alternative minimum taxable income, corporations using only small amounts of tax preferences would not need to compute the minimum tax. The $15,000 threshold amount would ensure that no corporation would be subject to a minimum tax liability greater than the regular tax liability computed by adding preferences to the regular tax base.

The inclusion of 25 percent of net interest expense as an item of tax preference (to the extent of the excess of CCRS deductions for personal property over economic depreciation) effectively treats the taxpayer's first investments in CCRS property as being financed by indebtedness of the taxpayer. The 25 percent fraction is intended to identify, on the basis of very conservative assumptions, the portion of such interest representing an inflation premium rather than a cost of borrowing money. For analysis of the treatment of IDCs as an item of tax preference, see Ch. 9.03.

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CHAPTER 14

REVISE TREATMENT OF RETIREMENT SAVINGS

Current law provides tax-favored treatment to funds set aside in any of several employer-sponsored or individual plans providing for deferred compensation or retirement savings. Such "tax-favored plans" include qualified profit-sharing, stock bonus, and pension plans (section 401(a)); qualified annuity plans (section 403(a)); certain annuity contracts, custodial accounts, and retirement income accounts (tax-sheltered annuities) (section 403(b)); individual retirement accounts and annuities (IRAs) (section 408(a)&(b)); and simplified employee pensions (SEPs) (section 408(k)).

The Administration proposals generally would maintain the current treatment of tax-favored plans. The proposals, however, would simplify existing rules and provide more uniform treatment of the various plans. In addition, the proposals would target the favorable tax treatment more directly at reasonable accumulations of retirement savings by applying excise taxes designed to recapture unintended tax advantages where plan benefits are diverted from retirement savings or are in excess of reasonable levels.

Uniform rules, including an excise tax on early distributions, would govern distributions from the various types of plans, and more uniform contribution limits would be established. The overall limit on non-top-heavy defined benefit and defined contribution plans would be eliminated, and an excise tax would be imposed on annual distributions from tax-favored plans in excess of specified limits. The current rules governing IRA contributions by married couples would be made more equitable. Cash or deferred arrangements would be made more comparable to IRAs by the application of a special annual dollar limit. In addition, the related nondiscrimination rules for elective contributions and employer matching contributions under these and similar elective arrangements would be modified to assure that broad cross-sections of employees actually benefit. A special nondiscriminatory coverage rule also would be applied to employer-maintained plans to assure that such plans achieve the same fundamental goal.

Certain adjustments would be made to the current rules governing the tax treatment of loans to participants from qualified plans to assure that tax-favored funds are not available for permanent use before retirement. An excise tax would be applied to qualified plan funds reverting to an employer upon plan termination. Qualified pension plans would be permitted to use benefits forfeited by separated employees to increase the benefits of other employees. Finally, the existing limits on unfunded deferred compensation for employees of States, with certain modifications, would be extended to unfunded deferred compensation arrangements for employees of tax-exempt employers.

INCREASE SPOUSAL INDIVIDUAL RETIREMENT ACCOUNT LIMIT

General Explanation

Chapter 14.01

Current Law

An individual generally is permitted to deduct annual contributions to an individual retirement account or annuity (IRA) up to the lesser of $2,000 or 100 percent of the individual's annual compensation. Thus, if a married individual and his or her spouse each receive compensation during a year, each may make separate deductible contributions to his or her own IRA up to the lesser of $2,000 or 100 percent of compensation.

If an individual receives no compensation during a year, the individual generally is not allowed to make a deductible IRA contribution for such year. Special "spousal IRA" limits, however, provide that if a married individual's spouse earns no compensation during a year for which the married couple files a joint return, the individual may deduct annual IRA contributions up to the lesser of $2,250 or 100 percent of the individual's annual compensation. The contributions may be allocated in any fashion between the individual's IRA and the nonearning spouse's IRA, except that no more than $2,000 may be contributed to either IRA.

The special spousal IRA maximum limit of $2,250 is not available if the married individual's spouse has compensation income during the year. Thus, if a husband and wife each has compensation income, each is separately subject to the $2,000 and 100 percent of compensation limits on deductible contributions. As a consequence of this rule, a married couple with a nonearning spouse is permitted to make larger total deductible IRA contributions than a married couple with a spouse who has compensation income of less than $250.

Reasons for Change

The tax benefits applicable to IRAs are intended to encourage individuals to save for retirement. Savings for this purpose also contribute to the formation of investment capital needed for economic growth. For many individuals, including individuals who are covered by employer-maintained retirement plans, IRAs may play an important part in an overall strategy to provide for retirement security. The use of IRAs for retirement saving should thus not only be encouraged, but made available on a broad and consistent basis.

The existing limitations on IRA contributions are illogical and inequitable as applied to married couples. The relatively minor allowances for a spousal IRA fail to recognize the important economic contributions made by nonearning spouses. Moreover, they are inconsistent with other rules of current law under which married couples are treated as an economic and taxpaying unit. Thus, a husband and wife that each earn $10,000 can make aggregate IRA contributions of $4,000 under current law. A couple with the same joint income of $20,000, all of it earned by one spouse, may make aggregate IRA contributions of only $2,250. A third couple, also with $20,000 of joint income, but with one spouse earning only $200, is limited even further to a $2,200 aggregate IRA contribution. These disparate results are inconsistent with both retirement savings policy and general tax principles requiring similar treatment of similarly situated taxpayers.

Proposal

A married individual filing a joint return, including an individual with no annual compensation, would be permitted to take into account his or her spouse's compensation (less the deductible IRA contribution made by such spouse) in determining the deduction limit for such individual. Thus, married couples with aggregate compensation of $4,000 or more ultimately would be entitled to a $4,000 aggregate IRA contribution ($2,000 apiece) regardless of how much of the aggregate compensation was generated by either spouse.

Deductible IRA contributions would be coordinated with the dollar limit on elective contributions under a cash or deferred arrangement. See Ch. 14.06.

Consideration would be given to the adoption of rules preventing in appropriate instances the deduction of interest attributable to indebtedness incurred to make deductible IRA contributions. If adopted, such rules would conform to current law principles barring the deduction of interest on indebtedness incurred or carried to generate tax-exempt income.

Effective Date

The spousal compensation rule for married individuals would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposed spousal compensation rule would permit certain married couples to set aside additional amounts in IRAs for long-term savings. This would enhance retirement security for such couples, and should also contribute to increased capital formation and productivity.

UNIFY RULES FOR DISTRIBUTIONS FROM TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.02

Current Law

Current law provides tax-favored treatment with respect to a variety of employer-sponsored and individual plans. Although these tax-favored plans are related in concept and purpose, distributions from the plans are subject to differing requirements and may result in significantly different tax consequences to individual recipients.

Minimum Distribution Requirements. Tax-favored retirement plans are subject to certain minimum requirements concerning the timing and amount of distributions. Qualified profit-sharing, stock bonus, pension, and annuity plans must generally commence distributions no later than the April 1 following the year in which the employee attains age 70-1/2 or, if later, the year in which the employee retires. (Distributions to five percent owners must commence no later than the April 1 following the year in which the individual attains age 70-1/2.) Benefits thereafter must be distributed under a minimum distribution schedule. Additional rules require minimum annual distributions where the employee dies before benefit distributions have commenced or have been completed. A qualified plan failing to satisfy the minimum distribution rules with respect to a participant may lose its tax-favored status.

Individual retirement accounts (IRAs) and simplified employee pensions (SEPs) must commence distributions no later than the April 1 following the year in which the IRA or SEP owner attains age 70-1/2, without regard to whether such owner has retired. Thereafter, benefits must be distributed under lifetime and after-death distribution schedules similar to those for qualified plans. An IRA or SEP that fails to satisfy the minimum distribution rules does not lose its tax-favored status. Instead, the payee is subject to an excise tax of 50 percent of the amount by which the required distribution exceeds the amount actually distributed.

Benefits provided through tax-sheltered annuities are not subject to minimum distribution rules for the period during which the original holder of the annuity remains alive. If, however, the holder dies before the entire interest in the annuity is distributed, distribution rules based on the after-death rules for qualified plans must be satisfied. (A technical correction bill has been introduced in Congress that would subject tax-sheltered annuities to lifetime and after-death distribution rules similar to those for qualified plans.)

Tax Treatment of Distributions. In general, amounts distributed from tax-favored plans are fully taxable to the recipient at the time of distribution. There are a variety of exceptions to this general rule under which certain distributions incur additional taxes and certain others receive more favorable tax treatment than ordinary distributions.

Early Distributions. Distributions from an IRA or SEP before the IRA or SEP owner dies, becomes disabled, or attains age 59-1/2 generally are subject to a ten percent additional tax. Similar distributions from a qualified profit-sharing, stock bonus, pension, or annuity plan are subject to an additional tax only in the case of employees owning more than five percent of the employer. Early distributions from tax-sheltered annuities are not subject to an additional tax. However, distributions from tax-sheltered custodial accounts are generally prohibited absent financial hardship, separation from service, the attainment of age 59-1/2, death, or disability.

Lump Sum Distributions. Preferential tax treatment is currently available for certain lump sum distributions from qualified profit-sharing, stock bonus, pension, and annuity plans. Under a special forward averaging rule, the tax liability on a lump sum distribution is generally determined as though the individual received the distribution ratably over ten years and as though the individual received no other taxable income during such period. In addition, the portion of a lump sum distribution attributable to plan participation before 1974 may be taxed at capital gain rather than ordinary income rates. Whether a lump sum distribution qualifies for favorable treatment is determined under an extensive set of rules, based in part on the employee's age, employment status and years of participation in the plan. Favorable lump sum treatment is not available for distributions from IRAs, SEPs, or tax-sheltered annuities.

Employer Securities. Current law also provides preferential tax treatment for unrealized appreciation on employer securities included in a lump sum distribution from a qualified profit-sharing, stock bonus, or pension plan. Such appreciation is not included in income at the time of distribution, but instead is taxable upon subsequent disposition of the securities, ordinarily at capital gain rates. If the distribution is not a lump sum distribution, only the unrealized appreciation on employer securities purchased with employee contributions qualifies for the special treatment. Unrealized appreciation on plan distributions of securities other than employer securities is fully taxable upon distribution.

Basis Recovery. Tax-favored plans are subject to special rules for the recovery of employee contributions previously subject to tax. Outside the area of tax-favored plans, an amount not received as an annuity before the annuity starting date is generally treated, first, as a taxable distribution and, second, as a tax-free recovery of employee contributions. This basis recovery rule is reversed, however, for a non-annuity distribution from a qualified profit-sharing, stock bonus, pension, or annuity plan or a tax-sheltered annuity, so that such distribution is treated, first, as a tax-free recovery of employee contributions.

Tax-favored plans are also granted special treatment for amounts received as annuities after the annuity starting date. Under the general basis recovery rules, employee contributions are recovered tax-free on a pro rata basis, in accordance with an exclusion ratio based on the employee's life expectancy at the time distributions commence. An employee's after-tax investment in a tax-favored plan, however, is recovered prior to any taxable distributions, provided that the aggregate amount to be distributed during the first three years exceeds such after-tax investment.

Rollovers. Distributions from a tax-favored plan (including distributions of property, such as employer securities) are not subject to taxation to the extent rolled over to another tax-favored plan. Generally, a plan distribution may be rolled over to another plan if it qualifies as a lump sum distribution, and may be rolled over to an IRA if it is at least 50 percent of the employee's total benefit in the plan. A complex series of rules governs the extent to which distributions from particular plans may be rolled over as well as the type of plans to which rollovers may be made. In general, these rules are designed to prevent individuals from avoiding restrictions applicable to certain plans by shifting benefits to a plan that is free of the restrictions.

Constructive Receipt. In general, benefits under tax-favored plans are taxable when received. For most plans, receipt occurs for tax purposes only when benefits are actually distributed. The doctrine of constructive receipt is applied, however, to benefits under tax-sheltered annuities, which may be treated as received either when actually distributed or when made available to the individual. As a consequence, benefits in such annuities may be taxable prior to their actual distribution.

Reasons for Change

The current rules for distributions from tax-favored plans are burdensomely complex for taxpayers and inconsistent in their treatment of similarly situated individuals. The current rules also undercut the basic rationale for tax-favored plans, which is the encouragement of retirement savings, and in certain instances provide excessively favorable treatment.

Uniform Treatment of Distributions. The various tax-favored plans are important components of a general policy to enhance individual retirement income security. The current absence of uniformity in the treatment of such plans creates significant disparities among individuals based on the type of plans to which the individuals happen to have access. Uniform rules would eliminate such disparities and also reduce the complexity of the existing rules governing plan distributions. Existing differences in the tax treatment of plan distributions give tax considerations undue influence over an individual's choice of retirement plans. Moreover, they require individuals either to master a complex set of rules or to seek professional advice. In too many cases they may result in a loss of possible benefits. Uniform rules would have the additional advantage of making unnecessary most of the current restrictions on the shifting of benefits from one plan to another.

The tax-favored status of retirement plans is intended to enable individuals to replace, after retirement, compensation that terminates with retirement. Minimum distribution rules support this rationale by limiting the extent to which tax-deferral on retirement savings can be extended beyond the individual's retirement. Given the purpose of minimum distribution rules, they should apply to all retirement plans receiving tax-favored treatment.

Uniform sanctions should also apply to violations of minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical requirements. Disqualification may result in adverse tax consequences to all plan participants, even though plan administration generally is outside the control of the participants and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the Internal Revenue Service.

Encourage Retirement Savings. The current favorable treatment of certain plan distributions undercuts retirement saving by encouraging early and lump sum withdrawals. The ability of individuals to gain access to the tax advantages provided to tax-favored funds before retirement permits employees to use tax-favored plans as short-term savings accounts rather than as retirement savings vehicles. Also, the special basis recovery rules for early distributions permit the accelerated tax-free recovery of employee contributions and thus further encourage the use of tax-favored plans for nonretirement purposes.

The special ten-year averaging and capital gain provisions for lump sum distributions (including lump sum distributions before retirement) encourage individuals to withdraw tax-favored funds from the retirement income stream and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and ten-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals to roll over distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA.

Finally, the rules permitting the deferral of tax on unrealized appreciation in employer securities encourage the investment and receipt of tax-favored funds in the form of such securities. The opportunity to defer tax even after distribution (and to escape tax altogether if the securities are unsold at death) permits the use of tax-favored plans for nonretirement purposes, such as the accumulation of funds to pass on to beneficiaries on a tax-favored basis. In addition, individuals are able to avoid having to sell employer securities upon distribution in order to pay the tax due by rolling the securities over into an IRA.

Proposals

Uniform Minimum Distribution Rules. All tax-favored plans, including tax-sheltered annuities, would be subject to uniform minimum distribution rules governing both lifetime and after-death distributions. Thus, distributions from all employer-maintained plans would be required to commence no later than the April 1 following the year in which the individual attains age 70-1/2 or, if later and the individual is not a five percent owner, the year in which the individual retires. Distributions from IRAs would be required to commence no later than April 1 following the year in which the individual attains age 70-1/2. Thereafter, both lifetime and after-death distributions would have to conform with minimum payout schedules. Certain simplifying modifications would be made to the existing rules to ease the calculation and improve the predictability of required annual distributions.

The uniform sanction for failure to satisfy the minimum distribution rules would be a nondeductible excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The recipient of the distribution would be primarily liable for payment of the tax, with a right, in appropriate cases, to recover the tax from the plan. The current sanction of disqualification would be eliminated.

Distribution Restrictions. Tax-sheltered annuities, including annuity contracts and retirement income accounts, would be subject to the distribution restrictions currently applicable only to custodial accounts. Financial hardship would be eliminated as an event permitting distributions. Thus, early distributions from all tax-sheltered annuities would generally be prohibited absent separation from service, the attainment of age 59-1/2, death, or disability.

Uniform Tax Treatment of Distributions, Including Lump Sum Distributions. Uniform rules would govern the tax consequences of plan distributions to individual recipients. Thus, distributions would be subject to tax only upon actual receipt. Current application of the constructive receipt doctrine to tax-sheltered annuities would be eliminated. In addition, the taxable portion of any distribution from a tax-favored plan would be taxed fully as ordinary income. The special capital gain and ten-year averaging treatment for lump sum distributions and the deferred inclusion of unrealized appreciation on distributions of employer securities would be eliminated.

In calculating the taxable portion of a plan distribution, the generally applicable basis recovery rules, with certain modifications, would apply. Thus, an amount received before the annuity starting date would be treated, first, as a taxable distribution and, second, as a nontaxable return of basis. Annuity distributions after the annuity starting date would be taxed in accordance with the exclusion ratio established when such distributions commenced; the three-year recovery rule would be eliminated. In establishing the exclusion ratio for an individual, standardized recovery periods of multiples of five years would be used in lieu of the individual's actual life expectancy; the recovery period for a particular individual would be the period closest to the individual's life expectancy at the time distributions commence. If distributions cease before the individual recovers his entire basis tax-free, the individual, his estate, or his heirs would be entitled to deduct the unrecovered basis. If the individual receives benefits for longer than his recovery period, all additional distributions would be fully taxable.

Recapture Tax on Early Distributions. Early distributions from tax-favored plans would be subject to uniform treatment. The taxable portion of an early distribution from any tax-favored plan would be subject to an excise tax of 20 percent designed to recapture some portion of the tax advantages provided with respect to the distributed funds. However, if the early distribution is used to pay for college expenses incurred by a dependent, for the purchase of the individual's first principal residence, or to replace unemployment benefits during a period of unemployment following the cessation of such benefits, the rate of the recapture tax would be reduced to ten percent. In any case, the tax would be nondeductible and could not be offset by any deductions or credits otherwise available to the individual. A distribution would be treated as an early distribution if it is made before the individual's death, disability, or attainment of age 59-1/2. However, a distribution before the attainment of age 59-1/2 (but not before the attainment of age 50) would not be treated as an early distribution if it is one of a scheduled series of substantially level payments under a single or joint life annuity or under a term certain of at least 180 months commencing upon retirement under the plan.

Rollovers. Individuals generally would be permitted to make tax-free rollovers of funds, within 60 days, between tax-favored plans. Rollovers and transfers would be limited, however, to prevent individuals from thereby avoiding the minimum distribution rules.

Effective Date

The proposed rules governing distributions generally would apply to distributions from tax-favored plans on or after January 1, 1986, in years beginning on or after such date. The following transition rules, however, are proposed with respect to certain of the rules.

The extension of uniform minimum distribution rules and early distribution restrictions to all tax-sheltered annuities would not apply to annuities with respect to which no additional contributions are made on or after January 1, 1986.

The repeal of capital gain and ten-year averaging treatment of lump sum distributions for individuals who, as of January 1, 1987, will have attained age 55 would be phased in over a six-year period. Under this transition rule, five percent of a lump sum distribution received in 1987 would not qualify for capital gain or ten-year averaging treatment; 25 percent would not qualify in 1988; 50 percent in 1989; 75 percent in 1990; and 100 percent in 1991. For all other individuals, the repeal of capital gain and ten year averaging treatment would be fully effective for distributions on or after January 1, 1986.

The repeal of the deferred inclusion of unrealized appreciation on employer securities would be phased in under the same rule. Thus, for individuals who will have attained age 55 by January 1, 1987, five percent of the unrealized appreciation on each employer security received in 1987 would not qualify for nonrecognition; 25 percent in 1988; 50 percent in 1989; 75 percent in 1990; and 100 percent in 1991. Again, for all other individuals, repeal of the deferred inclusion rule would be fully effective for distributions on or after January 1, 1986.

The proposed modification to the basis recovery rule for distributions before the annuity starting date would not apply to benefits accrued under a plan as of January 1, 1986. Also, distributions after such date will be treated, first, as distributions of benefits accrued as of January 1, 1986 and, thereafter, as distributions of benefits accrued after January 1, 1986. Thus, for example, if an employee's accrued benefit as of January 1, 1986 includes employee contributions, non-annuity distributions after January 1, 1986 would be treated, first, as distributions of employee contributions made before January 1, 1986; second, as distributions of taxable benefits; and, third, as distributions of employee contributions made after January 1, 1986.

The proposed modification to the three-year basis recovery rule and the exclusion ratio would not be effective with respect to amounts received as an annuity after the annuity starting date if such annuity was in pay status as of January 1, 1986. The recovery rules of current law would continue to apply to such amounts.

Analysis

The recapture tax on early distributions and the minimum distribution rules are intended to target the tax-favored treatment of plans at retirement savings. The tax is not designed as a penalty, but rather to recoup some portion of the unintended tax advantages that can be obtained by using tax-favored funds for nonretirement purposes, including colleges expenses and the purchase of a residence. As funds are permitted to accumulate for longer periods of time, the advantages of saving in a tax-favored vehicle increase relative to saving in a taxable vehicle. Thus, after funds have accumulated for a certain number of years, the recapture tax will recoup only a portion of the tax advantages provided with respect to the funds, and as the accumulation period increases, the recouped portion decreases. Concomitantly, the minimum distribution rules limit the ability of individuals to defer the receipt of retirement savings beyond retirement or to transfer such tax-favored accumulations to succeeding generations.

The elimination of capital gain and ten-year averaging treatment for lump sum distributions would not subject individuals using their tax-favored benefits for retirement purposes to significant adverse tax effects. Except to the extent precluded under the minimum distribution rules, an individual receiving a large distribution from a tax-favored plan could still avoid a large tax liability by rolling over some or all of such benefits to an IRA or other qualified plan. This would be consistent with the basic objective of promoting tax-favored distributions over an individual's entire retirement period. Also, even though the relative advantages of ten-year averaging treatment may be greater for smaller lump sum distributions, it is important that the tax rules not create incentives for individuals, particularly lower-paid individuals, to divert tax-favored funds from the retirement income stream before retirement.

The proposed modifications to the calculation of the exclusion ratio applicable to distributions after the annuity starting date would assure that an individual (or his estate or heirs) would receive the individual's after-tax investment in the plan without additional tax. Also, the modifications would assure that an individual who outlives his life expectancy would not receive significant amounts in excess of his after-tax investment without tax. Finally, the use of standardized recovery periods would simplify the calculation and application of the exclusion ratio by taxpayers and would facilitate the administration and enforcement of such rules by the Internal Revenue Service.

MODIFY DEDUCTION RULES FOR TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.03

Current Law

In general, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of employees. Moreover, income on amounts set aside by an employer to fund deferred compensation is generally taxable to the employer as earned. Exceptions to these general rules are provided for deferred compensation provided under the various types of tax-favored plans. Thus, within certain limits, employer contributions to such plans are currently deductible by the employer even though employees will not be taxable until they receive distributions from the plans. In addition, the income earned on assets held in a tax-favored plan is not subject to tax while it remains in the plan.

An employer's deduction for contributions to a tax-favored plan is subject to two separate limitations. The first applies on an individual-by-individual basis and covers contributions to defined contribution plans (i.e., profit-sharing, stock bonus, and money purchase pension plans), defined benefit plans, and combinations of the two. The second limitation applies plan by plan and is based on the total contributions for the group of employees covered by the particular plan. This group-based limitation applies to pension plans (i.e., money purchase pension plans and defined benefit pension plans), profit-sharing and stock bonus plans, and combinations thereof.

The individual-by-individual limitation is as follows: (i) the contributions and other additions on behalf of an individual under a defined contribution plan for a year may not exceed the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation for the year; (ii) the contribution to a defined benefit plan to fund an individual's annual retirement benefit may not exceed the contribution necessary, under reasonable actuarial methods, to fund an annual retirement benefit of $90,000 (indexed beginning in 1988); and (iii) the total contributions with respect to an individual covered by both a defined contribution plan and a defined benefit plan may not exceed a particular percentage (less than 100 percent, and dependent on the individual's compensation) of the sum of the two preceding limits. In addition to being nondeductible, contributions in excess of these limits may also trigger disqualification of the plan.

The group-based limitation applies different limits to pension plans and to profit-sharing and stock bonus plans. An employer's deduction for contributions to a pension plan is subject to limitations based on the minimum funding standards applicable to pension plans and on certain other actuarial determinations. An employer's deduction for contributions to a profit-sharing or stock bonus plan is limited to 15 percent of the aggregate compensation paid during the taxable year to all employees in the plan. A carryforward of the unused portion of the 15 percent limit to a succeeding year is permitted, subject to an overall 25 percent of aggregate compensation limit for the succeeding year. Excess contributions may be carried forward and deducted in a succeeding year, subject to the 15 percent of compensation limit for such year.

If an employer contributes to both a pension plan and a profit-sharing or stock bonus plan, the total deduction for a year is limited to the greater of (i) 25 percent of the aggregate compensation paid during the year to the employees covered by the plans, or (ii) the amount of contribution to the pension plan necessary to satisfy the minimum funding standards for such year. An employer may carry forward excess contributions to a succeeding year, but the deduction of current and carryforward contributions for any year is limited to 25 percent of compensation paid for such year.

The group-based deduction limitation also provides special rules with respect to the deductibility of contributions to employee stock ownership plans ("ESOPs"), which in general are profit-sharing, stock bonus, or money purchase pension plans that invest primarily in employer securities. Contributions to an ESOP to repay principal and interest on a loan incurred by the ESOP for the purpose of buying employer securities may be deductible even though they are in excess of the generally applicable limits. In addition, an employer may be allowed a tax credit in lieu of a deduction for contributions to an ESOP for up to 0.5 percent of the aggregate compensation paid during the year to employees under the ESOP. This tax credit is scheduled to expire at the end of 1987.

Reasons for Change

The limitations on an employer's deduction for qualified plan contributions are intended to restrict the tax-favored treatment associated with such plans for individual employees to amounts necessary to provide a reasonable level of retirement income security. Amounts in excess of these limitations are presumptively in excess of the amounts necessary to provide reasonable benefits and should not be eligible for tax advantages.

The current group-based limitation on deductible plan contributions is intended to be more restrictive for contributions to plans that may be used to finance current consumption or otherwise serve nonretirement purposes. Thus, employer deductions for contributions to profit-sharing and stock bonus plans have been subject to greater restrictions, since, unlike pension plans, profit-sharing and stock bonus plans are not subject to minimum funding requirements and generally are more liberal in permitting pre-retirement distributions.

Although profit-sharing and stock bonus plans are thus appropriately subject to greater limitations than pension plans, the current 15 percent of aggregate compensation limit on the deductibility of contributions to profit-sharing and stock bonus plans is not fully effective in restricting the use of these plans. The effectiveness of the 15 percent limit is undermined by the carryforward rules and, in certain situations, the ability of employers to contribute more than 15 percent of compensation for highly paid individuals and less than 15 percent for lower-paid individuals.

In addition, the 25 percent of aggregate compensation deduction limit applies only to combinations of profit-sharing or stock bonus plans and pension plans, rather than to combinations of defined contribution plans and defined benefit pension plans. As a result, an employer may make contributions to a money purchase pension plan and a defined benefit pension plan without regard to the 25 percent of aggregate compensation limit, even though money purchase pension plans are essentially equivalent to profit-sharing and stock bonus plans in that the benefit provided under each is based entirely on the individual's account balance at the time of retirement.

The special tax treatment of ESOPs cannot be justified on retirement policy grounds. ESOPs are not primarily retirement plans, but rather are aimed at promoting employee ownership of employer stock and at facilitating employers in raising capital.

Proposals

The 15 percent of aggregate compensation limit on deductions for contributions to profit-sharing and stock bonus plans would be eliminated. The current annual limit on the deductibility of the contributions for any individual in a defined contribution plan would be modified so that the contributions to a profit-sharing or stock bonus plan for any individual could not exceed 15 percent of such individual's compensation for the year. Contributions in excess of this limit would be deductible in a succeeding year subject to the 15 percent of compensation limit for that year.

Under the 15 percent of individual compensation deduction limit, a carryforward of an unused limit to a succeeding year would generally be prohibited. There would be an exception to this general rule, however, for employer contributions with respect to a "retirement-type" profit-sharing plan. Under the exception, there would be a carryforward of any unused portion of the 15 percent deduction limit with respect to a participant from one year to a subsequent year only if the profit-sharing plan is a "retirement-type" plan with respect to such participant for each year during the period beginning ten years before the year in which the unused limit arose through the year to which the unused limit is to be carried forward. In any case, the deduction limit with respect to a participant for any year, i.e., the sum of the new deduction limit plus the unused limit carried forward from any prior year, could not exceed 25 percent of the individual's compensation for such year.

For purposes of this rule, a profit-sharing plan would be treated as a "retirement-type" plan with respect to an individual for a year only if the following conditions are satisfied for such year: (1) the individual is an active participant under the plan; (2) the individual is not a participant in any other qualified profit-sharing or stock bonus plan maintained by the employer; (3) contributions on behalf of the individual are based on a contribution or allocation formula using a reasonable year-of-service factor; (4) employer-derived benefits attributable to the year and to any other year for which the plan was a "retirement-type" plan are not available, either by distribution or loan, before separation from service, death, or disability; and (5) the plan is not top-heavy.

The 25 percent of aggregate compensation limit on deductions for total contributions to combinations of pension plans and profit-sharing or stock bonus plans would be modified by applying the limit to combinations of defined contribution plans and defined benefit plans. Thus, if an employer maintains a money purchase pension plan and a defined benefit pension plan, the employer's deduction for total contributions to both plans would be limited to the greater of (1) 25 percent of the aggregate compensation paid to the employees covered by the plans, or (2) the amount necessary to satisfy the minimum funding standard for the defined benefit plan.

An excess contribution to a tax-favored plan would generally not trigger plan disqualification, but rather would be subject to an annual tax of ten percent for the year of contribution and for as long as the excess contribution both remained in the plan and was nondeductible.

The special rules for ESOPs--the tax credit and the special deduction limits for ESOP contributions to repay principal and interest on securities acquisition loans--would be eliminated. Thus, the deductibility of contributions to a tax-favored plan designed to invest primarily in employer securities would be governed by the generally applicable deduction limits. See Ch. 12.06.

Effective Date

The proposals generally would be effective for years beginning on or after January 1, 1986. A special rule would permit an employer to deduct contributions to a retirement-type profit-sharing or stock bonus plan for the benefit of an individual in excess of the 15 percent of individual compensation limit where annual contributions of less than 15 percent had been made on behalf of such individual before the effective date. In addition, a special rule would permit the deduction of excess contributions carried forward from years before the effective date.

The repeal of the special deduction limits for ESOP contributions to repay securities acquisition loans would not be effective with respect to ESOP contributions to repay principal and pay interest on securities acquisition loans outstanding on December 31, 1985. Securities acquisition loans outstanding on December 31, 1985 that are renegotiated, extended, renewed, or revised on or after that date generally would be treated as new loans made on the date of modification. In addition, the tax credit for contributions to ESOPs would be permitted to expire as scheduled at the end of 1987.

Analysis

The annual ten percent tax on accumulated excess contributions is intended to offset the advantage of tax-free accumulation to which excess contributions are currently entitled. The tax would parallel the tax currently applicable to excess contributions to a tax-sheltered annuity contract or custodial account, individual retirement account or simplified employee pension, except that it would apply to the year of contribution without regard to whether the excess contributions were distributed within any specified period.

The 15 percent of individual compensation deduction limit on contributions to profit-sharing and stock bonus plans is intended to be a more effective limitation on such plans where they are not designed as retirement plans, which is generally the case. However, the special carryforward rule recognizes that profit-sharing and stock bonus plans may be designed to function as retirement plans and, where this is the case, a 15 percent lifetime limit is more appropriate than a 15 percent annual limit.

MODIFY ANNUAL LIMITS ON CONTRIBUTIONS AND BENEFITS UNDER TAX-FAVORED PLANS

General Explanation

Chapter 14.04

Current Law

Current law provides favorable tax treatment to funds set aside in employer-maintained plans that satisfy certain qualification requirements. Among the qualification requirements applicable to such plans are restrictions on the annual contributions and benefits that may be provided with respect to any individual under the defined contribution plans and defined benefit plans of an employer. For this purpose, defined contribution plans generally include profit-sharing, stock bonus, money purchase pension, and annuity plans, tax-sheltered annuities, and simplified employee pensions. Defined benefit plans for this purpose are limited to defined benefit pension plans. Separate annual limits apply to each individual in a defined contribution plan and to each individual in a defined benefit plan ("separate plan limits"). An "overall limit" also applies to each individual covered by both a defined contribution plan and a defined benefit plan.

The separate plan limit for a defined contribution plan provides generally that the annual contributions, forfeitures, and other additions for any individual may not exceed the lesser of $30,000 (indexed for inflation beginning in 1988) or 25 percent of the individual's compensation for such year. In determining whether the applicable limit is satisfied with respect to an individual for a year, the lesser of (i) one-half of the employee contributions for the year or (ii) the excess of the employee contributions for the year over six percent of the individual's compensation for the year are treated as annual additions.

Special rules permit the employees of certain tax-exempt organizations, such as educational institutions, hospitals, and churches, to benefit from contributions and other additions to tax-sheltered annuities in excess of the general defined contribution plan limits. Similarly, special limits applicable to employee stock ownership plans (ESOPs) permit contributions to exceed the general limits for defined contribution plans.

The separate plan limit for a defined benefit plan provides that the benefit payable with respect to an individual for a year, when expressed as an annual retirement benefit, may not exceed the lesser of $90,000 (indexed for inflation beginning in 1988) or 100 percent of the average of the individual's highest three years of compensation. The defined benefit limit is not violated if the annual benefit payable to an individual who has never participated in a defined contribution plan is not in excess of $10,000. If an individual has less than ten years of service with an employer, the $90,000, the 100 percent of compensation, and the $10,000 annual benefit limits are reduced on a pro rata basis.

The overall limit coordinates the contributions and benefits that may be provided to an individual covered by both a defined contribution plan and a defined benefit plan. Calculation of the overall limit is complex, requiring that the sum of the defined contribution fraction and the defined benefit fraction for any individual subject to the separate plan dollar limits for any year not exceed 1.25. For an individual who is subject to the separate plan percentage-of-compensation limits, rather than the dollar limits, the sum of the fractions may not exceed 1.4. The numerator of an individual's defined contribution fraction is the aggregate additions made on behalf of the individual under the plan during all years of the individual's participation, and the denominator is the sum of each of the separate defined contribution plan limits that applied, or would have applied, for each of the individual's years of service with the employer. The defined benefit fraction is the individual's accrued annual retirement benefit over the applicable separate defined benefit plan limit for the year.

In the case of a "top-heavy" plan, i.e., a plan under which more than 60 percent of the total accrued benefits are for key employees (five percent owners, one percent owners with $150,000 in compensation, the ten employees with the largest ownership interests, and officers), the 1.25 limit on the sum of the defined contribution and defined benefit fractions for key employees subject to the separate plan dollar limits is reduced to 1.0. If, however, accrued benefits for the key employees are not greater than 90 percent of the total accrued benefits under the plan and if the non-key employees are provided with the required additional minimum contributions or benefits, the overall limit for key employees subject to the dollar limits is increased from 1.0 to 1.25.

Reasons for Change

The separate plan and overall limits on annual contributions and benefits reflect a policy that favorable tax treatment should be available only up to levels needed for reasonable retirement savings. The limits under current law, however, are unnecessarily complex and fail to limit the use of tax-favored plans in a consistent or equitable manner.

Calculation of the overall limit imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored plans.

The overall limit also creates a disincentive for employers to establish both defined contribution and defined benefit plans, since the aggregate contributions and benefits for an individual may not exceed a particular percentage (less than 100 percent, and dependent on the individual's compensation) of the sum of the separate plan limits. In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally; younger, more mobile employees tend to be favored by defined contribution plans, while older employees, particularly those close to retirement, generally are favored by defined benefit plans.

The effectiveness of the current limits is undermined by the inconsistency in their application. The separate and overall limits fail to take into account benefits under such tax-favored plans as individual retirement accounts (IRAs). In addition, certain individuals (e.g., participants in tax-sheltered annuities and ESOP participants) are permitted to receive annual contributions and benefits in excess of the generally applicable limits. Moreover, the limits consider only the contributions and benefits provided to an individual by a single employer; individuals who have accrued tax-favored benefits with more than one employer may receive total contributions and benefits far in excess of the existing limits. Finally, the limits do not effectively restrict the tax-favored benefits (as compared to the tax-favored contributions) that may be provided to an individual under a defined contribution plan.

In addition, the current limits fail to count all employee contributions and thus disregard the tax advantages such contributions receive. Although not deductible, employee contributions to a tax-favored plan may accumulate income on a tax-deferred basis. Also, highly-paid individuals generally are in a better position to take disproportionate advantage of the tax benefits for employee contributions.

Finally, the phase-in of the annual defined benefit limits over an individual's first ten years of service with an employer fails to preclude the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement. Because such a key employee generally will have in excess of ten years of service with the employer, the employee may be provided with a benefit under the defined benefit plan up to the full, unreduced annual limit. By delaying the establishment of the plan, however, the employer is able to avoid providing benefits to non-key employees who may have worked for the employer in earlier years.

Proposals

The overall limit on the annual contributions and benefits that may be provided to an individual under a defined contribution plan and a defined benefit plan of an employer would be eliminated. For top-heavy plans, however, the existing overall limits would continue to apply.

An additional tax would be applied to taxable, tax-favored benefits distributed to or with respect to a participant from all plans, including IRAs and tax-sheltered annuities, to recapture some portion of the tax advantages provided with respect to annual benefits in excess of reasonable levels. The recapture tax would be ten percent of the amount by which such annual benefits exceed 1.25 times the defined benefit dollar limit in effect for the year. The tax would be nondeductible for income tax purposes, and losses, deductions, and credits would not be applicable against the tax. Finally, the ten percent tax on excess annual distributions would be coordinated with the 20 percent recapture tax on early distributions (see Ch. 14.02) so that the same amounts are not subject to both recapture taxes.

In determining whether the separate plan limit for an employee in a defined contribution plan is satisfied, one-half of all employee contributions would be treated as annual additions on behalf of the employee. In addition, the special limits for employees of certain tax-exempt organizations participating in tax-sheltered annuities and for employees participating in ESOPs would be eliminated.

Finally, the phase-in of the separate defined benefit plan limit over ten years of service with the employer would be modified by providing for a phase-in of the $90,000 annual defined benefit dollar limit over the first ten years of plan participation. A minimum annual benefit would be permitted, however, for low-paid employees near retirement with significant years of service at the time plan participation commences.

Effective Dates

The modifications to the annual limits on contributions and benefits would apply to plan limitation years beginning on or after January 1, 1986. For collectively bargained plans, these modifications would apply to limitation years beginning after termination of the collective bargaining contract. The ten percent recapture tax on annual distributions in excess of the applicable dollar amount would apply to tax-favored distributions made on or after January 1, 1986, in taxable years of individual recipients beginning on or after such date.

The phase-in of the defined benefit dollar limit over an employee's first ten years of plan participation would itself be phased in according to the following schedule: for limitation years beginning in calendar year 1986, the applicable limit would be determined by applying a two years of participation phase-in rule; for years beginning in 1987, a three years of participation phase-in would apply; and so forth until for years beginning on or after January 1, 1994, the applicable dollar limit would be determined under a ten years of participation rule.

Analysis

Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus should promote the adoption of tax-favored plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans.

The ten percent tax on annual tax-favored distributions in excess of 1.25 times the applicable defined benefit dollar limit for the year is an appropriate limit on an individual's annual tax-favored retirement benefits. This tax is not designed as a penalty, but rather to recapture a portion of the tax advantages provided to excess benefits, without requiring significant employer involvement and without encouraging employers to maintain only one type of plan. By applying at the individual level, rather than on an employer-by-employer basis, the recapture tax also would apply to individuals who accrue excess benefits from multiple employers, without imposing significant administrative burden; the current limits fail to prevent a doubling up of benefits through multiple employers. For example, if in 1986 an individual receives total tax-favored retirement benefits of $200,000 from any number of employers, the excess of the $200,000 over $112,500, or $87,500, would be subject to the ten percent tax.

Of course, unless required to take a distribution into income by the minimum distribution rules, an individual may avoid the ten percent recapture tax on an excess distribution by rolling over some or all of such distribution to an IRA or qualified plan.

APPLY TEN PERCENT RECAPTURE TAX TO QUALIFIED PLAN ASSETS REVERTING TO EMPLOYER

General Explanation

Chapter 14.05

Current Law

As a general rule, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of the employee. Moreover, income from amounts set aside to fund deferred compensation is fully taxable to the employer as it is earned. Current law provides exceptions to these general rules for employer contributions to defined benefit plans. Thus, within certain limits, employer contributions to defined benefit plans are currently deductible, even though employees are not taxable until they receive distributions from the plan. In addition, income generated from plan assets is exempt from tax until distributed by the plan. These tax advantages are intended to encourage the creation of qualified plans and thus to improve the retirement income security of employees.

Current law requires employers to fund defined benefit plans on a "going concern," rather than a "termination," basis; i.e., employers must fund not merely benefits already accrued, but also some portion of the plan's projected benefits. Current minimum funding standards also provide that experience gains (e.g., better-than-expected claims or earnings experience) may not be taken into account in a single year for purposes of determining required contributions, but rather must be amortized over a fifteen-year period. As a result of these funding standards, and because employers may also receive a deduction for certain plan contributions in excess of minimum funding requirements, the funds in a defined benefit plan at any particular time may exceed the amount necessary to fund benefits accrued as of such time.

Although current law generally prohibits the use of plan assets by the employer, upon termination of a plan the employer may receive plan assets in excess of those necessary to fund fixed and contingent benefits as of the date of termination. Plan assets that revert to the employer upon termination generally are included in the employer's gross income.

Reasons for Change

Current law permits employers to gain unintended tax advantages by receiving tax-favored assets on plan termination. Although plan assets reverting to the employer are includable in its income, the employer retains the benefit of an initial deduction and of tax-deferral on the plan's income. As assets accumulate over longer periods of time in tax-favored plans, the value of these tax advantages becomes quite substantial. Such tax-favored treatment is inappropriate where plan assets are not used to provide retirement benefits to employees.

The problem is not limited to the situation where an employer intentionally overfunds and later terminates a defined benefit plan to gain the tax-favored funds. It also includes the situation where an employer, for independent business reasons, terminates a defined benefit plan that has become overfunded solely due to the performance of the plan's investments. In both situations, the employer is receiving the benefit of tax advantages that should be available only for retirement purposes.

The use of defined benefit plans for nonretirement purposes is evidenced in a number of recent cases in which employers have undertaken transactions that effectively permit the employer to receive assets from a defined benefit plan while continuing to maintain a defined benefit plan for its employees. These transactions are inconsistent with the minimum funding standards for qualified defined benefit plans and may undermine the security of the promised benefits in the continuing plans. The Treasury Department, along with the Labor Department and the Pension Benefit Guaranty Corporation, has issued current law guidelines regarding these transactions; these guidelines should effectively guard against many of the potential abuses related to plan terminations. However, because the guidelines are issued within the confines of existing administrative authority, they do nothing to recapture any portion of the tax advantages provided to defined benefit plan funds when such funds revert to the employer.

Proposal

An excise tax of ten percent of the plan funds reverting to the employer upon plan termination would be imposed on such employer to recapture some portion of the tax advantages provided with respect to such funds. This tax would be nondeductible for income tax purposes, and could not be offset by losses or other deductions or credits.

Effective Date

The ten percent recapture tax would apply to qualified plan assets reverting to an employer pursuant to a plan termination occurring on or after January 1, 1986.

Analysis

The recapture tax on plan assets reverting to an employer would parallel the tax on early distributions to individuals from tax-favored plans. Thus, it is designed not as a penalty on asset reversions, but rather to recapture a portion of the substantial tax advantages provided with respect to a terminating plan's assets when such assets are not used to provide benefits under the plan. Under the minimum funding rules currently applicable to defined benefit plans, an employer is effectively able to gain the benefit of excess plan assets by reducing its plan contributions over a five to ten year period. This approach, however, does not enable the employer to gain currently the benefit of the tax advantages provided with respect to plan assets, is fully consistent with the "going concern" approach of the funding standards, and does not create special risks about the security of employees' future retirement benefits.

REVISE CASH OR DEFERRED ARRANGEMENT (SECTION 401(K)) AND EMPLOYER MATCHING CONTRIBUTION RULES

General Explanation

Chapter 14.06

Current Law

Cash or Deferred Arrangements. In general, employees are subject to tax not only on compensation actually received, but also on amounts the receipt of which is, at the employee's election, deferred until a later year. An exception to this rule of constructive receipt is provided for so-called cash or deferred arrangements ("CODAs"), under which an employee may elect to defer the receipt of cash compensation and have the deferred amount contributed as an "elective contribution" to a qualified profit-sharing or stock bonus plan. If the CODA meets certain qualification requirements, the employee is not currently taxable on his or her elective contributions.

A taxable employer may maintain a qualified profit-sharing plan and thus may maintain a CODA. Congress has not directly addressed these questions, however, with respect to either tax-exempt employers or public sector employers, such as states or local governments.

A CODA is qualified if (1) the elective contributions are wholly nonforfeitable immediately upon contribution; (2) the elective contributions may not be distributable before the earlier of age 59-1/2, hardship, separation from service, disability, or death; (3) the employees eligible to make elective contributions under the CODA satisfy the coverage requirements generally applicable to qualified plans; and (4) the elective contributions satisfy the "actual deferral percentage test" (the "ADP test").

Under the coverage requirements generally applicable to qualified plans, the maximum year-of-service condition for eligibility to make elective contributions under a CODA is three years of service. Also, such coverage rules require that the employees eligible to make elective contributions under a CODA constitute either (1) at least 70 percent of all nonexcluded employees who have satisfied the applicable age and service conditions, or (2) a classification of nonexcluded employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. Excluded employees are those employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are nonresident aliens without U.S. earned income.

The ADP test is satisfied for a year if either (1) the ADP for the "highly compensated employees" for the year is not more than 150 percent of the ADP for all other eligible employees, or (2) the ADP for the "highly compensated employees" is not more than 250 percent of the ADP for all other eligible employees and is not more than 3 percentage points greater than the ADP for all other eligible employees. The ADP for a group of employees for a year is the average of the separate deferral ratios for each employee in the group; an employee's deferral ratio for a year is the ratio of the employee's elective contributions for the year to the employee's compensation for the year. For purposes of the ADP test, "highly compensated employees" are those employees who are more highly compensated than two-thirds of all employees eligible to make elective contributions under the CODA.

Elective contributions to CODAs are treated as employer contributions for purposes of applying the annual contribution and benefit limits that apply generally to tax-favored defined contribution plans. Thus, if allowed under the ADP test, the maximum elective contribution to a CODA on behalf of any employee who does not participate in another tax-favored plan is the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation.

Employer Matching Contributions. An employer may coordinate its own contributions to a tax-favored plan with either after-tax employee contributions to such plan or with elective contributions under a CODA that is part of such plan. Employee contributions that are a condition of an employer-provided contribution or benefit are labeled "mandatory contributions," and employer contributions that are geared to either mandatory employee contributions or mandatory elective contributions are "employer matching contributions."

Employer contributions to a tax-favored plan must satisfy the general nondiscrimination rule, which generally requires that contributions or benefits under the plan not discriminate in favor of employees who are officers, shareholders, or highly compensated (the prohibited group members). This rule is normally satisfied if the employer contributions on behalf of employees are a uniform percentage of the employees' compensation. Under certain circumstances, employer contributions may satisfy this general rule, even though they are not a uniform percentage of compensation, because the plan takes the employer's social security contributions into account or because such contributions actuarially produce nondiscriminatory benefits. There is significant uncertainty, however, regarding the application of the general nondiscrimination rules to employer matching contributions.

Nonelective employer contributions (including employer matching contributions) on behalf of an employee under a plan containing a CODA may be treated as elective contributions for purposes of determining the deferral ratio for such employee if the nonelective contributions are wholly nonforfeitable upon contribution and are subject to the distribution rules applicable to elective contributions. Thus, such nonelective contributions may be combined with elective contributions under a CODA to determine whether the elective contributions satisfy the ADP test. Such nonelective contributions, however, still must separately satisfy the general nondiscrimination rule.

Reasons for Change

The tax-favored treatment made available to employer-maintained and individual plans should be directed primarily at enhancing retirement income security. Consistent with this policy, the ability to make elective contributions to tax-favored plans should be available to individuals on a broad and consistent basis.

An elective contribution under a CODA has the same economic and tax effect for the employee as a deductible contribution by the employee to an individual retirement account ("IRA"). Despite this equivalence, the limits on elective contributions under a CODA are far more liberal than the IRA contribution limits. Current law thus provides tax advantages to employees of employers maintaining CODAs that substantially exceed those available to other individuals.

Some greater liberality in the limitations on CODA contributions is appropriate because of the effectiveness of CODAs in encouraging employees to save for retirement. The most important CODA feature is flexibility: employees need not make elective contributions unless their own financial circumstances permit. A higher annual limit on elective contributions facilitates this flexibility by enabling employees to catch up in a subsequent year for not having made elective contributions in an earlier year. Many employers make employer matching contributions with respect to elective contributions, thereby further enhancing employee participation. The availability of plan loans, distributions upon hardship or separation from service, and numerous investment options also add to the relative attractiveness of CODAs. Finally, some claim that employers that would not otherwise adopt tax-favored plans are adopting CODAs.

If liberal CODA contribution limits are to be justified because of the effectiveness of CODAs in encouraging employee retirement saving, such limits should be applicable only to the extent elective contributions actually are made by broad cross-sections of employees on a nondiscriminatory basis; nondiscriminatory availability alone is insufficient to justify more favorable treatment. The existing CODA rules, however, permit employers to exclude many employees from eligibility, and permit excessive disparity between the elective contributions by highly compensated employees and the elective contributions by other eligible employees.

In addition, because the ADP test applies on an average basis and treats a broad category of employees as "highly compensated" (e.g., surveys indicate that the compensation breakpoint between the "highly compensated employees" and other eligible employees often is less than $30,000), it is not uncommon for certain very highly paid employees to make elective contributions far in excess of the maximum ADP permitted for highly compensated employees generally. Although employee participation at the lower and middle income levels may be greater in CODAs than in IRAs, the disparity in contributions and benefits in favor of the highly paid employees generally is greater in CODAs than in other defined contribution plans. This disparity can be reduced without affecting the most important feature of CODAs, i.e., employee flexibility.

Tax-exempt employers and public sector employers each have access to their own tax-favored elective contribution plans for retirement savings. Tax-exempt employers may offer their employees tax-sheltered annuities and public sector employers may permit employees to make elective deferrals under eligible State deferred compensaton plans (see Ch. 14.10) and, in some cases, to tax-sheltered annuities; coordination rules are provided for public sector employees who participate in both types of tax-favored elective deferral arrangements. Thus, the extension of CODAs to tax-exempt and public employers would be inappropriately duplicative.

Employers should be encouraged to make employer matching contributions for employees on a fully nonforfeitable basis and subject to the CODA distribution restrictions. In addition, the application of the general nondiscrimination rules to employer matching contributions should be clarified. Uncertainty about the applicable rules hinders some employers in fully utilizing plans with employer matching contributions and permits other employers to provide excessive contributions and benefits for highly paid employees. As is the case with other tax-favored contributions to and benefits in employer-maintained plans, it is important to assure that employer matching contributions are actually being provided to broad cross-sections of employees on a nondiscriminatory basis. Employers should not be permitted to design plans using employer matching contributions as mechanisms to deliver disproportionate tax-favored benefits to highly paid employees. Accordingly, appropriate nondiscrimination rules should be applied to employer matching contributions.

Proposals

CODA (401(k)) Rules. The rules governing CODAs would be modified so that an employee's elective contributions for a year would be limited to $8,000. Elective contributions would continue to count as employer contributions against the annual contribution and benefit limits for tax-favored plans.

Deductible IRA contributions by an individual for a year would count against the dollar limit on elective contributions under a CODA by such individual for the plan year beginning in the calendar year to which the IRA contributions relate. Thus, if an individual with $20,000 in compensation makes a $2,000 IRA contribution for 1987, the dollar limit on the CODA contributions by such individual for the plan year beginning in 1987 would be reduced by $2,000.

The ADP test for CODAs would be modified in a number of ways. First, the prohibited group members in applying the ADP test for a year would not be the "highly compensated employees" of current law, but rather those employees who, at any time during the three year period ending on the last day of the year in question, meet any one of the following descriptions: (1) owners of one percent or more of the employer (under appropriate attribution rules); (2) employees receiving at least $50,000 in annual compensation; (3) employees who were among the top ten percent of employees by compensation or who were among the highest three employees by compensation, but not if they received less than $20,000 in annual compensation; or (4) family members of a prohibited group member with respect to such year. It would be appropriate to provide for the automatic expansion or contraction of the ten percent and highest three classes in category (3) based on certain objective characteristics, such as the salary structure of an employer's workforce, and to contract the highest three class for very small employers. It may also be appropriate to adjust the three year lookback period where there has been a significant change in the size of an employer's workforce. Finally, the $50,000 and $20,000 dollar amounts would be indexed for inflation.

Second, the ADP test would be satisfied only if no prohibited group member had a deferral ratio in excess of the greater of the following two amounts: (1) 125 percent of the ADP for the non-prohibited group eligible employees, or (2) the lesser of 200 percent of the ADP for the other eligible employees or the ADP for the other eligible employees plus two percentage points. In calculating the deferral ratio for a prohibited group member, only the first $200,000 of compensation would be considered.

Third, if the deferral ratio for any prohibited group member for a year exceeded the applicable limit for such year, the excess elective contributions would be treated as nondeductible employer contributions subject to the ten percent tax on contributions in excess of the applicable deduction limits. Thus, excess elective contributions would not be deductible by the employer in the year paid and would be subject to an annual tax of ten percent for the year of contribution. See Ch. 14.03. Also, excess elective contributions (and any earnings attributable thereto) would have to be distributed by the end of the plan year following the plan year to which the contributions related. Such a required distribution would not be treated as violating the distribution restrictions applicable to elective contributions or to qualified plans generally. Also, a required distribution would be exempt from the early distribution recapture tax applicable to tax-favored plan. See Ch. 14.02. If excess elective contributions and related earnings are not distributed by the end of the applicable plan year, the CODA would cease to be qualified as of the plan year to which the excess contributions related.

A special nondiscriminatory eligibility test would be applied to CODAs. Under this test, the ratio of prohibited group members eligible to make elective contributions under the CODA to the total prohibited group members could not exceed 125 percent of the analogous ratio for the other employees. In applying this test, employees with less than one year of service, employees who have not attained age 21, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income would be disregarded. See Ch. 14.09.

For purposes of applying the ADP test, CODAs covering a common prohibited group member would be treated as a single CODA.

A CODA would be precluded from requiring, as a condition of eligibility, employees to complete more than one year of service.

The CODA distribution restrictions would be modified to preclude distributions of amounts attributable to elective contributions before the employee's death, disability, or separation from service, or plan termination.

An employer would be prohibited from conditioning, either directly or indirectly, contributions and benefits (other than employer matching contributions) to employees' elective contributions under a CODA.

Finally, CODAs would be available only to taxable employers. Tax-exempt and public sector employers would be precluded from maintaining CODAs.

Employer Matching Contributions. Special nondiscrimination rules would be applied to employer matching contributions in lieu of the general nondiscrimination rules. Employer matching contributions that (1) are wholly nonforfeitable upon contribution, (2) may not be distributed from the plan prior to the employee's death, disability, or separation from service, or plan termination, and (3) are not in excess of 100 percent of the employees' mandatory contributions would be required to satisfy the ADP test as if such contributions were elective contributions. If the employer matching contributions were tied to elective contributions under a CODA, the matching contributions would be combined with the elective contributions for purposes of determining whether both the elective contributions and the matching contributions satisfied the ADP test.

If the employer matching contributions were (1) not wholly nonforfeitable upon contribution, (2) distributable before the employee's death, disability, or separation from service, or plan termination, or (3) in excess of 100 percent of the employees' mandatory contributions, the matching contributions would be required to satisfy the ADP test as though they were elective contributions. For this purpose, however, the deferral ratio for each prohibited group member would be limited to the greater of the following two amounts: (1) 110 percent of the ADP for the non-prohibited group members, or (2) the lesser of 150 percent of the ADP for the non-prohibited group members or the ADP for the non-prohibited group members plus one percentage point.

If employer matching contributions under a plan for any individual for a year were in excess of the applicable limit for such year, the excess matching contributions would be treated in the same fashion as excess elective contributions to a CODA. Thus, such excess matching contributions would not be deductible by the employer for the year of contribution and would be subject to a ten percent tax for the year of contribution. See Ch. 14.03. Also, excess matching contributions (and any earnings attributable thereto) would have to be distributed by the end of the plan year following the plan year to which the contributions related. This is the case without regard to whether the excess matching contributions were vested upon contribution. A required distribution of excess matching contributions and related earnings would not be treated as violating any applicable distribution restrictions. Also, such a required distribution would be exempt from the early distribution recapture tax applicable to tax-favored plans. See Ch. 14.02. If excess matching contributions and related earnings are not distributed by the required date, the plan will cease to be qualified as of the plan year to which the contributions related.

Effective Dates

The proposals relating to CODAs and employer matching contributions would apply to plan years beginning on or after January 1, 1986. For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collective bargaining agreement.

However, an employee's accrued benefit under a CODA as of the last day of the first plan year ending on or after December 31, 1985 would continue to be subject to the current law distribution limits on elective contributions.

Analysis

The following table illustrates the proposed modifications to the nondiscrimination rules for CODAs (i.e., fully vested and nondistributable elective contributions and employer matching contributions) and for other employer matching contributions. Note that the percentage limits set forth below under current law and under the proposals refer to the employees' compensation, and that the current law CODA limits apply to the average of the elective deferrals by the highly compensated employees, whereas the proposed limits apply to each prohibited group member's deferral ratio.

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Table 14.06-1

Current and Proposed Nondiscrimination Limits for CODAs and Other Employer Matching Contributions

(In Percent)

Base ADP for Non-Prohibited Group	Current Maximum CODA ADP for High-Paid Group	Proposed Maximum CODA Deferral Ratio for Each Prohibited Group Member	Proposed Maximum Non-CODA Matching Contribution for Each Prohibited Group Member
1	2.5	2.00	1.5
2	5.0	4.00	3.0
3	6.0	5.00	4.0
4	7.0	6.00	5.0
5	8.0	7.00	6.0
6	9.0	8.00	7.0
7	10.5	9.00	8.0
8	12.0	10.00	9.0
9	13.5	11.25	10.0
10	15.0	12.50	11.0
11	16.5	13.75	12.1
12	18.0	15.00	13.2

Office of the Secretary of the Treasury May 28, 1985

The proposals would reduce the currently excessive disparity permitted between the elective contributions of the prohibited group members and the elective contributions of the other employees. However, the proposals would still authorize some disparity, which is appropriate to permit prohibited group members near retirement to make larger contributions. Also, by more narrowly defining the "prohibited group," the proposals would generally enhance employee flexibility in CODAs.

As the table reflects, under the proposals, there would be a significant difference between the maximum elective and matching deferrals permitted under a CODA for prohibited group members and the maximum employer matching contributions that may be provided to prohibited group members without satisfying the vesting and distribution rules for CODAs. This difference in maximums is necessary to encourage employers to make employer matching contributions that comply with the CODA vesting and distribution requirements.

MODIFY RULES FOR BENEFIT FORFEITURES

General Explanation

Chapter 14.07

Current Law

Tax-favored treatment is provided with respect to funds set aside in employer-maintained plans that satisfy certain qualification requirements. Among these requirements is one providing that benefits under a money purchase pension plan that are forfeited upon the employee's separation from service for the employer maintaining the plan may not be used to increase the benefits any other employee would receive under the plan. The forfeited amounts must be used to reduce future employer contributions to the plan or to offset plan administrative expenses. Forfeited benefits under a profit-sharing or stock bonus plan may be reallocated to the remaining participants and thus may be used to increase the benefits that the participants would otherwise receive.

Reasons for Change

Uniform rules governing the treatment of forfeitures should be applied to all qualified plans. Also, because forfeitures are treated as contributions and other additions for purposes of the annual limits on contributions, permitting pension plans to reallocate forfeitures among plan participants generally will benefit rank-and-file employees, and not merely highly compensated employees.

Proposal

Qualified money purchase pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits that other employees would otherwise receive under the plan.

Effective Date

The proposal would apply to plan years ending on or after January 1, 1986.

Analysis

Under the proposal, a qualified money purchase pension plan could provide that forfeited benefits will be used to reduce future employer contributions or to offset administrative expenses, or that forfeitures will be reallocated among the remaining participants.

MODIFY LOAN RULES FOR
TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.08

Current Law

Generally, if an employee or beneficiary in a qualified profit-sharing, pension, stock bonus, or annuity plan or a tax-sheltered annuity receives any amount as a loan, such amount is treated as having been received as a taxable distribution. An exception to this general rule provides that a loan shall not be treated as a taxable distribution to the extent that the loan (when added to the outstanding balance of all other loans from such plan) does not exceed the lesser of two amounts: (1) $50,000, or (2) the greater of $10,000 or one-half of the employee's accrued benefit under the plan. This exception is available, however, only for a loan that is required to be repaid within five years or, if the loan proceeds are used to acquire or improve the principal residence of the employee or a member of the employee's family, is required to be repaid within a reasonable time.

Reasons for Change

The rules governing the tax treatment of loans from certain tax-favored plans are aimed at limiting the extent to which an employee may currently use assets held by a plan for nonretirement purposes and at assuring that loans are actually repaid within a reasonable period. However, there is concern that the current rules do not prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third-parties.

In addition, the current rule permitting home loans with repayment periods extending beyond five years for family members of the employee and for certain improvements on existing principal residences is overly broad and difficult to apply. The rule's breadth effectively eliminates the application of the five year limit in many situations for which a five-year rule is appropriate. The favorable tax treatment for amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and any exceptions to this general policy should be narrowly limited.

Proposals

The exception to the general rule for loans less than a specified amount would be modified so that the $50,000 limit is reduced by the highest outstanding loan balance owed by the employee to the plan during the prior twelve months. Thus, the exception as modified would provide that a loan would be treated as a taxable distribution only to the extent that the loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of the following two amounts: (1) $50,000, reduced by the highest outstanding loan balance owed by the employee to the plan during the prior twelve months, or (2) the greater of $10,000 or one-half of the employee's accrued benefit under the plan.

The special rule for home loans would be available only for the first-time purchase of a principal residence by and for the employee. Plan loans to improve an existing principal residence, to purchase a second home, and to finance the purchase of a home or home improvements for other members of the employee's family would be subject to the five year repayment rule.

Effective Date

The modifications to the rules governing the tax treatment of loans from certain tax-favored plans would apply with respect to all amounts received as a loan on or after January 1, 1986. Loans outstanding on January 1, 1986 that are renegotiated, extended, renewed, or revised on or after that date generally would be treated as loans made on the date of modification.

Analysis

Under the proposed limit on plan loans, an employee who borrowed $50,000 from a qualified plan on January 1, 1986, and repaid the full principal, with interest, on December 31, 1990, would be precluded from borrowing additional amounts from the plan on a nontaxable basis until 1992. Thus, employees would generally not be able to maintain permanent $50,000 outstanding loans from plans through the use of balloon payments and short-term bridge loans.

Most employees, however, repay plan loans on a regular basis, often by payroll deduction. These employees generally would not be affected by the proposed modification. For example, assume an employee borrows $50,000 from a qualified plan on January 1, 1986, and commits to repaying the principal in equal monthly installments over a five-year period ($833.33 per month, plus interest). During the first year of repayment, the employee would not be able to make a second, nontaxable loan. However, at the end of the second year, $10,000 would be available for loan on a nontaxable basis. At the end of the fifth year of repayment, $40,000 would be available. And in 1992, the full $50,000 would again be available as a nontaxable loan.

MODIFY NONDISCRIMINATORY COVERAGE TEST FOR TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.09

Current Law

A profit-sharing, stock bonus, pension, or annuity plan must be nondiscriminatory in coverage in order to qualify for favorable treatment. More specifically, such qualified plans must provide benefits to a group meeting one of the following descriptions: (1) at least 70 percent of all the nonexcludable employees who have satisfied the maximum age and service conditions; (2) at least 80 percent of all eligible employees, but only if at least 70 percent of the nonexcludable employees who have satisfied the maximum age and service conditions are eligible; or (3) a classification of nonexcludable employees that is not discriminatory in favor of employees who are officers, shareholders, or highly compensated. For purposes of this rule, excludable employees are those employees who are covered by a collective bargaining agreement and nonresident aliens without U.S. earned income. The maximum service condition for a plan is one year of service for the employer (or, if employees are fully vested on employer-derived benefits immediately upon accrual, three years of service), and the maximum age condition is age 21.

Neither the Congress nor the Internal Revenue Service has attempted to define in a detailed way the classes of individuals--i.e., officers, shareholders, and highly compensated employees--in whose favor discrimination is prohibited (the "prohibited group"). Moreover, no objective standards have been established for determining whether coverage is based on a nondiscriminatory classification. Instead, these issues, i.e., whether an employee is a shareholder, an officer, or highly compensated, and whether any particular classification of covered employees is nondiscriminatory, have been left for resolution on the basis of the facts and circumstances in each particular case.

The existing facts and circumstances approach to the classification test requires that the class of covered employees be nondiscriminatory both on its face and in actual operation. In determining whether a classification discriminates in operation, there may be a "reasonable difference" between (1) the ratio of the prohibited group members covered under a plan to the total prohibited group members employed by the employer and (2) the ratio of the other employees covered under the plan to the total non-prohibited group employees of the employer. The comparison of these ratios, however, is only one of the factors to be considered in testing whether a classification is nondiscriminatory.

Reasons for Change

The basic rationale for the tax-favored treatment afforded qualified plans is that such plans, in providing for the retirement security of individual employees or groups of employees, contribute to the national goal of providing security for all retired workers. Thus, tax incentives for qualified plans harness the initiative and energy of the private sector to meet responsibilities that might otherwise fall upon government and government-funded programs. If this use of the tax system is to be justified, however, coverage under qualified plans must be made available on the broadest possible basis. Absent such broad coverage, qualified plans are less an instrument of national retirement policy than a form of tax-preferred investment for a limited class of taxpayers.

The nondiscriminatory coverage test of current law fails adequately to assure that the tax advantages of qualified plans are available only where coverage is provided on a broad, nondiscriminatory basis. Under the current facts and circumstances approach, employers are left with substantial uncertainty concerning whether their plans qualify. As a consequence, some employers will apply relatively strict standards to ensure qualification. Others, however, take the lack of certainty as permitting an agressive approach to coverage issues. The result is a patchwork of employee coverage patterns, ranging from plans that cover a broad cross-section of employees at all income levels to plans that focus benefits on the highly compensated. Such inconsistent coverage is unfair to individual employees and fails to condition tax-favored treatment on broad, nondiscriminatory coverage.

In order that qualified plan coverage be provided on the broadest possible basis, it is important not only that nondiscrimination tests provide greater certainty, but also that such tests prevent coverage that disproportionately favors the highly compensated. Current administrative rulings have made possible arguments that, for example, a plan may satisfy the nondiscriminatory classification test so long as a high percentage of an employer's employees is in the middle- and lower-income groups and a meaningful percentage (e.g., 40 percent) of these employee groups is covered, even though the plan may cover 100 percent of the employer's prohibited group members. To prevent discriminatory coverage, it is appropriate that the coverage ratios for prohibited and for non-prohibited group members not vary by a substantial margin. Such requirement, if combined with a procedure for case by case review of plans presenting special circumstances, would ensure that tax-favored treatment be limited to plans that serve the national policy of providing retirement security on a broad, nondiscriminatory basis.

Proposals

A profit-sharing, stock bonus, pension, or annuity plan would be required to satisfy a nondiscriminatory coverage test as a condition of tax qualification. Under this test, the percentage of the employer's prohibited group members benefiting under the plan would not be permitted to exceed 125 percent of the percentage of the employer's other employees benefiting under the plan. Employees in a class of excludable employees would be disregarded in applying this 125 percent test if the plan does not benefit any employee in such class.

An employee would be treated as a prohibited group member with respect to a plan year if, at any time during the three year period ending on the last day of the plan year, the employee met any one of the following descriptions: (1) an owner of one percent or more of the employer (under appropriate attribution rules); (2) an employee receiving at least $50,000 in annual compensation; (3) an employee who is among the top ten percent of employees by compensation or who is among the highest three employees by compensation, but not if he or she received less than $20,000 in annual compensation; or (4) a family member of another prohibited group member with respect to such year. It would be appropriate to provide for the automatic expansion or contraction of the ten percent and highest three classes in category (3) based on certain objective characteristics, such as the salary structure of an employer's workforce, and to contract the highest three class for very small employers. It may also be appropriate to adjust the three year lookback period where there has been a significant change in the size of an employer's workforce. Finally, the $50,000 and $20,000 dollar amounts would be indexed for inflation.

In applying the 125 percent coverage test, the following classes of employees would be treated as excludable: (1) employees with less than one year of service (or, if benefits are vested immediately on accrual and the plan does not contain a cash or deferred arrangement (see Ch. 14.06), two years of service); (2) employees who have not attained age 21; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens with no U.S. earned income.

In very limited situations where compelling business reasons indicate that application of the 125 percent test would not be appropriate (e.g., for a limited period following a merger or acquisition of businesses), an employer would be permitted to obtain a timely ruling from the Internal Revenue Service that the employer's plan satisfies the nondiscriminatory coverage test even though it fails to satisfy the 125 percent test. The Internal Revenue Service would be permitted to apply any reasonable conditions on the continued validity of such a ruling.

In addition, any classification of employees used by a plan for participation purposes would be required to be nondiscriminatory on its face. For example, except to the extent permitted under the rules permitting integration with social security, it would be impermissible for a plan to provide that only employees earning more than $45,000 in compensation will be covered, even if the plan otherwise satisfies the 125 percent coverage test. A plan requiring an employee contribution as a condition of participation or excluding employees in a bona fide job category from participation would generally not be deemed to be discriminatory on its face.

For purposes of applying this nondiscriminatory coverage test, plans covering a common prohibited group member would be treated as a single plan.

Effective Date

The proposed nondiscriminatory coverage test would apply to plan years beginning on or after January 1, 1987. For collectively bargained plans, the test would not apply to plan years beginning before the termination of the collective bargaining agreement.

Analysis

The proposed 125 percent coverage test would assure that a plan claiming favorable tax treatment actually provides benefits to a nondiscriminatory classification of employees. The test would require some qualified plans to provide benefits to additional numbers of non-prohibited group employees. Without changes to the plans' benefit formulas, this would tend to increase the costs of these plans. However, because these increased costs would be attributable to expanded plan coverage, the costs would be justified as furthering the fundamental objective of providing benefits to broad cross-sections of employees on a nondiscriminatory basis. In addition, a plan could offset any resulting increased costs by reducing the benefits provided to all employees for future years of service or by reducing the coverage of prohibited group members.

Application of the 125 percent coverage test is illustrated by the following example. Assume that an employer has 100 nonexcludable employees, 20 of whom are prohibited group members with respect to a plan year. Assume further that 60 of the 80 non-prohibited group employees are covered under the plan (i.e., 75 percent), and that 12 of the covered non-prohibited group employees do not actually receive benefits under the plan because the plan is properly integrated with social security. Under the proposed test, the percentage of the 20 prohibited group members who benefit under the plan would not be permitted to exceed 125 percent of the percentage of the non-prohibited group employees who benefit under the plan; sixty non-prohibited group employees benefit under the plan for this purpose. Thus, if more than 18 of the prohibited group members (1.25 x (60/80) x 20, or 18.75) benefitted under the plan, it would not satisfy the test.

The 125 percent test would not be an appropriate test in certain limited situations. For example, assume that an employer maintaining a qualified plan acquires another company during a plan year and the acquired company did not maintain a qualified plan for its employees. It thus may be appropriate to treat the acquiring company's qualified plan, if it satisfied the 125 percent test before the acquisition, as satisfying the nondiscriminatory coverage test for a limited period after the acquisition to permit the post-acquisition employer to redesign the qualified plan or to establish a new plan to satisfy the

125 percent test. Of course, during the limited period, the acquiring company's plan would be required to satisfy any reasonable conditions that the Internal Revenue Service may impose as part of the timely ruling, such as that the plan satisfy the nondiscriminatory coverage test by reference to the entire post-acquisition company with a more liberal percentage (e.g., 150 percent) substituted for 125 percent.

Finally, consideration would be given to adoption of a rule precluding the exclusion of employees or any group of employees in the absence of a bona fide business purpose, in order to prevent an employer from excluding, by design, the maximum number of non-prohibited group members that can be excluded without failing the 125 percent test.

UNIFY RULES FOR UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS OF STATES AND TAX-EXEMPT EMPLOYERS

General Explanation

Chapter 14.10

Current Law

In general, employees are subject to tax not only on compensation actually received but also on amounts the receipt of which is, at the employee's election, deferred until a later year. The application of this general rule of constructive receipt to nonqualified and unfunded deferred compensation arrangements is modified for amounts deferred under either a "private deferred compensation plan" or an "eligible State deferred compensation plan." Neither of these plans is available to tax-exempt employers.

A "private deferred compensation plan" is a plan or arrangement maintained by a taxable employer under which the receipt of cash compensation is deferred, at an employee's election, on an unfunded basis. The taxable year of inclusion under these plans is to be determined in accordance with the applicable rules and judicial decisions in effect on February 1, 1978.

Under an "eligible State deferred compensation plan," an employee of a State who elects to defer the receipt of current compensation will be taxable on the deferred amounts (and on any income attributable thereto) when such amounts are paid or otherwise made available. In order to qualify as an eligible State plan, deferred amounts must remain, at all times until subsequently paid or made available, solely the property of the State, subject only to the claims of the State's general creditors. The maximum annual deferral under an eligible State plan is the lesser of (1) $7,500 or (2) 33-1/3 percent of the employee's compensation. The rules provide a special catch-up limit permitting higher deferrals for the three years immediately preceding an employee's normal retirement age. Amounts deferred by employees under tax-sheltered annuities are taken into account in applying these limits.

Amounts deferred by an employee under an eligible State plan may be automatically transferred to the eligible plan of another employer in which the employee becomes a participant if (1) the entities sponsoring the plans are located within the same State, (2) the transferee plan provides for the acceptance of the amounts, and (3) the transferor plan provides that if an employee separates from service in order to accept employment with another such entity, deferred amounts will be automatically transferred.

A deferral under an eligible State plan may not be made available to an employee before separation from service with the State or an unforeseeable emergency. In addition, distributions of amounts under an eligible plan must commence within 60 days after the later of two dates: (1) the close of the year in which the employee or former employee attains the normal retirement age, or (2) the close of the plan year in which the employee separates from service for the State. Distributions over the employee's lifetime must be projected to exceed 50 percent of the total benefits payable with respect to the employee and any beneficiaries. Finally, if the employee dies before his or her entire benefit is distributed, the remaining portion of the benefit must be distributed to the employee's beneficiary over (1) the life of the beneficiary (or shorter period), if the beneficiary is the employee's surviving spouse, or (2) a period not in excess of fifteen years.

If an unfunded State plan does not qualify as an eligible plan, a deferral is included in the employee's gross income when there is no longer a substantial risk of forfeiture of such amount (e.g., the employee's right to the deferred amount is no longer conditioned upon the future performance of substantial services).

Reasons for Change

Employees of tax-exempt employers should have access to nonqualified, unfunded deferred compensation arrangements on essentially the same basis as other employees. Current law denies such equal access by applying constructive receipt principles to employees of tax-exempt entities, while permitting deferral of tax for State employees and employees of taxable employers until actual receipt. As a consequence, employees of tax-exempt employers are at a relative disadvantage in providing for their retirement income security. Moreover, under current law, some employees of tax-exempt employers are deferring compensation on a nonqualified and unfunded basis without regard to either the general constructive receipt rule or the rules governing eligible plans. Application of specifically defined rules would ensure that employees of tax-exempt employers who do defer compensation on a nonqualified, unfunded basis receive comparable tax treatment.

Although employees of tax-exempt employers should have comparable access to nonqualified, unfunded deferred compensation arrangements, there are practical constraints on the use of such arrangements by taxable employers that would not similarly affect tax-exempt employers. A taxable employer's deduction for deferred amounts in a nonqualified arrangement is postponed until the employee includes the amounts in income. There is thus a tension between the tax treatment of a taxable employer and that of an employee which limits the amount of compensation the employer will permit an employee to defer. However, as is the case with States, tax-exempt employers are indifferent about the timing of the tax deduction for deferred compensation. Thus, in order that nonqualified, unfunded deferred compensation arrangements be available to all employees on roughly the same basis, it is appropriate to limit the amount of deferral for employees of tax-exempt employers as well as for public sector employees.

In addition, nonqualified and unfunded deferred compensation plans should not enable employees to defer the receipt of income indefinitely or to transfer deferred amounts to subsequent generations. Thus, certain modifications to the existing distribution rules applicable to eligible State plans should be made to assure that the employee, rather than the employee's beneficiaries, will receive a substantial portion of the deferred benefits over the employee's lifetime. Finally, certain of the existing restrictions on deferred compensation arrangements impose burdens that do not further the retirement security of employees.

Thus, the existing rules prohibit an employee from electing to receive deferred amounts before separation from service or an unforeseeable emergency even though the employee has decided to cease participation in the eligible plan and the deferred amounts are de minimis. In addition, the existing restrictions on transfers between eligible plans have the practical effect of forcing employees to receive their deferred amounts even though they are participating in an eligible plan maintained by another State.

Proposals

The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees, a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or a tax-exempt employer under an ineligible deferred compensation plan would be includable in the employee's gross income when there is no longer a substantial risk of forfeiture.

The expanded rules governing eligible deferred compensation plans generally would be consistent with the current rules applicable to States. However, certain modifications would be made to these rules in expanding them to cover both categories of employees.

The required distribution rules for benefits under eligible deferred compensation plans would be modified to require that (1) the benefits projected to be payable over the lifetime of the employee exceed 66-2/3 percent of the total benefits projected to be payable with respect to the employee; (2) if payments are to be made over a period extending beyond one year, payments be made on at least an annual and substantially nonincreasing basis; and (3) distributions of benefits to a beneficiary of an employee commence within one year following the employee's death.

A deferred compensation arrangement would not fail to be an eligible deferred compensation plan and amounts would not be treated as made available to an employee merely because, under the arrangement, an employee may at any time elect to receive, in a single sum within 60 days of the election, all amounts deferred for his or her benefit. However, this rule would apply with respect to an employee only if such employee's total deferred benefit is not in excess of $3,500 and the employee is no longer eligible to defer compensation with respect to the State or tax-exempt employer.

Finally, the applicable rules would be modified to permit the automatic transfer of deferred amounts between any two eligible plans, whether or not maintained within the same State, only if the following are satisfied with respect to both the transferor and transferee plans: (1) the plans provide for the acceptance of such automatic transfers with respect to all individuals who become employees of the employers maintaining the plans; and (2) the plans provide for the automatic transfer of deferred amounts with respect to all employees who separate from service and become employed for employers maintaining eligible plans that accept such transfers. Transfers not conforming to these conditions would be prohibited.

Effective Date

The application of the rules governing eligible State plans to the nonqualified and unfunded deferred compensation arrangements of tax-exempt employers, and the modifications to these rules for both States and tax-exempt employers, would apply to taxable years of individuals beginning on or after January 1, 1986.

Analysis

The expansion to tax-exempt employers of nonqualified, unfunded deferred compensation arrangements will permit their employees to provide for retirement security on the same basis as other employees, and would ensure uniform treatment of those employees of tax-exempt employers that may now be deferring compensation, without regard to constructive receipt principles or to the limits applicable to eligible State plans. The proposal would not, however, affect the treatment of a nonqualified deferred compensation plan under the labor provisions of the Employees Retirement Income Security Act of 1974.

The modifications to the rules currently applicable to eligible State plans are designed to target the permitted arrangements more specifically at retirement savings. Thus, the minimum distribution modifications would limit the ability of employees to defer benefits beyond retirement. Also, the modification to permit automatic benefit transfers between eligible plans in different States would enhance the portability of these deferred amounts and thus the likelihood that they will be received as retirement income.

CHAPTER 15

REFORM INTERNATIONAL TAXATION

The Administration proposals would retain the basic structure for taxing foreign income of U.S. taxpayers that has evolved since 1913. This structure is intended to cause foreign income to bear a fair share of U.S. tax in a manner that does not distort investment decisions; at the same time, special measures reflect concern for the international competitiveness of U.S. business. Thus, the general rule is that U.S. taxpayers are subject to U.S. tax on their worldwide income. A credit is allowed against U.S. tax for foreign income taxes paid in order to avoid double taxation of foreign income which has been taxed by the country where the income is earned. The special measures include the deferral of U.S. tax on income earned by U.S.-controlled foreign corporations until that income is remitted to U.S. shareholders. (Certain tax haven income is, however, taxed to the U.S. currently even though not repatriated.) In addition, the first $80,000 of foreign earned income of a qualifying U.S. citizen or resident whose tax home is in a foreign country is excluded from income subject to U.S. tax.

In reaching the decision to continue the worldwide taxation of U.S. taxpayers with allowance for foreign tax credits, the Administration considered and rejected the alternatives of exempting foreign source income from U.S. tax, or taxing foreign source income but only allowing a deduction for foreign taxes. While an exemption approach would in some circumstances facilitate overseas competition by U.S. business with competitors from countries that tax foreign income on a favored basis, such an approach also would favor foreign over U.S. investment in any case where the foreign country's effective tax rate was less than that of the United States. Moreover there would be a strong incentive to engage in offshore tax haven activity. The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions. Exempting foreign income from tax would favor foreign investment at the expense of U.S. investment. The other alternative, to allow only a deduction for foreign taxes, would not satisfy the objective of avoiding double taxation. Nor would it promote tax neutrality; it would be a serious disincentive to make foreign investments in countries where there is any foreign income tax.

The Administration proposals therefore would correct certain problems in the existing system of U.S. taxation of international transactions. When combined with the proposed reductions in tax rates, the net effect of the Administration proposals would be to reduce the U.S. tax burden on foreign income. By 1990, after the rate reductions are fully phased-in, the U.S. tax collections on foreign income would be $9.4 billion, compared with $11.4 billion if current law continued to apply. This 18 percent net reduction in U.S. tax on foreign income would enhance the overall competitiveness of U.S. business abroad.

The Administration strongly supports a foreign tax credit as the appropriate measure to avoid international double taxation. However, the existing overall foreign tax credit limitation allows high foreign taxes to be credited against U.S. tax on other low-taxed foreign income. This allows a high tax country's tax to be utilized to offset the residual U.S. tax that otherwise would be imposed with respect to low-taxed foreign income, and as a consequence favors foreign over U.S. investment. The Administration proposal to adopt a per-country limitation on the foreign tax credit would limit the foreign tax credit to its function of eliminating international double taxation of foreign income by restricting the ability to average foreign income subject to high and low foreign effective tax rates.

The other Administration proposals are intended to rationalize and improve existing law relating to the taxation of international t-ransactions. Certain income source rules and expense allocation rules would be modified to associate income more appropriately with the source of the underlying economic activity and associate interest expense with assets supported by the borrowing. The proposals relating to taxation of U.S. branches of foreign corporations, tax relationships with U.S. possessions and taxation of foreign exchange gains and losses represent important technical improvements to existing law. While a number of these changes could be made administratively under current law, it is appropriate to describe such proposals in conjunction with tax reform proposals requiring legislative amendments.

REFORM FOREIGN TAX CREDIT

General Explanation

Chapter 15.01

Current Law

Foreign Tax Credit Limitation

The United States taxes its citizens and residents, including U.S. corporations, on their worldwide income. To avoid international double taxation when the foreign income of a U.S. citizen, resident or corporation is taxed by a foreign country, the United States permits a taxpayer to elect to credit the foreign income taxes paid against his U.S. tax liability. The amount of foreign tax credit which may be claimed in any taxable year is limited to the U.S. tax otherwise imposed on foreign source income for that year. This limit is measured as the portion of U.S. tax, before credit, corresponding to the portion that foreign taxable income is of worldwide taxable income. The limitation is calculated on an overall basis; that is, the amount of credit potentially allowable is the aggregate of income taxes paid to all foreign countries, and foreign source taxable income is the aggregate of all taxable income from sources outside the United States. In effect, each taxpayer is allowed to average foreign effective tax rates above and below the U.S. rate. Only if the average foreign tax rate exceeds the U.S. tax rate are any potential credits denied. Potential credits that exceed the limitation in a particular year may be carried back two years and forward five years.

The foreign tax credit limitation is calculated separately for several different categories or baskets of income, including a passive interest income basket. The separate basket rules prevent taxpayers from averaging for foreign tax credit limitation purposes foreign tax rates on different classes of income that may be easily moved from one source to another or that are typically subject to lower aggregate foreign tax. Special limitations also apply in determining the amount of credit that can be claimed with respect to income derived from oil and gas related activities.

Indirect Credit for Foreign Taxes Paid by Foreign Subsidiaries

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. corporations are allowed to credit a share of taxes paid by foreign subsidiary corporations when the earnings of the subsidiary become subject to U.S. tax. This is called the "indirect" or "deemed paid" foreign tax credit. The share of foreign taxes paid by the foreign corporation for a taxable year that is eligible for the indirect credit is related to the share of that corporation's "accumulated profits" that is repatriated as a dividend to the U.S. parent corporation. Shareholders that are currently taxable under the provisions of subpart F on income of a controlled foreign corporation are also entitled to an indirect credit for the foreign taxes paid by that corporation. The share of taxes eligible for the indirect credit under subpart F is related to the share of "earnings and profits" of the controlled foreign corporation for the taxable year included in the shareholder's income. These taxes are subject to the limitation described above.

For purposes of computing the indirect credit with respect to an actual dividend distribution, distributions are treated as made out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year are generally treated as paid out of the prior year's accumulated profits. Foreign taxes paid are required to be associated with the accumulated profits to which they relate on a year by year basis. For purposes of computing the indirect credit with respect to a subpart F inclusion, taxpayers are required to associate foreign taxes with earnings and profits of the current year.

Accumulated profits as calculated for purposes of the indirect credit with respect to actual distributions and earnings and profits as calculated for purposes of the indirect credit with respect to subpart F inclusions may differ in several respects. For example, the subpart F rules require adjustment to U.S. financial and tax accounting principles to be made only if the adjustment is material. Differing foreign currency translation rules also apply as discussed in more detail in Ch. 15.04. Existing regulations permit, but do not require, a corporation to calculate accumulated profits and earnings and profits on the basis of the same accounting and tax adjustments although different currency translation rules are mandatory.

In calculating the indirect credit, dividends received are generally characterized as from foreign or domestic sources on the basis of the place of incorporation and other tax attributes of the corporation paying the dividend. Existing law also contains rules preventing the conversion of U.S. source income into foreign source income and interest income into non-interest income by routing that income through foreign affiliates.

Reasons for Change

Foreign Tax Credit Limitation

The purpose of the foreign tax credit is to relieve international double taxation of foreign income. Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income. Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.

The existing law prohibits averaging of foreign taxes on passive interest income, which is often exempt from foreign tax under foreign law or treaties or subject only to withholding tax at modest rates, with foreign taxes on other foreign income. Foreign tax on other types of passive income, including portfolio dividends, is permitted to be averaged with tax on active business income, even though this passive income may also be subject to foreign tax at low rates. The existing overall limitation also permits high foreign taxes in one country and low foreign taxes in a second country to be averaged in computing the available foreign tax credit. The deferral of U.S. tax on foreign subsidiary earnings until those earnings are repatriated allows taxpayers to control this averaging process by controlling the timing of foreign subsidiary dividend distributions.

The averaging of effective rates permitted under current law is undesirable for at least two reasons. First, the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries. For a taxpayer with excess foreign tax credits, low tax country investments may be more attractive than investments in the United States that generate a higher pre-tax economic return simply because of the possibility of using the excess credits to offset a portion of the U.S. tax otherwise due. In that way the effective rate of overall tax on the foreign investments can be reduced below the effective rate that would apply if the investment in the low tax country had been made in the United States. The overall limitation under current law thus causes economic decisions to be distorted purely for tax advantage.

This potential for distortion of economic decision making that results from the overall limitation exists at the U.S. tax rates prevailing under existing law. However, the incentives to invest in low tax countries may be more pronounced when U.S. corporate tax rates are greatly reduced under the tax reform proposal. The substantial proposed tax rate reduction will cause many more taxpayers to operate in an excess foreign tax credit position. The additional excess credits created by the proposed rate reduction will result in a significant opportunity for reducing a corporation's overall tax burden by making investments in low tax countries instead of the United States. A similar strong incentive will be created to generate averageable low tax passive income that is not subject to the existing separate basket rules and definitions.

A second problem is that the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment. Under an overall limitation system, a company with operations in a low tax country is able to invest in a high tax country without bearing the full burden of the high foreign tax. The overall limitation inappropriately requires the

U.S. Treasury to bear the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income. A neutral U.S. tax system would require U.S. corporations to bear the full burden of high foreign taxes rather than allowing these costs to be passed on to the U.S. Treasury and other taxpayers through the foreign tax credit mechanism. As a result of adopting a per country limitation, high tax countries may find it appropriate to reevaluate their rules for taxing U.S. capital. Such countries would have a stronger incentive to adopt lower taxes either unilaterally or through the treaty process.

It is impossible as a practical matter to eliminate all tax rate averaging by calculating the foreign tax credit on a transactional basis. Taxes are not ordinarily levied on such a basis and the technical complexity of such a system would make it unworkable. The question therefore becomes how much tax rate averaging to permit in the system and at what cost in terms of the complexities of compliance and enforcement.

At a minimum, passive and active income should be separated for credit purposes in order to prevent averaging of easily movable types of income that are generally taxed in different ways by most foreign countries. Calculating the foreign tax credit limitation on a per country basis would go further and prevent averaging between income from high tax and low tax countries. A separate basket, per country limitation would therefore provide as close a proxy as practically possible for a separate transaction type limitation calculation. Such a limitation would effectively restrict the foreign tax credit to its purpose of eliminating double taxation.

Indirect Credit

The requirement that accumulated profits and earnings and profits be associated with foreign taxes on an annual basis for purposes of the indirect credit can lead to seriously defective results. Where a subsidiary incurs a foreign loss under U.S. tax principles in a year in which it is required to pay foreign tax under foreign tax principles, an indirect foreign tax credit may not be available for the foreign tax paid. See Rev. Rul. 74-550, 1974-2 C.B. 209. On the other hand, taxpayers are sometimes able to accelerate or increase artificially the available credit simply by appropriately controlling the timing of receipt of income, payment of foreign tax, and distribution of earnings.

The different methods of computing accumulated profits and earnings and profits in calculating the indirect credit with respect to actual distributions and subpart F deemed distributions can cause very different foreign tax credit results to follow from a current distribution of non-subpart F earnings and a subpart F inclusion, even though the transactions may be economically equivalent. Taxpayers are free to accelerate credits by intentionally generating subpart F income (for example, by making a loan to a controlling U.S. shareholder) if the earnings and profits calculation results in a larger credit than would the accumulated profits calculation applicable to an actual distribution.

Proposal

Per Country Foreign Tax Credit Limitation

The amount of income tax paid to a foreign country which may be claimed as a foreign tax credit in any year will be limited to the U.S. tax on income from that country. The limitation with respect to each country will be a fraction of the total pre-credit U.S. tax equal to the ratio of taxable income from that country to worldwide taxable income. United States tax principles and rules for determining the source of income will apply for purposes of calculating the taxable income from individual countries.

The separate baskets of income defined under current law will be retained. The separate passive income basket, currently limited to passive interest income, will be broadened to include dividends received from companies in which the taxpayer owns less than a 10 percent interest and gains derived from the disposition of assets that generate passive income (other than *Corn Products* type assets). The Administration will continue to consider whether other types of easily movable income that are generally taxed abroad on a gross withholding basis should also be included in the passive income basket. Interest, rents and royalties received from subsidiaries or other affiliated corporations will be treated as active business income, however, and will not be included in the passive income basket.

Special Issues Under the Direct Credit

Sourcing of Income and Related Issues. Taxpayers will be required to calculate their income from sources within individual countries for purposes of computing the foreign tax credit. The source rule changes proposed in Ch. 15.02 are designed in part to facilitate such separate country sourcing.

Situations will arise, as they do under current law, in which the United States and the foreign country characterize income as being derived from different sources. For example, income received for architectural and engineering services performed in the United States but relating to foreign construction projects may be treated as taxable local source income by the foreign country, but will be treated as U.S. source income in the United States. Similarly, because of differing tax accounting rules, depreciation allowances, and other reasons, income may be taxable in a foreign country in taxable years either before or after the year in which income would be includible under U.S. tax principles. Without rules to minimize the effect of temporal mismatching of income and conflicting source rules, timing and sourcing differences could result in a permanent loss of credits.

Two changes in the operation of the credit will be made to help alleviate mismatching problems that arise or are made potentially more severe under a per country limitation. First, to reduce the consequences of temporal mismatching, the carryforward period for excess credits will be extended to ten years. A longer carryback period would arguably also be appropriate. However, because the carryback of excess credits creates serious administrative difficulties by requiring recomputation of past years' taxes, it is not practical to extend the carryback period beyond two years.

Second, to alleviate severe mismatching of income by source, taxpayers will be permitted to elect whether to deduct or to credit foreign taxes on a country by country basis. This will permit taxpayers to obtain a deduction for foreign taxes paid to a particular country even if they have no income, or a taxable loss, in that country under U.S. tax principles, without losing their ability to obtain a foreign tax credit for taxes paid to other countries. Such changes would not be necessary or acceptable under an overall limitation.

Allocation of Expenses. The expense allocation rules of existing law require only that expenses be divided between U.S. and foreign source income and do not require a separate country by country subdivision of the expenses allocated to foreign income. Under the proposal, expenses will be required to be allocated and apportioned to separate countries. Consideration will be given to applying simplified rules for allocating and apportioning expenses which otherwise would require asset based allocation.

Losses. Three alternative treatments of losses would be possible under a per country limitation. First, losses could be permitted to offset only other subsequent income from the loss country. Such a rule would lead to excessively harsh results if a loss operation in a foreign country were abandoned without recouping the losses. Second, losses could be permitted to offset only U.S. income, which would tend to transfer much of the economic risk of a foreign loss to the U.S. Treasury. There is, however, no reason to conclude that foreign losses should be more closely associated with U.S. income than with other income. Third, losses could offset a pro rata portion of all income, irrespective of source. The proposal adopts this third option by requiring that losses be spread to all income rather than simply reducing the tax on U.S. income. In the year a loss occurs, it would be prorated against income earned in all other countries (including the United States) and separate baskets in proportion to each separate country and separate basket share in that year's worldwide taxable income. The proration of losses in this manner would be required whether the taxpayer elected to deduct or credit the foreign taxes paid to the loss country for the year in question.

If the taxpayer earns income in the loss country in a subsequent year it will be re-sourced in proportion to the previous loss allocation. If the loss had the effect of increasing or creating excess foreign tax credits in a country the subsequent resourcing of income in that country will make additional credits available. If the loss proration had the effect of reducing the U.S. tax on either domestic or low taxed foreign income, resourcing the subsequent income should recapture the previously foregone tax.

As noted above, in applying these loss rules, the United States will be treated as any other country except that U.S. income will be treated as in a single basket. A share of any loss in a foreign country will be allocated to U.S. income and result in the reduction of U.S. tax liability. Similarly, a U.S. loss will be allocated to foreign income and prorated over all countries and baskets. Subsequently earned U.S. source income will be resourced in proportion to the initial loss proration.

Rules Relating to Oil and Gas Income. The limitations contained in existing section 907(a) on the creditable foreign tax imposed on oil and gas extraction income will be retained and applied on a separate country basis. After reducing the creditable tax in accordance with these rules, the ordinary rules for computing the foreign tax credit limitation, including the loss allocation rules, will be applied to taxpayers in the oil and gas industry. Accordingly, an extraction loss in one country would not reduce the creditable foreign extraction taxes paid to another country. However, a foreign oil and gas extraction loss in any country will be prorated against other income from that and other countries, including income from non-extraction activities, and be fully recaptured when income ultimately is earned in the loss country.

Rules for Applying a Per Country Limitation to the Indirect Credit

Under the proposal, foreign taxes would be matched as closely as possible with the foreign income to which they relate. Tracing income and taxes to the proper country and basket of income for purposes of the indirect credit under a multi-tiered corporate structure raises several issues.

Source of Dividend Distributions. The ordinary U.S. source rule for dividend income sources the dividend at the place of incorporation of the payor. Application of such a rule in calculating the indirect credit on a separate country basis would permit a taxpayer to use a foreign holding company to average high and low tax foreign source income from lower tier corporations, thereby avoiding the purpose of the per country limitation. Such averaging would not be permitted if the same income were earned either through a branch or as subpart F income. In order to preserve the integrity of the per country limitation, dividends from subsidiaries earning income in more than one country will ordinarily be required to be resourced for purposes of calculating the foreign tax credit limitation.

Dividends will be sourced for foreign tax credit purposes pro rata to the country or countries from which the payor corporation has derived the accumulated profits out of which the dividend is paid. Thus, if a subsidiary has derived 40 percent of its accumulated profits from country X and 60 percent of its accumulated profits from country Y, 40 percent of a dividend it pays will be sourced in country X and 60 percent of the dividend will be sourced in country Y. Taxpayers receiving dividends from subsidiaries which derive less than 10 percent of their accumulated profits from countries outside their country of incorporation may elect not to have a portion of those dividends resourced under these rules, provided no election is made to use the tax reallocation rules described below. Dividends paid out of profits accumulated prior to the effective date will be sourced in the distributing corporation's country of incorporation. The rules of existing section 904(g) for maintaining U.S. source will be retained.

Maintaining Separate Basket Character of Dividend Income. Dividends will also be required to be traced to separate baskets in proportion to the distributing corporation's accumulated profits derived from separate basket income under rules similar to those of current section 904(d). For example, if ten percent of a foreign subsidiary's accumulated profits are derived from passive basket income, ten percent of a dividend paid by that subsidiary will be treated as passive basket income in the hands of the shareholder. These rules will prevent taxpayers from using a multi-tiered structure to blend income in the various separate baskets. The rules will require corporations at each level of the corporate structure to maintain separate basket accounts in each country from which they derive income. Similar rules for maintaining the separate basket character of other payments to related parties attributable to separate basket income of the payor will be considered.

Interaction of the Indirect Credit with Subpart F. Under the provisions of subpart F, certain income of foreign corporations controlled by U.S. shareholders is taxed currently to those U.S. shareholders. A credit for the foreign taxes paid with respect to that income is allowed to the shareholder. When income that has been previously taxed under subpart F is subsequently distributed, it is not taxed a second time. These rules will be maintained under the proposal. Dividend distributions from foreign subsidiaries will be treated as having been paid first out of previously taxed subpart F income and will be excluded from the shareholder's gross income. Only the portion of any dividend that exceeds previously taxed income will be subject to the dividend resourcing and recharacterization rules described above. Rules of existing law allowing credits for withholding taxes on distributions of previously taxed income will be retained.

Allocation of Foreign Taxes to Income from Lower Corporate Tiers. Subject to the exceptions described below, taxes on net income paid to a foreign country will be treated for foreign tax credit limitation purposes as taxes of the country to which they are paid. Gross basis withholding taxes on dividends will be treated as if they had been paid to the country or countries in which the dividend income is resourced under the rules described above. Gross basis withholding taxes on non-dividend income such as interest, rents and royalties will be treated as paid to the country that imposes the tax.

Where a foreign subsidiary of a U.S. company is taxed on a worldwide net income basis in its country of residence and derives more than 10 percent of its income from sources outside of its country of residence, its dividend payments will be at least partially resourced under the rules described above. If taxes paid in the country of residence were not also resourced, mismatching of tax and income could occur in some circumstances. Accordingly, such taxpayers will be permitted to elect to treat a portion of a subsidiary's residence country tax as if it were paid to other countries in which the subsidiary derived income. The amount of foreign tax that may be reallocated in this manner will be calculated by (i) computing the ratio of total foreign income tax (excluding gross basis withholding tax) paid to all countries with respect to the distribution to the total distributed accumulated profits; (ii) multiplying the distributing subsidiary's distributed accumulated profits from sources in the residence country by that ratio; and (iii) subtracting the resulting amount from the total income tax (excluding withholding tax) paid to the residence country with respect to the distributed accumulated profits. The resulting amount will be reallocated to other countries in proportion to the subsidiary's accumulated profits from sources in those countries. However, no amount of residence country tax need be allocated to countries in which the effective tax rate on the distributed accumulated profits (calculated under U.S. principles) equals or exceeds the ratio computed in step (i) above.

Allocation of Foreign Subsidiary Expenses. Current law requires that expenses incurred by U.S. companies be allocated among separate baskets of income and between domestic and foreign source income in determining net foreign source taxable income for purposes of the foreign tax credit limitation calculation. The proposal would retain this requirement, modified as described above, to enable expenses to be allocated to specific foreign sources. Expenses incurred by foreign subsidiaries would also be required to be allocated among separate baskets of income and individual foreign countries. Consideration will be given to applying simplified rules for purposes of allocating foreign subsidiary expenses.

Other Changes to the Indirect Credit

For purposes of computing the indirect foreign tax credit, dividend distributions and subpart F inclusions will be deemed to be made from the pool of all of the distributing corporation's accumulated profits (or earnings and profits in the case of subpart F inclusions) rather than being related to accumulated profits (or earnings and profits) from any particular year. Earnings of the current year would be included in the relevant pool. The rule treating distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits would be repealed. A dividend or subpart F inclusion will similarly be deemed to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.

Accumulated profits will be required to be calculated in the same manner as earnings and profits. In general, the earnings and profits and accumulated profits computations will be required to be made under rules similar to those contained in the existing regulations under section 964. The rules for translating foreign currency contained in the existing section 964 regulations, however, will be modified as described in Ch. 15.04.

Effective Date

The proposals would be effective for taxable years beginning on or after January 1, 1986. A five year carryforward of excess foreign tax credits existing on the effective date would be permitted subject to an overall limitation. The ten year carryforward period contained in the proposal would apply only to excess credits generated after the effective date. Excess credits generated after the effective date would not be permitted to be carried back to pre-effective date years.

Pre-effective date overall losses would be required to be recaptured out of post-reform income. Each year until such losses are exhausted, taxpayers will determine the amount they would have been required to recapture under pre-effective date law. This amount of foreign income would be recharacterized as U.S. source. Rules would be prescribed to determine the countries from which this income would be deemed to have been taken.

The proposal to treat dividends as paid out of a pool of accumulated profits would apply only prospectively. Future dividends would be treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that accumulated pool of post-effective date earnings would be treated as paid out of pre-effective date accumulated profits under the ordering principles of existing law.

Analysis

The adoption of a per country foreign tax credit limitation will limit the ability of taxpayers to average low foreign taxes imposed in one country with high foreign taxes imposed in a second country in calculating the foreign tax credit. The broadening of the passive income basket will limit the ability of taxpayers to average foreign taxes on types of income typically taxed abroad at low or zero tax rates with foreign taxes on other types of income that are typically subject to higher aggregate foreign taxes. Rules for tracing source and character of income will preserve neutrality in the application of a per country limitation between foreign branches and foreign subsidiaries by preventing use of creative corporate structures to avoid the effect of the per country and separate basket rules.

By restricting the ability of taxpayers to average high and low foreign taxes, the proposed changes will limit the foreign tax credit to its function of eliminating international double taxation of foreign income. The changes will preserve the residual U.S. tax on lightly taxed foreign income while causing other countries to bear the full investment disincentive effects of their own high tax rates. The proposed changes would help to counteract the incentives otherwise created by the proposed reduction in U.S. tax rates for U.S. taxpayers to invest in low tax countries or foreign assets generating lightly taxed passive income. The proposed changes will not violate the provisions of existing United States tax treaties.

It is recognized that these appropriate results will be achieved only through imposition of significant new burdens on both taxpayers and the Internal Revenue Service. Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation. The recordkeeping burdens on taxpayers and auditing burdens on the IRS will be correspondingly increased.

The proposal attempts to minimize these burdens to the extent that can be done consistent with the purpose of the per country limitation. It contains a de minimis rule for resourcing dividends. Simplified expense allocation rules will be considered. The proposal also suggests extending the carryover period, permitting a separate country deduction election, and permitting tax reallocations on an elective basis to limit the potential harshness of the proposal. The Administration will continue to consider other methods of simplifying the credit calculation that are consistent with the objective of limiting the averaging of high and low foreign tax rates. In particular, the Administration will consider workable options for calculating the credit on a regional or integrated operation basis if that can be done in a manner consistent with the underlying rationale of the per country limitation. The Administration has not, however, yet been able to devise an integrated operation approach that both prevents inappropriate averaging and is significantly simpler than a per country approach. In the absence of a workable regional or integrated group proposal, the advantages of the per country limitation are believed to be important enough to warrant the additional complexity and recordkeeping burdens.

The proposed changes to the foreign tax credit other than the per country limitation proposal, i.e. the broadening of the passive income basket, making earnings and profits calculations consistent for all indirect credit purposes, and adopting a pooling approach to making the relevant earnings calculations under the indirect credit, all have independent merit. They would each make the foreign tax credit mechanism operate more consistently and without unintended harshness to taxpayers or unintended incentives for economically unjustified activities that serve only to increase or accelerate the available credits. Each of these proposals would be beneficial regardless of the method used to calculate the foreign tax credit.

MODIFY SOURCING RULES FOR INCOME AND DEDUCTIONS

General Explanation

Chapter 15.02

Current Law

Rules for defining the source of particular items of income serve two principal purposes. First, those rules define the scope of U.S. taxation of non-resident aliens and foreign corporations, particularly those that do not engage in a U.S. trade or business. Second, through the operation of the foreign tax credit mechanism, the source of income rules define the circumstances under which the United States is willing to concede primary jurisdiction to a foreign country to tax U.S. citizens and residents on income because that income is deemed to be earned in that foreign country. In the respects relevant to the proposals set forth below, existing rules for determining the source of income and the allocation and apportionment of related expenses are as follows:

Income Derived from Purchase and Resale of Property. Income derived from the purchase and resale of personal property, both tangible and intangible, is ordinarily sourced at the location where the sale occurs. The place of sale is generally deemed to be the place where title to the property passes to the purchaser.

Income Derived from Manufacture and Sale of Property. Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under existing regulations, half of such income generally is sourced on the basis of the location of the taxpayer's property, reflecting the place of manufacture, and half of the income is sourced on the basis of the place of sale (determined under the title passage test). The division of the income between manufacturing and selling components may be made on the basis of an independent factory price rather than on an arbitrary 50/50 basis if such a price exists.

Income Derived from License of Intangible Property. Royalty income derived from the license of intangible property generally is sourced by reference to the place where the licensed intangible property is used. For certain limited purposes income derived from the sale of intangible property for an amount contingent on the use of the intangible is also sourced as if it were royalty income.

Dividend Income. Dividend income is generally sourced at the place of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources, dividends paid by that corporation are treated as foreign source income.

Interest Income. Interest income is generally sourced on the basis of the residence of the payor. Under one exception to this rule, interest income received from a U.S. corporation which earns more than 80 percent of its income from foreign sources is treated as foreign source income. Certain other exceptions to the source rules applicable to interest income are designed as tax exemptions for limited classes of income earned by foreign persons.

Transportation Income. Under existing regulations income derived from providing transportation services generally is allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit to the territorial waters of the United States are treated as foreign expenses for purposes of this allocation. Special rules apply to income derived from coast-wise shipping and from transportation between the United States and its possessions. Income derived from the lease or disposition of vessels and aircraft that are constructed in the United States and leased to United States persons is treated as U.S. source income. Expenses, losses and deductions incurred in leasing such vessels and aircraft are also attributable to U.S. source income. These rules apply regardless of where the vessel or aircraft may be used.

Allocation and Apportionment of Interest Expense. The determination of taxable income (gross income less expenses) by source or activity requires that expenses be matched with the category of income in question. Under existing regulations, the allocation and apportionment of interest expense to income is based on the principle that money is fungible and that interest expense is attributable to all property of a taxpayer regardless of the specific purpose for incurring the obligation on which interest is paid. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable to attribute part of the cost of borrowing to such other purposes.

Under existing regulations, tax exempt income and assets generating tax exempt income are permitted to be taken into account in allocating deductible interest expense. Interest expense incurred by a related group of corporations that file a consolidated tax return is required to be allocated between domestic and foreign source income in computing foreign source taxable income and the foreign tax credit limitation. Under existing regulations, this allocation is made on a separate company basis, rather than on a consolidated group basis. Thus, a company within the consolidated group that incurs interest expense takes only its own assets and gross income into account in allocating the expense, rather than those of the entire consolidated group.

Reasons for Change

Source of Income

The following basic principles should be applied in formulating rules for determining the source of income. First, appropriate source of income rules should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earning of that income. Income derived from the use of property or capital ordinarily should be sourced where the property or capital is used. Second, the rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries. Unless there are sufficient reasons to the contrary, international norms for source of income determinations should be followed to the extent such norms exist. Third, the rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation. The rules should generally preserve the residence country's taxing right in cases where other countries typically do not assert a source basis claim to tax the income. Fourth, to the extent possible the rules should operate clearly and not require difficult factual determinations on a transaction by transaction basis. Clarity and ease of application would be even more important under the Administration proposal to calculate the foreign tax credit limitation on a per country basis because of the requirement that income be sourced to specific foreign countries.

Plainly, it will not be possible to fully satisfy each of these objectives in every case. Some balancing of the objectives is therefore necessary in reaching appropriate source rules. Existing rules for determining source of income are deficient in the following respects:

Sales Income. Under the existing title passage test, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating that income. Particularly where property manufactured in the United States is sold to a sales subsidiary abroad, half or more of the income from the sale may be treated as foreign source income even though only a negligible portion of the seller's relevant economic activity may occur outside the United States.

Because the place of title passage may be arbitrarily determined by affected taxpayers, the existing rule permits artificial manipulation of the foreign tax credit limitation and the U.S. tax base. Most foreign countries do not tax sales income merely because title passes in that country. (The United States would not tax such income in the reverse case solely because of U.S. title passage.) The existing U.S. source rule therefore surrenders U.S. primary taxing jurisdiction over sales in many situations where the income is not taxed abroad. Under the foreign tax credit limitation provisions, the zero foreign tax on such income may be averaged with foreign source income that is highly taxed by a foreign country. This averaging artificially increases the amount of the foreign taxes imposed by a high tax country that may be credited against U.S. tax liability and thereby permits the credit for the foreign tax to reduce U.S. tax otherwise due on income derived from what is essentially domestic economic activity.

Sales of Intangible Property. Income derived from the sale of intangible property generally is determined under a title passage test while income derived from the license of such property is determined by reference to the place where the property is used. Existing rules that treat sales and licenses similarly are limited in their scope. The economic distinction between a sale and a license of intangible property often is elusive. Clarity and uniformity of treatment would be served by applying the same source of income rules to all transactions involving intangible property. The title passage rule is no more satisfactory when applied to sales of intangible property than when it is applied to sales of tangible property. Moreover, the principal factor giving intangible property value is the legal protection afforded that property in the country where it is used, a factor arguing for a source rule based on the place of use in all transactions involving intangible property.

Dividend Income. The existing source rule applicable to dividend income focuses on the place of incorporation of the corporation distributing the dividend income. This rule, or a close variant of it focusing on the corporation's place of management, is followed in the tax systems of most countries. The rule is clear and easily applied and otherwise generally satisfies the characteristics of appropriate source rules.

The exception to this general rule for so-called 80-20 companies alters a sound, well accepted rule under circumstances where most foreign countries do not assert a competing source based claim to tax the income. Because foreign countries normally do not tax such dividends, the treatment of the 80-20 company dividend as foreign source may have the effect of making what would otherwise be excess foreign tax credits usable. This occurs despite the fact that a full foreign tax credit is available with respect to the foreign tax on the 80-20 corporation's operating income. Very often the result will be the total exemption of the 80-20 dividend from shareholder level tax either in the United States or in the country where the earnings were derived. Moreover, foreign taxpayers may be able to use an 80-20 holding company to convert distributions by U.S. operating subsidiaries into foreign source income and thereby avoid U.S. withholding tax on those distributions.

Interest Income. Just as with dividends, the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source based claims of foreign countries. The 80-20 rule for interest therefore gives rise to the same type of U.S. withholding tax avoidance and total U.S. and foreign tax exemption as does the dividend rule. Where it is desirable to provide a U.S. tax exemption for specific classes of interest income, that should be done directly rather than through modifications to the source rules.

<u>Transportation Income</u>. Under current rules, large portions of transportation services income are treated as earned in international waters or skies and outside the generally asserted source taxing jurisdiction of any country. Such income may therefore go totally untaxed as a result of the foreign tax credit mechanism. Section 861(e) modifies the general source rule for income and related expenses derived from U.S. produced vessels and aircraft leased to U.S. persons. The general source rule is abandoned solely to provide a very indirect subsidy for users of U.S. produced ships and aircraft by allocating losses on the lease of such ships and aircraft to the United States, so as to avoid a reduction in the foreign tax credit limitation. This subsidy is inappropriate in a system of neutral source rules. An appropriate source rule would reflect the economic activity generating the income.

Allocation and Apportionment of Interest Expense

The current regulation's treatment of a single taxpayer's interest expense under the fungibility approach generally apportions interest expense to income based on the relative value of assets used to generate the income. It also permits allocation on the basis of gross income provided the result does not depart too significantly from the result of an asset based allocation. It is inappropriate, however, to apply the fungibility concept on a separate company basis when a taxpayer is a member of an affiliated group and is included in a consolidated return. The separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by simply manipulating the location of borrowing within the consolidated group. This may result in an unwarranted increase in the amount of foreign tax credit available to a consolidated group of corporations.

The inclusion of tax-exempt interest and assets generating tax exempt interest in the allocation formula has similarly provided opportunities for artificial inflation of the foreign tax credit limitation. The inclusion of exempt U.S. source income and assets in the expense allocation increases the amount of expense allocated to U.S. source income even though the income generated is not subject to U.S. tax. The proposed change complements the Administration proposal to deny deductions to all taxpayers for interest incurred to carry tax-exempt obligations. The change in expense allocation rules would be justified, however, in the absence of a change in the rules relating to deductibility of the expense.

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Proposal

Source of Income

Source Rules Relating to Sales Income. Income derived from the sale of personal property is divided into three broad categories for purposes of determining source: (i) income from sales of inventory-type property in the ordinary course of business; (ii) income from sales of non-inventory property used in a trade or business; and (iii) income from sales of other personal property including personal financial property such as stocks, bonds and commodities contracts. Income derived from the purchase and resale of inventory-type goods will be sourced in the country of the taxpayer's residence. An exception to this general rule will apply if the seller maintains a fixed place of business located outside of its country of residence and that fixed place of business participates materially in the sale generating the income. In such a case, the income would be sourced in the country where the fixed place of business is located. However, all sales to a taxpayer's foreign subsidiaries and affiliates would be sourced at the seller's residence even if the seller maintains a fixed place of business in another country. A fixed place of business maintained by an independent distributor would not be attributed to the seller for purposes of this source rule. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income. The proposal modifies the original Treasury Department proposal by requiring only that a foreign fixed place of business participate materially in a sale, rather than conduct the predominant portion of the selling activity, in order to qualify for the exception to the residence based source rule. This change will make the source rule correspond to the principles of existing section 864(c)(4)(B)(iii) and will avoid disputes over the relative contribution to a sale of sales activity conducted in two places of business. It is believed that the Administration proposal will correlate the source of sales income with the location of the underlying selling activity much more closely than does existing law.

Similar changes would also be made in the rules for determining the source of income derived from the manufacture and sale of inventory-type products. The existing practice of sourcing an arbitrary percentage of such income on the basis of the place of manufacture would continue. The remaining portion of the income would be attributed to sales activity and would be sourced on the basis of the rules described in the preceding paragraph. The title passage test would be eliminated. Accordingly, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would be sourced in a foreign country unless the seller maintains a fixed place of business in that foreign country and that place of business participates materially in the sale. Similarly, the sale of property manufactured by the taxpayer in the United States to a foreign sales subsidiary or affiliate would generate no foreign source income. (The sales subsidiary's income would itself be foreign source and, assuming appropriate pricing, would represent the full return to selling activity.)

Current law arbitrarily divides income between manufacturing and sales activities on a 50/50 basis. It is probable that this division overallocates income to selling activity in many cases. The Administration will consider whether a fixed percentage allocation apportioning greater income to manufacturing activity would more appropriately be applied as a general rule to divide the income. The option of applying an independent factory price in allocating divided source income would be retained, however. The special manufacture-sale rules in the existing regulations relating to U.S. possessions would be eliminated and the rule described above would be applied to such sales.

Income derived from sales of personal property used by the taxpayer in its business (including Corn Products type property that would otherwise be passive investment property) would be sourced in the place where the property is used. Income derived from the sale of personal property not described above, including in particular gains derived from the sale of passive investment property such as stock, securities and commodity futures contracts, would be sourced on the basis of the taxpayer's residence.

Income Derived from Sales of Intangible Property. The rules relating to royalty income derived from licenses of intangible property will be retained in their present form. Source rules relating to sales of intangible property will be modified to correspond to the rules relating to licenses. Accordingly, income derived from the sale of intangible property, other than passive investment property, will be sourced on the basis of where the underlying property is to be used.

80-20 Corporation Rules Relating to Interest and Dividends. The 80-20 corporation exceptions to the general source rules applicable to dividend and interest income will be repealed. Thus, dividends received from a domestic corporation earning most of its income outside the United States will be sourced on the basis of the place of incorporation of the corporation paying the dividend. (See Ch. 15.03 for a proposal to repeal the interest and dividend source rules relating to foreign corporations that earn more than half of their income from U.S. sources and to replace those rules with a branch profits tax.) Interest income received from all U.S. residents and domestic corporations will be sourced on the basis of the residence of the payor without looking to the underlying source of the payor's income. Other provisions of the existing source rules relating to interest income that are designed to provide tax exemptions for particular activities will not be repealed but will be restructured as overt exemption provisions in the interest of establishing neutral source rules. Thus, for example, interest paid on deposits in U.S. banks will be treated as U.S. source income but will be exempt from tax if the interest is paid to a non-resident alien individual or foreign corporation and is not effectively connected with the conduct of a trade or business in the United States.

Transportation Income. Consideration will be given to modifications in the rules relating to transportation income in order to cause those rules to reflect more accurately the underlying economic activity, to more fully exercise U.S. taxing jurisdiction over income not taxed abroad, and to make those rules operate in a manner consistent with a per country foreign tax credit limitation. Specifically, more general application of the 50 percent convention applied to possessions related transportation income will be considered. The special source rule of section 861(e) relating to income derived from the lease or disposition of vessels and aircraft manufactured in the United States will be repealed.

Allocation of Interest Expense

Interest expense incurred by a corporation joining in filing a U.S. consolidated return will be required to be allocated to income from various sources on a consolidated group basis. The assets or gross income of all members of the consolidated group shall be aggregated for purposes of determining the percentage of interest expense to be allocated to foreign income. That percentage will then be applied to the interest expense of each member of the group in calculating the foreign tax credit under the consolidated return regulations. The separate company basis of allocation will be retained for taxpayers not filing a consolidated return.

Only deductible expenses are required to be allocated between foreign and domestic sources in calculating net taxable income from foreign sources. In order to reach the proper result when a portion of a taxpayer's interest expense is not deductible because it is incurred to carry tax exempt obligations, tax exempt interest income and assets generating tax exemp't interest income will not be considered in allocating interest expense to foreign source income for purposes of the foreign tax credit calculation.

Effective Dates

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. The modification of the source rule for interest income received from 80-20 corporations would be effective only with respect to interest paid on debt obligations incurred after January 1, 1986. The repeal of the section 861(e) source rule would not affect income derived by the taxpayer owning the asset on January 1, 1986, from the lease or disposition of ships or aircraft first leased by the taxpayer prior to January 1, 1986. Transitional rules applicable to the sales income source rules would be provided for sales made under unrelated party contracts entered into prior to January 1, 1986. The rules relating to the consideration for expense allocation purposes of tax-exempt interest and tax exempt obligations would not apply to obligations or income derived from obligations held by the taxpayer prior to January 1, 1986.

Analysis

The proposals would create a set of rules for determining the source of income that more clearly reflects the situs of relevant economic activity than do the existing rules. The proposals regarding the source of sales income and the source of interest and dividends paid by 80/20 companies would also limit the circumstances in which the United States cedes its primary tax jurisdiction by treating income that is not ordinarily taxed by foreign countries as foreign source income for U.S. tax purposes. These rules will therefore appropriately restrict the ability of U.S. taxpayers to average down high foreign tax rate income and to use foreign tax credits to offset U.S. tax on income derived from domestic economic activity. The source rule proposals are meritorious without reference to the Administration proposals regarding the foreign tax credit limitation. However, they also complement the proposed modifications of the foreign tax credit limitation and provide rules more suitable to separate country sourcing of income and to the computation of the foreign tax credit limitation on a per country basis.

It can be anticipated that under these proposals somewhat greater amounts of income of U.S. taxpayers derived from sales of products to destinations located outside the United States would be treated in the future as domestic source income. As a result some U.S. export activities would lose collateral foreign tax credit benefits if the exporting companies have excess foreign tax credits from their purely foreign activities. However, the United States should retain the primary taxing right over export income when the activities giving rise to the income are carried out in the United States and should not be granting foreign tax credits with respect to broad classes of income not generally taxed abroad. To the extent export subsidies are included in the tax law they should be overt and evenly applied.

REPLACE SECOND DIVIDEND AND INTEREST TAXES WITH BRANCH-LEVEL TAX

General Explanation

Chapter 15.03

Current Law

The effectively connected income of a U.S. branch of a foreign corporation is subject to U.S. income tax, but there is no additional tax, comparable to the withholding tax imposed on dividends paid by a U.S. subsidiary of a foreign corporation, on the branch's remittances to the home office. Instead, the United States imposes a withholding tax, known as the "second dividend tax," on a proportionate part of the dividends paid by the foreign corporation, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

There is also no tax, comparable to the withholding tax on interest paid to foreign persons by a U.S. subsidiary of a foreign corporation, on the interest paid to foreign persons on debt allocable to the branch. Instead, the United States imposes a withholding tax, known as the "second interest tax," on a proportionate part of the interest paid by the foreign corporation to foreign persons, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits, and, in addition, its foreign shareholders are subject to a withholding tax on the dividends which they receive (30 percent by statute, reduced to as little as five percent by treaty). No comparable tax, beyond the corporate tax, is imposed on the distributed profits of a U.S. branch of a foreign corporation. The "second dividend tax" is intended as the analogue to the dividend withholding tax, but it fails to equalize the tax treatment of branches and subsidiaries in many cases. The "second dividend tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the dividend withholding tax applies to all distributions of subsidiary profits. Moreover, the enforcement of this tax is very difficult. It is difficult to know when the tax is due and difficult to enforce its collection by a foreign corporation.

Foreign holders of debt of a U.S. corporation owned by nonresidents are subject to a tax on the interest which they receive (30 percent by statute, unless reduced or eliminated by treaty), although for debt issued after July 18, 1984 this tax applies to a limited class of interest. No comparable tax is imposed on the interest paid on debt allocable to the branch. The "second interest tax" is intended as the analogue to the interest withholding tax, but it also fails to equalize the treatment of branches and subsidiaries in many cases. Like the "second dividend tax," the "second interest tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the interest withholding tax applies generally to all interest paid by the subsidiary (except where the interest is exempt by statute or treaty). The "second interest tax" suffers from the same enforcement problems as the "second dividend tax."

Proposal

The "second dividend tax" and "second interest tax" would be repealed and replaced by an additional tax on the profits of U.S. branches of foreign corporations and on interest on (i) debt issued by a foreign corporation to an affiliate which is allocable to a U.S. branch of the corporation and (ii) extensions of credit by a foreign bank to a foreign corporation which is allocable to a U.S. branch of the corporation. The branch-level tax would place the branch of a foreign corporation on a more comparable footing with a U.S. subsidiary of a foreign corporation.

The profits subject to the tax would be defined so as to approximate the distributed profits of a U.S. subsidiary. The taxable income of the branch as shown on its U.S. corporate tax return would be reduced by the U.S. corporate tax before foreign tax credits and by further adjustment to reflect reinvestment of profits in the branch. To adjust for such reinvestment, increases in net investment in the branch, for both fixed and working capital, would be deducted from the after-corporate tax branch profits and increases in net liabilities incurred for such reinvestment would be added to such profits. The addition of increases in net liabilities to taxable profits would ensure that branches could not decrease their branch-level tax through the purchase of assets with debt rather than reinvested earnings. A deficit in taxable profits could not be carried forward or back to other taxable years.

Since the branch-level tax would in part replace the "second interest tax," which is a withholding tax on gross amounts of interest, the interest subject to the branch-level tax would be the gross amount of interest on (i) debt issued by a foreign corporation to an affiliate which is allocable to its U.S. branch and (ii) extensions of credit by a foreign bank to a foreign corporation which are allocable to a U.S. branch of the corporation.

The rate of the branch-level tax would be the same as the dividend and interest withholding tax rates, currently 30 percent. Where the foreign corporation is resident in a treaty country, the treaty rate applicable to direct investment dividends would apply to the taxable profits and taxable interest (if such rate would otherwise be available to the foreign corporation under the treaty).

The same rule for determining what debt of a foreign corporation is allocable to its U.S. branch would apply for purposes of the branch-level tax as for determining allowable interest deductions for purposes of the corporate income tax.

All foreign corporations with a branch in the United States (a trade or business under the tax code or a permanent establishment under tax treaties) would be subject to the branch-level tax, unless it is prohibited by an existing U.S. tax treaty. The tax would not override existing treaties, but the Treasury Department would seek to amend those treaties which now prohibit the tax to permit its imposition. (Many treaties do not prohibit the imposition of such a tax.)

Effective Date

The proposal would take effect for taxable years beginning on or after January 1, 1986.

Analysis

Under the proposal, U.S. tax would apply more evenly to foreign corporations doing business in the United States than under present law. Thus, the tax rules would have less of an influence on a foreign investor's decision whether to operate in the United States through a branch or a subsidiary. (Under current law a branch operation is generally subject to lower U.S. taxes than a subsidiary, if the subsidiary pays dividends.) The branch-level tax is also more easily administrable and enforceable than the "second dividend tax" and "second interest tax." It can be reported on the regular corporate income tax form of the branch. Many foreign countries, including Canada, France, and Australia, impose a branch profits or remittance tax.

There may be situations under bilateral income tax treaties with other countries where the availability of a dividends-paid deduction to a U.S. subsidiary of a company resident in the treaty country will result in heavier U.S. taxation of income earned through a U.S. branch of such company than through a subsidiary. In that event, consideration might be given to granting comparable corporate tax relief to branches of companies resident in the other country in the context of bilateral treaty negotiations.

The proposed changes are not likely to have a significant effect on flows of capital into the United States. The latest available data indicate that most foreign corporations operating in the United States through branches are in the finance, insurance and real estate industries, with most of the income attributable to branch banks.

REVISE TAXATION OF FOREIGN EXCHANGE GAINS AND LOSSES

General Explanation

Chapter 15.04

Current Law

Foreign Currency Transactions

Recognition of Income. Foreign currency is treated as property for Federal income tax purposes. Generally, exchange gain or loss is recognized when payment is made on a foreign-currency-denominated obligation. However, the recognition of loss on a forward exchange contract or other foreign-currency-denominated position in actively traded personal property that substantially diminishes a taxpayer's risk of loss with respect to another such position is subject to the taxing regime for straddles. Further, certain foreign currency forward contracts are marked-to-market on the last day of a taxpayer's taxable year.

It is uncertain how the original issue discount rules (providing for the accrual of discount income) are to apply to foreign-currency-denominated obligations issued for foreign currency. If foreign currency is treated as property, the recently enacted imputed interest rules applicable to debt instruments issued for property would apply (unless the obligation is traded on an established securities market). Generally, these rules would impute interest on foreign currency loans at 120 percent of the "applicable Federal rate" whenever the stated interest rate was equal to or less than 110 percent of the applicable Federal rate. This would have the effect of treating the loan as though it were translated to U.S. dollars on the date made and recharacterizing payments as interest based on dollar interest rates. The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, states that Congress did not intend for the imputed interest rules to apply to foreign currency loans where the value of the currency is readily ascertainable by reason of active trading in an established market. If the issue price were determined with reference to the current value of an actively traded foreign currency, however, original issue discount generally would only be found where the stated interest rate in the foreign currency is less than the arm's length interest rate in the foreign currency.

The Secretary is granted broad regulatory authority to modify the original issue discount rules as necessary to carry out the purposes of the original issue discount provisions. The General Explanation provides that such regulations should deal with treatment of foreign-currency-denominated obligations issued for property.

Character and Source. Because foreign currency is treated as property, the full panoply of rules pertaining to characterization of gain and loss as capital or ordinary applies. There is great uncertainty under the relevant judicial decisions as to the proper characterization of exchange gain or loss. Moreover, foreign currency forward contracts held as capital assets are marked-to-market and gain or loss is treated as 60 percent long-term and 40 percent short-term capital gain or loss. Straddles consisting of such contracts and foreign-currency-denominated positions are subject to the mixed straddle rules.

Furthermore, there is little authority under current law regarding the source of foreign exchange gain and the proper allocation of foreign exchange loss. Because foreign currency is treated as property, the source of exchange gain has been determined under the passage of title test applied to source gain from the sale of personal property. This test is extremely difficult to apply to international transactions involving foreign currency.

Foreign Currency Translation

Income and loss of a taxpayer for Federal income tax purposes is determined in U.S. dollars. (References herein to dollars are to the U.S. dollar.) While taxpayers are permitted to keep books and records in a foreign currency under current law, there are no clear standards for when this is appropriate. Taxpayers that maintain books and records in a currency other than the dollar have been permitted to use a variety of methods to translate results recorded in a foreign currency into dollars.

Foreign Branch of a Domestic Corporation. A domestic taxpayer that maintains books and records of a foreign branch in a foreign currency may report income or loss of the branch using either the "net worth" or the "profit and loss" method of currency translation. Under the net worth method, the dollar value of the income or loss of the branch is measured by adding the increase (or decrease) in the dollar value of the branch net worth and the dollar value of any remittances from the branch to the home office. For purposes of determining the dollar value of the branch net worth at the beginning and end of each period, current assets and liabilities are translated at the year-end exchange rates, and non-current assets and liabilities are translated at the exchange rate for the date acquired or incurred. Remittances are translated at the exchange rate on the date remitted. No specific rules govern the source or character of income of a net worth branch. The net worth method causes exchange gain or loss on unrealized income or loss to be taken into account currently.

Under the profit and loss method, only the profit or loss of the branch, determined in the foreign currency, is translated into dollars. Unremitted profits are translated at the year-end exchange rate and remittances are translated at the exchange rate on the date made. There are no clear rules for translating losses, or for determining the character or source of remittances from a profit and loss branch. The profit and loss method results in the recognition of exchange gain or loss only with respect to income or loss that has been realized in the foreign currency.

Foreign Corporations. A domestic taxpayer that conducts foreign operations through a foreign corporation is subject to U.S. tax on actual distributions of earnings of the foreign corporation or on deemed distributions from a controlled foreign corporation that are included in a U.S. shareholder's income under subpart F of the Code. In addition, gain realized by a domestic taxpayer on the sale of stock of a controlled foreign corporation may be recharacterized as a dividend to the extent of the untaxed earnings of the foreign corporation. A domestic corporate shareholder that owns 10 percent or more of the voting stock of a foreign corporation generally will be allowed a foreign tax credit for taxes paid by the foreign corporation with respect to earnings distributed as a dividend, or as a deemed distribution under subpart F or in connection with a sale of stock in the corporation (the indirect credit).

The rules for translating into dollars earnings of a foreign corporation that maintains its books and records in a foreign currency depend on how the earnings are subjected to U.S. tax. An actual distribution is translated into dollars at the exchange rate for the date received. In determining the indirect credit with respect to an actual distribution that is a dividend, the dividend, accumulated profits and foreign tax deemed paid with respect to the dividend are translated at the exchange rate for the date the distribution is received by the taxpayer. (The translation of distributions for dividend and indirect credit purposes at a current exchange rate was endorsed in *Bon Ami Company*, 39 B.T.A. 825 (1939), a decision of the predecessor to the Tax Court, and is referred to herein as the *Bon Ami* approach.)

If a domestic corporation is considered to receive a deemed distribution of earnings of a foreign subsidiary under subpart F, the amount of the distribution and the earnings to which the distribution is attributable are translated to dollars under rules which (i) translate the profit and loss to dollars at an average exchange rate for the period, and (ii) increase or decrease the dollar profit or loss amount by an additional exchange gain or loss reflecting a translation of the balance sheet of the corporation (the subpart F method). Transactions in dollars are reflected at their dollar amount. The foreign tax deemed paid is translated at an average exchange rate for the period in which the income is earned.

Income Taxes Available for the Foreign Tax Credit. For purposes of the direct credit, cash basis taxpayers translate the amount of foreign income taxes paid into dollars at the exchange rate for the date of payment. Accrual basis taxpayers use the year-end rate for the year of accrual or, if paid during the year, the exchange rate for the date of payment. Accrued taxes paid in a later year must be restated to the value on the date of payment.

For purposes of the indirect credit, foreign taxes deemed paid with respect to an actual distribution are translated to dollars at the exchange rate for the date the distribution is received. Foreign taxes deemed paid with respect to income inclusions under subpart F are translated at an average rate for the period in which the income is earned by the foreign corporation.

Reasons for Change

The various rules for taxing foreign currency transactions of a dollar taxpayer and for translating into dollars the income and loss of a foreign branch or corporation that maintains its books and records in a foreign currency have never been rationalized. In 1980 the Treasury Department conducted a comprehensive review of the law pertaining to taxation of foreign currency. That review resulted in a discussion draft presenting a system for taxing foreign exchange gains and losses (the Discussion Draft) that reflected the "functional currency" foreign currency translation principles proposed in an exposure draft by the Financial Accounting Standards Board (later published as FASB, Statement No. 52: Foreign Currency Translation (1981)). The functional currency concept is based on the proposition that the most meaningful measurement unit for assets, liabilities and operations of an entity is the currency in which it primarily conducts its business.

The Administration proposals generally follow the Discussion Draft and adopt the functional currency concept for determining when an entity must subject transactions in a foreign currency to the tax rules for foreign currency transactions. Conversely, the functional currency concept would be used to determine when an entity would be allowed to maintain its books and records in a foreign currency, for Federal income tax purposes, and account for transactions in the foreign currency as though that currency were the dollar (and the dollar were a foreign currency).

Foreign Currency Transactions

The Internal Revenue Code and Treasury regulations provide little direct guidance regarding the taxation of gain or loss from transactions in a foreign currency. The administrative and judicial decisions have failed to enunciate a clear or consistent set of rules; moreover, they do not take account of changes in the law relating to the time value of money, straddles and mark-to-market taxation of certain property. Finally, innovations in the financial markets have rendered even existing tax rules anachronistic. The result is uncertainty of tax treatment for many legitimate business transactions and opportunities for abuse and whipsawing of the fisc.

A significant defect of the current tax treatment of foreign currency transactions is its failure to reflect the underlying economic relationship of exchange rate fluctuations to interest.

Generally, exchange rate fluctuations will tend to offset interest rate differences between two currencies. The relationship between interest rates for a particular currency and expected movements in exchange rates is not perfect, because of different risk factors associated with different currencies. In addition, international currency markets are not perfectly efficient, particularly for less actively traded currencies. However, the relationship between interest rates in two currencies and expected exchange rates is quite close for those traded currencies in which the preponderant amount of international commercial transactions are conducted. The failure of current law to reflect this underlying economic reality gives rise to the same kinds of mismatching of income and deductions and manipulation of the principal amount of indebtedness that caused enactment of the original issue discount provisions of current law.

For example, assume that a dollar taxpayer sells property in exchange for an obligation denominated in Swiss francs bearing interest at a market rate for francs of 5 percent when the dollar interest rate on an obligation of the same maturity for a comparable borrower would be 10 percent. While the lender will earn interest income at a 5 percent rate in francs, he will generally expect the franc to appreciate in value over the term of the obligation so that he can buy sufficient additional dollars to bring his overall yield on the obligation up to a return equivalent to that which he could have earned by purchasing a comparable dollar obligation. In this circumstance the true interest element of the transaction generally would be understated and the principal component overstated. This may occur without regard to whether there is original issue discount in terms of the market interest rate for the foreign currency.

Alternatively, assume that a dollar taxpayer issues an obligation denominated in Brazilian cruzeiros bearing interest at a market interest rate for cruzeiros of 32 percent when the comparable dollar rate is 10 percent. While the borrower will accrue interest expense based on the 32 percent rate in cruzeiros, he will expect the cruzeiro to depreciate in value over the term of the obligation so that his true cost of borrowing will not exceed the rate at which he could borrow in dollars. If the anticipated exchange loss is not accrued, his true interest expense will be overstated. While recently enacted time value of money legislation authorizes regulations that would provide for correct timing of recognition of anticipated exchange gain or loss, it would be preferable to establish a coherent set of tax rules for foreign currency transactions.

A second defect of current law is the extreme uncertainty of application of rules to determine the character and source of income. At least one U.S. Court of Appeals has held that foreign exchange gain on the repayment of a taxpayer's foreign-currency-denominated obligation is the equivalent of cancellation of indebtedness income. (Some taxpayers argue that such gain is eligible for deferral from current tax if the taxpayer elects to decrease basis in certain depreciable assets.) Other case law suggests that exchange gain with respect to a foreign-currency-denominated obligation that is a capital asset in the hands of a taxpayer would be capital gain. The inconsistent authority has created uncertainty. The same U.S. Court of Appeals referred to above also affirmed a divided Tax Court decision holding that an exchange loss on repayment of a foreign-currency-denominated loan is ordinary in character because the repayment of a loan does not constitute a sale or exchange. Treatment of exchange gain as cancellation of indebtedness income and exchange loss as ordinary loss affords opportunity for tax avoidance.

Foreign Currency Translation

Under current law, there are no clear standards for determining when books and records for a branch (or a controlled foreign corporation) may be maintained for Federal income tax purposes in a foreign currency. This is significant because if transactions are accounted for in the local currency, exchange gain and loss (in relation to the dollar) will not be recognized with respect to individual transactions at the time income or loss is realized. Instead, under the net worth, profit and loss or subpart F methods, exchange gain or loss is determined in different ways for the aggregate results of the reporting entity for the taxable year. The distinction in treatment that results from use of one of the net translation methods instead of translating separate transactions requires that standards be provided to ensure that income in dollars is clearly reflected.

Foreign Branch of a Domestic Corporation. The use of the net worth method for foreign branches under current law generally allows exchange gain or loss on net current assets to be taken into income currently even though income from the disposition of the assets has not been realized. The subpart F method produces a similar result for controlled foreign corporations. Therefore, in the case of a controlled foreign corporation a taxpayer may in effect elect to recognize foreign exchange loss (or gain) currently by realizing subpart F income in a corporation operating in a weak (or strong) currency. The recognition of exchange loss (or gain) on unrealized income may have the effect of overstating (or understating) the indirect foreign tax credit.

In a world of flexible exchange rates, it is inappropriate for a taxpayer operating primarily in a foreign currency to accelerate recognition of foreign exchange gain or loss if the underlying income or loss is not realized or property is not taken out of use in the foreign currency environment. In this regard, the profit and loss method is more consistent with the functional currency concept than is the net worth or subpart F method.

Foreign Corporations. The virtues of the *Bon Ami* approach are its relative simplicity and that it maintains the relationship between the dollar value of a dividend grossed-up for foreign taxes and the foreign taxes deemed paid with respect to the earnings. The *Bon Ami* approach, however, has significant defects. First, even if there is a distribution of the current year's earnings, the date of distribution translation rate under Bon Ami generally will differ from the average exchange rate used under the subpart F method. A taxpayer therefore may "trigger" a deemed distribution of those earnings under subpart F and obtain a different result. The inconsistency in translation of income and foreign tax paid between an actual distribution and a subpart F distribution (and the results if the income is earned through a branch) is more dramatic if earnings are not distributed currently.

For example, assume that a foreign corporation earns 100 Swiss francs and pays Swiss tax of 40 francs when the exchange rate is four Swiss francs to the dollar. (In dollars, pre-tax earnings would be $25 and the Swiss tax $10.) If these earnings are distributed in a later year when the Swiss franc has appreciated to two francs to the dollar, the dividend (grossed-up for foreign taxes paid) would be $50 and the deemed paid taxes would be $20. Similarly, if the franc declined to eight francs to the dollar, the grossed-up dividend would be $12.50 and the deemed paid Swiss tax $5.

As may be seen from the example, the exchange rate gain or loss between the date the income is earned and the date it is paid is in effect characterized as an increase or decrease in the earnings of the foreign corporation. In addition, the deemed paid foreign tax is increased or decreased by subsequent exchange fluctuations even though the tax may actually have been paid in an earlier year. Treating the exchange gain or loss as part of the distribution and translating the deemed paid foreign tax at the current rate distorts the amount of allowable foreign tax credits. Moreover, it gives rise to a different result than would occur if the same income were subpart F income or were earned through a branch and remitted to the head office at a later date.

Proposal

Functional Currency of an Entity

Each business entity of the taxpayer would have a single functional currency. For this purpose, a business entity would be any separate and distinct business operation of the taxpayer, the activities of which constitute an active trade or business and are accounted for by a complete and separate set of books and records. Each taxpayer always will be a business entity separate from any affiliated taxpayer, though a single taxpayer may include more than one business entity. (A business entity is hereinafter referred to as an entity.)

The functional currency of an entity generally would be the primary currency of the economic environment in which the entity operates. Thus, most U.S. taxpayers operating in the United States would use the dollar as their functional currency. A taxpayer always would be allowed to elect to treat the dollar as the functional currency of an entity. (An entity whose functional currency is the dollar is referred to herein as a dollar taxpayer.) The Administration is considering whether special rules should be applied with respect to taxpayers operating in a highly inflationary economy.

If a taxpayer does not elect to use the dollar as the functional currency for an entity, the entity's functional currency generally would be the currency of the country in which the entity is located and the books and records maintained. However, the identification of a foreign functional currency of an entity would be a question of fact to be determined on the basis of the relevant facts and circumstances. Factors to be taken into account would include:

(i) the currency in which the books of account of the entity are maintained;

(ii) the currency in which the revenues and expenses of the entity are primarily generated;

(iii) the currency in which the entity primarily borrows and lends; and

(iv) the functional currency of related entities and the extent of integration of the operations of related entities.

These factors generally correspond to the factors relevant for determination of a functional currency required for financial accounting purposes under FASB Statement No. 52. While the functional currency of an entity generally would correspond to that for financial accounting purposes, it is not necessary that it do so. (Moreover, a "business entity" for tax purposes will not necessarily comprise the same activities as a reporting enterprise for financial accounting purposes.)

Although identification of a functional currency would depend on the facts and circumstances relevant to each entity, consistent criteria for identifying the functional currency of entities conducting similar trades or businesses in different countries would be required. If in a particular case the facts and circumstances did not indicate choice of a particular currency, taxpayers would have discretion in choosing a functional currency from among the possible alternatives. A consistent choice would have to be made for similarly situated entities. The choice of a functional currency for an entity, including an election to use the dollar as the functional currency, would be treated as a method of accounting which may be changed only with the consent of the Secretary.

The choice of a functional currency is significant because it will determine the circumstances in which exchange gain or loss will be recognized. If an entity adopts a functional currency other than the dollar, the entity would be required to maintain books and records for Federal income tax purposes in the functional currency. Transactions in the functional currency would not be subject to the taxing rules for foreign currency transactions. However, if the entity conducts transactions in a currency other than its functional currency, exchange gain or loss (in relation to the functional currency) would be recognized under the rules for foreign currency transactions.

For example, if an entity that uses the French franc as its functional currency promises to pay francs in six months in exchange for property, exchange gain or loss would not be realized upon payment (without regard to whether the value of the franc had changed in relation to the dollar). Instead, the income or loss from the transaction would be included as part of the entity's profit or loss for the period. The entity's profit and loss (in francs) would be translated under the proposals for foreign currency translation. However, the entity's exchange gain or loss from transactions in currencies other than the franc (including the dollar) would be taxed under the proposals for foreign currency transactions.

Foreign Currency Transactions

This section describes rules for the taxation of transactions in a currency other than the entity's functional currency. For ease of exposition, it is assumed that the entity's functional currency is the dollar and that the transaction is denominated in a foreign currency.

Recognition of Income. Exchange gain or loss would not be realized with respect to a foreign-currency-denominated item of income or expense that is received and translated on the same date as it is recognized as income or allowed as a deduction for Federal income tax purposes. For example, if an entity sells property for Swiss francs and receives the francs on the date the sales income is taken into account for tax purposes, no exchange gain or loss will arise since the item of income is translated on the same date as the income is recognized for tax purposes. Thus, exchange gain or loss does not arise in a broad range of everyday transactions. Moreover, if in the foregoing example the entity's functional currency is the Swiss franc, the entity would not be required to recognize exchange gain or loss on a transaction in francs but would translate the results of its operations for the period under the profit and loss method.

Foreign exchange gain or loss may arise with respect to a foreign-currency-denominated financial asset or liability. A foreign-currency-denominated financial asset or liability is any financial asset or liability (e.g. trade receivables or payables, preferred stock and debt instruments) the principal amount of which is determined in one or more foreign currencies. If there is a change in the exchange rate between the date on which a foreign-currency-denominated asset is taken into account for tax purposes (i.e. recorded as an item of income or expense, treated as a liability or assigned an asset basis) and the date it is paid, foreign exchange gain or loss will exist.

Exchange gain or loss with respect to financial assets or liabilities denominated in a currency other than the functional currency of an entity may properly be thought of as an economic equivalent to interest. In most transactions the parties anticipate that exchange gain or loss with respect to a foreign-currency-denominated financial asset generally will offset the difference between the yield in the foreign currency and the yield for a comparable dollar asset over the life of the asset. It is therefore appropriate to treat foreign exchange gain or loss as the equivalent of interest for tax purposes.

In order to prevent the mismatching of income and deductions that can arise if foreign exchange gain or loss is not taken into account until it is realized, "anticipated exchange gain or loss" would be recognized on an accrual basis with respect to a foreign-currency-denominated financial asset or liability that provides for a fixed or determinable payment in the future (e.g., an accrued item of income or expense, or an obligation). Anticipated exchange gain or loss would be determined under rules comparable to those which apply to impute interest with respect to obligations issued for property. Unanticipated exchange gains and losses would be recognized when realized.

Anticipated currency gain or loss would be based on the difference between the nominal dollar yield on the asset or liability and the applicable Federal rate with respect to an equivalent dollar-denominated asset or liability. The nominal dollar yield of the asset may be measured by translating the principal amount and future payments on the asset into dollars at the exchange rate on the date incurred and calculating the yield using those amounts. The anticipated exchange gain or loss would equal that amount which would increase or decrease the nominal dollar yield to the market dollar yield. (If the functional currency is not the dollar, the anticipated exchange gain or loss with respect to a transaction in a currency other than the functional currency would be based on the difference between the nominal yield and the market yield in the functional currency.) The accrual of anticipated exchange gain would increase the holder's basis in the obligation; the accrual of anticipated exchange loss would decrease basis in the obligation.

It is recognized that the proposed treatment of foreign exchange gains and losses would raise the complexities similar to those existing today in connection with the rules applicable to dollar obligations issued for property. The Administration will consider whether it is possible to establish safe harbors for circumstances where the mismatching of income and expense would not be material.

Character and Source. Anticipated and unanticipated exchange gain or loss generally would be treated as an increase or decrease in interest income or expense with respect to the foreign-currency-denominated asset or liability. However, if exchange gains exceed interest expense, such gains would be treated as additional interest income. If exchange losses exceed interest income, such losses will be treated as additional interest expense. Exchange gains will be sourced under the same rules as apply to interest income. Exchange losses would be allocated and apportioned under the same rules as apply to interest expense.

Forward Exchange Contracts. This subsection describes rules for the taxation of gain or loss on a forward sale or purchase contract, or a contract to receive or pay dollars or a foreign currency, that hedges a specific foreign-currency-denominated asset or liability (including an item of income or expense). For this purpose, a forward sale contract is any contract to sell or exchange foreign currency at a future date under terms fixed in the contract. A forward purchase contract is any contract to purchase foreign currency with dollars at a future date under terms fixed in the contract. A contract to exchange foreign currency for another foreign currency at a future date under terms fixed in the contract would be considered a forward sale contract.

A contract will be considered to hedge a foreign-currency-denominated item if (i) the item hedged would constitute ordinary income or expense to the taxpayer, (ii) the primary purpose of the contract (either alone or in combination with other contracts) is to offset the effect of a change in the exchange rate on the dollar value of the foreign-currency-denominated item, and (iii) either the taxpayer identifies the contract(s) as hedging a particular item or the Commissioner determines that, under the facts and circumstances, the contract hedges a particular item. For this purpose, a contract offsetting risk of exchange fluctuations on the value of stock in a non-consolidated subsidiary or of assets held by, or liabilities of, a non-consolidated subsidiary would not be considered a hedge.

The exchange gain or loss on a forward sale contract hedging the principal amount of a foreign-currency-denominated financial asset would be recognized on an accrual basis and would be treated as in increase or decrease in the interest received with respect to the asset. The exchange gain or loss on a forward purchase contract hedging the principal amount of a foreign-currency-denominated financial liability would be characterized and sourced in the same manner as interest paid with respect to that liability. The gain or loss on a forward sale or purchase contract hedging, respectively, an item of income or expense would be characterized and sourced in the same manner as an increase or decrease in the item of income or expense. Comparable rules would also apply to contracts for payments made to offset foreign exchange fluctuations.

Foreign Currency Translation

Foreign Branches. An entity that uses a functional currency other than the dollar would be required to use a profit and loss method to translate income or loss into dollars at the average exchange rate for the period. For example, if an entity using the Swiss franc as its functional currency earned 10,000 Swiss francs and made no remittances to the home office during the period, and if the average exchange rate for the period was 4 francs to the dollar, the profit of the entity would be $2,500.

It is necessary to establish rules for translation of losses and to account for exchange gain or loss with respect to property that is transferred to and from an entity of the taxpayer having a different functional currency, in order to ensure that the cumulative gain or loss recognized over the life of the entity is the same without regard to its functional currency. If translation rules are not provided for losses and remittances, exchange gain or loss with respect to assets acquired with income or capital of the entity might never be recognized.

A taxpayer using the dollar as its functional currency would be considered to have a dollar (i.e. functional currency) "basis" in an entity solely for purposes of recognition of exchange gain or loss. The taxpayer's dollar basis in the entity would be analogous to a partner's basis in a partnership interest; it would identify when exchange gain or loss should be recognized with respect to distributions and losses. The basis in the entity would be increased by contributed property translated on the date of contribution and by unremitted earnings translated at the average exchange rate for the year. Losses translated at the average rate for the year and remittances translated at the exchange rate for the date remitted would reduce entity basis. Exchange gain and loss on remittances would be recognized once entity basis is recovered. Exchange gain or loss realized on remittances of property would be treated as ordinary and domestic source income.

For example, assume that a dollar taxpayer's head office contributes 200 Swiss francs to an entity using the Swiss franc as its functional currency when the exchange rate is four francs to the dollar. The entity earns 100 francs during a period in which the exchange rate does not change. At the end of the period, the entity's profit would be $25 and the taxpayer's dollar basis in the entity would be $75 ($50 + $25 = $75). If the entity loses 40 francs the following year when the exchange rate is two francs to the dollar, the loss would be $20 and the entity basis would be $55 ($75 - $20 = $55). No exchange gain or loss would be required to be recognized during that year. If the entity were liquidated after the end of the second year and the remaining 260 francs were remitted when the exchange rate remained at two francs to the dollar, the difference between the value of the francs on the date of remittance and the branch basis would be treated as exchange gain or loss. In this case there would be exchange gain of $75 ($130 - $55 = $75). The exchange gain would be treated as ordinary and domestic source income.

<u>Foreign Corporations</u>. As described in Ch. 15.01, the Administration proposes that the indirect tax credit be computed using a "pooling" concept. That is, dividend distributions and subpart F

income inclusions will be considered made from the pool of all of the distributing corporation's earnings and profits. For translation purposes, it is tentatively proposed that the Bon Ami approach be followed. Accordingly, an actual distribution, the pool of earnings and profits from which the distribution derives and the foreign taxes deemed paid with respect to such earnings would be translated at the exchange rate for the date of distribution. Amounts deemed distributed under subpart F, the pool of earnings from which the deemed distribution derives and the deemed paid taxes would be translated at the average exchange rate for the year in which the subpart F income is earned. Earnings previously taxed under subpart F would be segregated in a separate pool. When such earnings are later actually distributed, any further exchange gain or loss on the distribution would be treated as ordinary and domestic source income or loss. The exchange gain or loss would be measured by multiplying the foreign currency distribution by the difference between the exchange rate for the date of the deemed distribution and the exchange rate on the date of actual distribution.

Because of the concerns described above with respect to the Bon Ami approach, the Administration is continuing to consider an alternative approach which would separate the exchange gain or loss from the value of an actual distribution at the time it was earned. Under this approach, the grossed-up dividend distribution would be translated at the historic exchange rates applicable to the earnings from which the distribution is derived. Any subsequent exchange gain or loss with respect to the actual distribution (which would not include the gross-up for the foreign taxes deemed paid) would be recognized at the time of the distribution. Such an approach would reduce the disparity in treatment of exchange gain and loss between actual and deemed distributions and between income earned by foreign branches of domestic corporations and foreign corporations.

Other Translation Matters. The average exchange rate for a period is a rate which, if used to translate total gross receipts of an entity during the period, would produce approximately the same dollar amount as would have been obtained had each gross receipt of the entity been translated at the exchange rate for the date the receipt was recorded for tax purposes. A taxpayer would be permitted to use any reasonable procedure, consistently applied, to determine an appropriately weighted exchange rate for the period.

If an entity or foreign corporation uses one currency as its functional currency and maintains books or records in another currency or conducts transactions in another currency, results in the other currency would be translated into the functional currency before translation into dollars.

The amount of foreign income taxes claimed as a credit would be restated to take account of any refund or difference between the amount accrued and the amount paid. The restated foreign tax, however, would be translated at the same rate as applied to the tax which was originally taken into account for Federal income tax purposes.

Effective Dates

The proposals would be effective for taxable years beginning on or after January 1, 1986. The proposals governing taxation of foreign currency transactions would be effective for foreign-currency-denominated assets acquired or liabilities incurred after January 1, 1986.

Analysis

The proposals would rationalize the taxation of foreign exchange transactions by (i) providing rules to identify a taxpayer's functional currency, (ii) treating exchange gain or loss on assets or liabilities not denominated in a functional currency as the equivalent of interest, (iii) taxing anticipated exchange gain or loss on an accrual basis, and (iv) providing clear and unambiguous character and source rules for anticipated and unanticipated exchange gain and loss. The treatment of exchange gain or loss as interest and subjecting anticipated exchange gain or loss to tax on an accrual basis takes account of the economic relationship between exchange rate fluctuations and interest rates. Accrual taxation would prevent overstatement of deductions for borrowings in weak currencies and understatement of income with respect to loans in strong currencies. The former, in particular, has been the basis for a number of tax shelters. The proposed source rule for anticipated and unanticipated exchange gain corresponds to the source rule for interest.

The proposals for translating books and records maintained in a foreign currency generally would rationalize the translation rules for income earned by foreign branches and subpart F income of a foreign corporation. The Bon Ami rule for translating actual distributions from a foreign corporation and associated deemed paid taxes at the current exchange rate follows current law and maintains a consistent relationship between the amount of the distribution and foreign taxes deemed paid. However, the Administration will continue to consider alternatives to Bon Ami.

REFORM MIRROR SYSTEM OF TAXATION FOR UNITED STATES POSSESSIONS

General Explanation

Chapter 15.05

Current Law

In General

The income tax laws of the United States are in effect in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their local income tax systems. These jurisdictions are "possessions" of the United States for tax purposes. To transform the Internal Revenue Code of 1954, as amended (the "Code"), into a local tax code, each possession, in effect, substitutes its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. Although this word-substitution system, known as the "mirror system", applies to Guam, the CNMI, the Virgin Islands, and American Samoa, the U.S. tax relationship with each possession is governed by somewhat different rules, as described below.

Guam

Under the Organic Act of 1950, Guam currently employs the mirror system of taxation. Under Code section 935, an individual resident of the United States or Guam is required to file, with respect to income tax liability to those jurisdictions, only one tax return -- with Guam if he is a Guamanian resident on the last day of the taxable year, or with the United States if he is a U.S. resident on the last day of the year (the "single filing rule"). Income taxes withheld by the jurisdiction in which a return is not filed may be claimed as a credit against tax imposed by the jurisdiction of filing. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals (but not corporations), the U.S. is treated as part of Guam for purposes of Guamanian taxation, and Guam is treated as part of the United States for purposes of U.S. taxation.

A corporation chartered in Guam that receives U.S. source income (other than certain passive income) must file a U.S. return and pay U.S. tax on that income. Under Code section 881(b), a Guamanian corporation is not treated as a foreign corporation for purposes of the 30% withholding tax on certain passive income paid to foreign corporations if (a) less than 25% in value of its stock is owned by foreign persons, and (b) at least 20% of its gross income is derived from sources within Guam.

Under U.S. law, Guam is authorized to impose up to a 10% surtax on income tax collected under the mirror system and may provide for rebates of mirror system taxes in certain circumstances.

Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, applies to Guam. In effect, a section 936 corporation operating in a possession such as Guam enjoys an exemption from all U.S. tax on the income from its business activities and qualified investments in that possession. To qualify for this treatment, the section 936 corporation must meet two conditions: (a) at least 80% of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within the possession; and (b) at least 65% of its gross income for that period must be from the active conduct of a trade or business in the possession.

Federal statutes do not permit Federal employers to withhold territorial income taxes. However, under code section 7654, the United States generally covers into (i.e., transfers to) the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on U.S. military personnel stationed in Guam. Similarly, Guam covers into the treasury of the United States certain tax collected from individuals on U.S. source income.

CNMI

As of January 1, 1985, the CNMI is required to implement the mirror system in substantially the same manner as the mirror system is in effect in Guam. Code references to Guam are deemed to include the CNMI. Thus, the single filing rule for individuals under Code section 935 and the special withholding tax rule for interest and other passive income earned by corporations under section 881(b) also apply to the CNMI. In addition, U.S. law provides that the CNMI may by local law impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.

Virgin Islands

Under the Naval Appropriations Act of 1922, the income tax laws of the United States, as amended, are held to be "likewise in force in the Virgin Islands", except that the proceeds of the income tax are paid into the treasury of the Virgin Islands. The courts have interpreted this provision to establish a mirror system of taxation in the Virgin Islands.

Under the Revised Organic Act of the Virgin Islands, as interpreted by the courts, an "inhabitant" of the Virgin Islands is exempt from U.S. tax as long as it pays tax to the Virgin Islands on its worldwide income. The term "inhabitant", for these purposes, has generally been interpreted to include individual residents of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and corporations not organized under the laws of the Virgin Islands if such corporations have contacts with the Virgin Islands sufficient to establish "residence" in the Virgin Islands.

Notwithstanding section 28(a) of the Revised Organic Act, Virgin Islands corporations, which are generally treated as foreign corporations, are liable for the U.S. 30% withholding tax on certain payments to foreign corporations. However, under Code section 881(b), a Virgin Islands corporation is not treated as a foreign corporation for purposes of this tax if (a) less than 25% in value of its stock is owned by foreign persons, and (b) at least 20% of its income is derived from sources within the Virgin Islands.

Under Code section 934, the Virgin Islands is generally prohibited from reducing or rebating taxes imposed under the mirror system, with the following exceptions: (a) the prohibition does not apply (with respect to taxes on income derived from Virgin Islands sources) in the case of a full-year Virgin Islands resident individual; and (b) the prohibition does not apply (with respect to taxes on non-U.S. source income) in the case of a Virgin Islands or U.S. corporation which derives at least 80% of its income from Virgin Islands sources and at least 65% of its income from a Virgin Islands trade or business. (Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, does not apply to investment in the Virgin Islands. However, Code section 934(b), in conjunction with section 28(a) of the Revised Organic Act, provides similar results.) Under Code section 934A, the 30% withholding tax on certain payments to foreign persons (including U.S. persons), as imposed under the Virgin Islands mirror system, applies to payments to U.S. persons at a reduced 10% rate (which may be further reduced by the Virgin Islands).

The Virgin Islands is authorized to impose up to a 10% surtax on the mirror system tax. Otherwise, the Virgin Islands does not have the power to impose local taxes on income.

<u>American Samoa</u>

Unlike the possessions described above, U.S. law permits American Samoa to assume autonomy over its own income tax system. In 1963, however, American Samoa adopted the U.S. Internal Revenue Code as its local income tax, thereby also adopting the mirror system of income taxation. While American Samoa has the power to modify the Code in its capacity as American Samoa's territorial tax, this authority has been exercised on few occasions, generally to simplify the Code and adapt it to the needs of American Samoa.

Under section 931, U.S. citizens who receive 80% or more of their gross income from sources within American Samoa and 50% or more of their gross income from the conduct of a trade or business in American Samoa are exempt from U.S. tax on income derived from sources without the United States. In addition, Code section 936 applies to qualifying U.S. corporations doing business in American Samoa.

<u>Reasons for Change</u>

The Internal Revenue Code, with all its complexities, is designed primarily to tax income in the highly developed U.S. economy. The mirror system, which entails imposing the Code in its entirety as local law, may be wholly inappropriate for the island economies of the U.S. possessions. The possessions need tax systems that help them to pursue development policies independently and to exercise greater control over their own economic welfare.

The frequency and extent of revisions to the Code in recent years have highlighted the problems inherent in the mirror system. For example, in the possessions generally, a large portion of the revenue is collected from individuals in the lower tax brackets. Generally, the portion of local revenues collected from corporations and higher-income individuals is very small. Thus, any revisions to the Code that lower the tax rates on individuals (such as the rate reductions enacted by the Economic Recovery Tax Act of 1981 and those proposed in this report) could have a potentially harsh revenue effect on the possessions. In addition, revenue-neutral proposals that compensate for lowering tax rates by broadening the tax base may well not be revenue neutral in a possession where very little tax is collected from corporations or higher-income individuals.

The present mirror systems are very complex and the possessions often lack the resources to enforce these mirror systems effectively. Because of the difficulties of enforcement and the ambiguities and inconsistencies inherent in the mirror system, U.S. taxpayers are known to abuse the mirror systems without making real economic contributions to the possessions.

To promote fiscal autonomy of the possessions, therefore, it is important to permit each to develop a tax system that is suited to its own revenue needs and administrative resources. It is also important to coordinate the possessions' tax systems with the U.S. tax system in a rational manner in order to provide certainty and minimize the potential for abuse.

The deficiencies in the current mirror systems of taxation afflict each possession, though in differing respects. The close economic relationship between Guam and the CNMI has given rise to mirror system problems for which there is no clear solution, resulting, in some cases, in harsh consequences for residents of Guam. With respect to the CNMI, the mirror system of taxation went into force for the first time in 1985. The CNMI has repeatedly voiced its concern that it will have difficulty administering and enforcing the complex mirror system because of its lack of resources. In addition, American Samoa has had difficulty collecting tax from U.S. Government employees because of the United States' lack of authority to withhold Samoan tax from wages.

With respect to the Virgin Islands, the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gives rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties have made administration of the law problematic, created a climate of uncertainty for investors, and raised the possibility of unintended tax benefits for some and harsh consequences for others. In addition to fostering tax avoidance and tax evasion, the "inhabitant" rule of the Revised Organic Act, in conjunction with tax reductions authorized by the Virgin Islands, effectively permits United States corporations meeting certain requirements to derive income from a Virgin Islands business *free of any U.S. tax and subject to reduced Virgin Islands tax rates.* (Such corporations, generally described in Rev. Rul. 80-40, are known as "80-40" companies.) However, due to substantial uncertainty as to the operational requirements of the so-called "80-40" mechanism, it does not appear to have encouraged U.S. investment in the Virgin Islands to any appreciable extent. Moreover, where the mechanism is used, the resulting U.S. tax benefit (i.e., exemption from U.S. tax of the "80-40" corporation's income from all sources) bears no necessary relation to the corporation's investment in the Virgin Islands or employment of Virgin Islands residents.

Proposal

In General

The proposal outlined below is divided into two parts. The first part deals with reform of the mirror system in the Virgin Islands. This part of the proposal is based in large part on extended discussions with the Virgin Islands in recent years regarding mirror system reform. It differs from the proposals for the other possessions because of the unique history of the relationship between the Virgin Islands and the United States. The second part relates to reforming the mirror system of taxation in Guam, the CNMI, and American Samoa.

Virgin Islands

Changes relating to all taxpayers. Under the proposal, certain tax provisions not contained in the Internal Revenue Code would be repealed or amended. First, the "inhabitant" rule contained in the Revised Organic Act would be repealed, and provisions in the Act relating to the covering of taxes would be revised to reflect such repeal. Second, the provision in the Naval Appropriations Act establishing the mirror system would be clarified to ensure that, in "mirroring" the Internal Revenue Code, (a) the Virgin Islands is not treated as having any possessions, (b) provisions in the Code referring to the Virgin Islands or to other possessions are not themselves mirrored, (c) possessions other than the Virgin Islands are treated as foreign countries for purposes of the Virgin Islands mirror system, and (d) certain provisions not intended to be included in the Virgin Islands mirror code are not mirrored. Third, the Revised Organic Act would be amended to provide the Virgin Islands with authority to enact nondiscriminatory local income taxes in addition to those imposed under the mirror system. Fourth, measures coordinating the tax administration and collection functions of the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue, as well as procedures for exchanging tax information, would be implemented.

Additionally, the 80 percent and 65 percent requirements contained in Code section 934(b) would be eliminated with respect to U.S. corporations (other than corporations validly electing to be covered by the five-year grandfather protection for existing section 934(b) corporations, as described in Ch. 12.05). Moreover, consideration would be given to authorizing the Virgin Islands to reduce or rebate the tax liability of certain foreign persons with respect to income derived from Virgin Islands sources.

Changes relating only to individuals. The tax treatment of individuals who are citizens or residents of the United States or the Virgin Islands would be modified through amendments to the Code. Under the proposal, for purposes of determining the tax liability of such individuals, the United States would be treated as including the Virgin Islands (for purposes of determining U.S. tax liability), and the Virgin Islands would be treated as including the United States (for purposes of determining liability for the Virgin Islands tax). However, a corporation organized in one jurisdiction would continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year (determined under general principles of Federal income tax law in effect prior to the enactment of section 7701(b)) would pay tax to the Virgin Islands under the mirror system on his worldwide income, and would have no final tax liability for such year to the United States. Any taxes withheld in the United States from payments to such an individual, and any estimated tax payments properly made by such an individual to the United States, would be covered into the Virgin Islands treasury and would be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands would list all items of such income on an attachment to his Virgin Islands return. Information contained on these attachments would be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

In the case of a citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands, tax liability to the Virgin Islands would be a fraction of the individual's U.S. tax liability, based on the ratio of adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income. Such an individual would file identical returns with the United States and the Virgin Islands. The individual's Virgin Islands tax liability (if paid) would be credited against his United States tax liability. Taxes paid to the Virgin Islands by the individual other than the tax paid pursuant to the mirror code would be treated, for U.S. tax purposes, in the same manner as State and local taxes.

In the case of a joint return filed by a couple of which only one spouse qualified as a resident of the Virgin Islands, resident status of both spouses would be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year. Rules for the payment to the Virgin Islands of estimated taxes by a U.S. resident would also be provided.

Changes relating only to corporations. Under the proposal, Code section 881(b) would be amended by deleting the 20% source-of-income requirement and adding, in its place, a requirement that 65% of the corporation's income be effectively connected with a trade or business in a possession or in the United States. In addition, the exemption from the withholding tax would not be available for a corporation used as a conduit for payments to persons not resident in the Virgin Islands. Generally, the branch profits tax described in Ch. 15.03 would not apply to a corporation qualifying under Code section 881(b).

For purposes of the wage credit described in Ch. 12.05, the Virgin Islands would be treated as an eligible possession. Moreover, U.S. corporations that have validly qualified for the benefits of section 934(b) for their last taxable year beginning on or before December 31, 1985 would be allowed to elect to be covered by the five-year grandfather protection extended to existing section 936 corporations, as described in Ch. 12.05.

Guam, the CNMI, and American Samoa

Guam and the CNMI would each be granted full authority over its own local income tax system, subject to certain qualifications discussed below. Thus, as is currently the case with respect to American Samoa, either possession could adopt a mirror system as its local law if desired. The tax systems implemented by Guam and the CNMI would raise at least as much revenue as the mirror systems currently implemented in those possessions.

American Samoa already has autonomy with respect to its local tax system, but certain anti-abuse provisions described below would apply to American Samoa as well as Guam and the CNMI.

A resident of Guam or the CNMI would be required to file a U.S. return if he received U.S. or foreign source income. However, he would be required to pay U.S. tax only if he received more than a threshold amount of income, including U.S. source income, from sources outside these possessions. The threshold amount would approximate the tax exempt threshold for U.S. individual taxpayers (i.e., the zero bracket amount plus one or two personal exemptions, depending on filing status). The United States would cover into the treasury of Guam or the CNMI all U.S. income tax paid by a Guamanian or CNMI resident.

Code section 881(b) would be modified to provide that a Guamanian or CNMI corporation would not be exempt from the 30% withholding tax unless (a) less than 25% in value of the corporation's stock were owned by foreign persons; and (b) 65% of the corporation's income were effectively connected with the conduct of a trade or business in a U.S. possession or in the United States. In addition, the exemption from the withholding tax would not be available for a corporation used as a conduit for payments to persons not resident in the possession. A similar exemption provision would be enacted with respect to the branch profits tax described in Ch. 15.03 imposed on a U.S. branch of a Guamanian or CNMI corporation.

Qualifying U.S. corporations doing business in Guam, CNMI, or American Samoa would be eligible for the wage credit and the five-year grandfather protection for existing section 936 corporations, as described in Ch. 12.05.

For purposes of determining the U.S. tax liability of a Guamanian or CNMI resident, a dividend paid by a Guam or CNMI corporation would be deemed to be income derived from sources within Guam or the CNMI only if 50% or more of the corporation's gross income were derived from sources within those possessions.

Anti-abuse provisions would be implemented to coordinate the source rules, subpart F, and foreign personal holding company provisions to prevent the use of holding companies incorporated in Guam, CNMI, or American Samoa by U.S. or foreign persons to avoid U.S. tax, and to avoid application of those provisions in a non-abusive situation. Additional provisions would be enacted to eliminate certain reporting requirements with respect to Guamanian or CNMI residents who are not subject to U.S. tax. Local taxes of Guam, the CNMI, and American Samoa would be creditable for U.S. tax purposes if such taxes qualified as creditable taxes under the applicable foreign tax credit regulations.

Guam, the CNMI, and American Samoa would be prohibited from imposing discriminatory taxation on citizens and residents of the United States. These possessions would be required to exchange tax information with the United States under a mutually agreed upon procedure. Each would be authorized to enter into mutual agreement procedures and agreements to coordinate tax administration and withholding. Withholding on the compensation of U.S. Government personnel stationed in Guam, including military personnel, would be covered into the Guamanian, CNMI, and American Samoan treasuries, as appropriate. Finally, taxation by Guam, the CNMI, and American Samoa of the same individual or entity would be coordinated. This coordination is necessary because of the close economic relationships among these possessions.

Effective Dates

Virgin Islands

The Virgin Islands proposal would be effective for taxable years beginning on or after January 1, 1986.

Guam, the CNMI, and American Samoa

The proposed grants of authority to Guam and the CNMI, as well as the conforming changes to U.S. law, anti-abuse provisions, and administrative provisions, would be effective as of January 1, 1986. However, the mirror codes currently administered by Guam and the CNMI would continue to operate *mutatis mutandis* as their respective local income tax laws until and except to the extent that each possession took action to amend its tax laws. The anti-abuse and administrative provisions with respect to American Samoa also would be effective as of January 1, 1986.

Analysis

The proposals would promote the important goal of fiscal autonomy in the possessions and would permit those jurisdictions to enact and enforce tax laws that suit their revenue needs and administrative capabilities. The proposals are designed to resolve the technical flaws in current law and to permit the possessions to rationalize their tax systems.

The proposal relating to Guam, the CNMI, and American Samoa would clarify and promote the ability of these possessions to pursue economic development unhindered by a complex tax code designed for an entirely different type of economy. The major elements of these proposals have been discussed over the past several years with representatives of Guam, the CNMI, and American Samoa in general terms. The governments of these possessions generally favor changes to the current mirror systems that would free them from the frequent (and often detrimental) revisions to the Internal Revenue Code.

Rationalizing the tax provisions relating to the Virgin Islands would accomplish the following: (a) simplify the tax treatment of individuals moving between the Virgin Islands and the United States, (b) rectify the inequitable treatment of U.S. individuals deriving income from the Virgin Islands, (c) enhance the ability of the Virgin Islands to attract foreign capital, and (d) eliminate known and unknown opportunities for avoidance and evasion of United States and Virgin Islands taxes through inappropriate but untested interpretations of the mirror system and the Revised Organic Act.

APPENDIX A

EXPIRING PROVISIONS

The following provisions of the Internal Revenue Code are scheduled to expire under current law:

		Administration Proposal
1.	Residential and business energy tax credits.	See Ch. 9.01
2.	Targeted jobs credit.	Allow to expire as scheduled.
3.	Expensing of expenditures to remove architectural barriers to the elderly and handicapped.	Allow to expire as scheduled.
4.	Credit for testing orphan drugs.	Allow to expire as scheduled.
5.	Special treatment for dividend reinvestment in public utility stock.	Allow to expire as scheduled.
6.	Exclusion of employer-provided legal services.	Make permanent, but require a qualified group legal services plan to require the irrevocable establishment of the employee's annual contributions prior to the beginning of the plan year.
7.	Exclusion of employer-provided education assistance.	Make permanent, and drop the $5,000 annual limit of current law on the amount of educational assistance benefits that can be excluded.
8.	Exclusion of employer-provided vanpooling.	See Ch. 3.03.

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APPENDIX B

EFFECTIVE DATES AND TRANSITION RULES

The Administration proposals are designed to provide for fair and orderly transition to a new tax system. In general, prompt implementation of the proposals is desirable in order to capture their benefits as quickly as possible. Immediate implementation of some proposals, however, would be unfair and disruptive to taxpayers who have made economic commitments based on the current tax structure. Moreover, certain of the proposals would generate substantial windfall gains or losses if implemented immediately. These concerns mandate transition rules that reflect the differing effects of the various proposals.

In those areas where immediate implementation of the proposals would be unfair or disruptive, transition rules are provided to minimize unanticipated effects. These rules include delayed and phased in implementation of reform, as well as a wide variety of grandfather provisions that insulate existing investments. The proposed changes and transition rules for each element of the Administration proposals are summarized in Table B-1. More complete statements are found in each General Explanation.

In general, consistent with Secretary of the Treasury James A. Baker, III's February 27, 1985, testimony before the House Ways and Means Committee, no Administration proposal contains an effective date before January 1, 1986. Even though not effective until 1986, many of the proposals would affect the tax treatment of investments contemplated before 1986. Thus, for example, the new rules for capital cost recovery and repeal of the investment tax credit are proposed to be effective for all property placed in service after 1985, without regard to contractual commitments to acquire such property entered into before 1986. In recognition of the prerogative of the congressional tax-writing committees to design appropriate transition rules, grandfather rules were not specified in this and similar instances. Announcement of a binding contract exception effective as of the date of announcement of the Administration proposals would have encroached on this congressional prerogative; announcement of a binding contract exception to take effect at a future date was considered inappropriate because it would tend to accelerate investments solely for tax reasons.

With respect to life insurance inside build-up and the taxation of deferred annuity investment income, the Administration proposals adopt the rule suggested in the March 15, 1985, statement by House Ways and Means Committee Chairman Dan Rostenkowski and Senate Finance Committee Chairman Bob Packwood. That is, such income would be taxed, beginning January 1, 1986, only on policies issued after the date of committee action. This rule again defers to the tax-writing committees with respect to the termination date of the grandfather period.

The Treasury Department looks forward to working with the congressional committees to develop any additional transition rules that the committees determine are necessary to implement the Administration proposals in a fair and orderly manner.

Table B-1

PROPOSED CHANGES, EFFECTIVE DATES AND TRANSITION RULES

Proposed Changes	Effective Dates and Transition Rules
I. INDIVIDUAL INCOME TAXES	
1. Reduce Marginal Tax Rates	
1.01 Reduce rates and collapse present 15 tax rates for single taxpayers and 14 tax rates for married taxpayers and heads of households into 3 rates of 15, 25 and 35 percent.	The proposed rates would be effective July 1, 1986. Thus, the rate schedule for taxable years beginning on or after (TYBOA) January 1, 1986, would reflect blended rates; withholding to reflect the rate reduction would change on July 1, 1986.
2. Increase Fairness for Families	
2.01 Increase ZBAs and personal exemption.	
a. Increase the Zero Bracket Amounts from \$2,480 to \$2,900 for single filers, from \$2,480 to \$3,600 for heads of households, and from \$3,670 to \$4,000 for joint filers (in 1986 dollars).	TYBOA 1/1/86.
b. Increase personal exemption from \$1,080 to \$2,000 (in 1986 dollars).	TYBOA 1/1/86.
2.02 Fold additional exemptions for the blind and elderly into an expanded credit for the elderly, blind and disabled, and make all taxable disability income eligible for the credit.	TYBOA 1/1/86, with credit applying to workers' compensation and black lung disability payments only as these become taxable (generally, 1/1/87).
2.03 Repeal deduction for two-earner married couples.	TYBOA 1/1/86.
2.04 Increase and index the Earned Income Tax Credit.	TYBOA 1/1/86.
2.05 Replace child and dependent care credit with a deduction from gross income with the same cap (\$2,400 for one child, \$4,800 for two or more children).	TYBOA 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
3. Make the System More Neutral and Fair	
A. Excluded Sources of Income--Fringe Benefits	
3.01 Include a limited amount of employer-provided health insurance in taxable income ($300 per year for family coverage, $120 per year for individual coverage).	Applies to employer contributions received in TYBOA 1/1/86.
3.02 Repeal $5,000 exclusion for employer-provided death benefits.	Applies to benefits paid due to deaths occurring on or after 1/1/86. For collectively bargained plans, applies to years beginning after the earlier of 1/1/89 or the termination of collective bargaining contract.
3.03 Repeal exclusion for employer-provided commuting services.	Allow to expire for TYBOA 1/1/86.
3.04 Establish a uniform nondiscrimination rule for all fringe benefit plans.	Applies to all non-health care fringe benefit plan years beginning on or after 1/1/86 and to health care plan years beginning on or after 1/1/87. For all collectively bargained plans, applies to plan years beginning after termination of collective bargaining contract.
3.05 Repeal exclusion for employee awards.	Applies to awards received in TYBOA 1/1/86.
B. Excluded Sources of Income--Wage Replacement Payments	
3.06 Repeal exclusion for unemployment and disability payments.	
a. Repeal tax-exempt threshold for unemployment insurance compensation.	Applies to unemployment compensation received in TYBOA 1/1/87.
b. Repeal tax exemption for workers' compensation and black lung disability payments, but make all such income eligible for the expanded credit for the elderly, blind and disabled.	Applies to workers' compensation received in TYBOA 1/1/87 for disabilities occurring on or after 1/1/87, and applies to black lung disability payments received in TYBOA 1/1/87.

Proposed Changes	Effective Dates and Transition Rules
C. Excluded Sources of Income--Other	
3.07 Repeal exclusion for scholarships and fellowships in excess of tuition.	Applies to scholarships and fellowships received in TYBOA 1/1/86. However, if binding commitment to grant a scholarship or fellowship in the case of a degree candidate was made before 1/1/86, it would be excluded through 1990.
3.08 Repeal exclusion of prizes and awards.	Applies to prizes and awards received in TYBOA 1/1/86.
D. Preferred Uses of Income	
3.09 Repeal itemized deduction for state and local taxes.	TYBOA 1/1/86.
3.10 Accelerate expiration of deduction for charitable contributions for non-itemizers.	TYBOA 1/1/86.
E. Tax Abuses--Mixed Business/Personal Use	
3.11 Deny deduction for all entertainment expenses, including club dues and tickets to public events, except for business meals furnished in a clear business setting. For business meals, deny deduction for one-half of cost of meal above $25 per meal per person.	TYBOA 1/1/86.
3.12 Limit deduction for travel expenses.	
a. Establish bright-line rule to separate indefinite and temporary assignments at one year.	TYBOA 1/1/86.
b. Deny deduction for travel as a form of education.	TYBOA 1/1/86.
c. Deny deduction for seminars held aboard cruise ships.	TYBOA 1/1/86.
d. Deny deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above the cost of otherwise available business transportation (with medical exception).	TYBOA 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
F. Tax Abuses--Income Shifting	
3.13 Tax unearned income of children under 14 at the parent's rate; the child's personal exemption could be used first against such income.	TYBOA 1/1/86.
3.14 Revise grantor and non-grantor trust taxation.	
a. Revise grantor trust rules to eliminate the shifting of income to lower rate beneficiaries through trusts in which the grantor retains an interest.	TYBOA 1/1/86, but if classification of existing irrevocable trust changes from a grantor to a non-grantor trust, may elect to be treated as grantor trust.
b. During grantor's lifetime, tax trusts at the grantor's tax rates and allow deductions only for non-discretionary distributions and set-asides. After grantor's death, tax all undistributed trust or estate income under a graduated rate schedule.	TYBOA 1/1/86, but irrevocable non-grantor trusts created before 1/1/86 can keep fiscal year if elected by 1/1/86, deduct all distributions, and use the tier system.
3.15 Revise income taxation of estates.	Applies to estates of decedents dying on or after 1/1/86.
4. <u>Reduce Recordkeeping and Complexity</u>	
4.01 Combine miscellaneous itemized deductions with employee business expenses and itemized state and local taxes (other than income taxes) incurred in an income-producing activity and allow a deduction for such expenses if they exceed 1 percent of adjusted gross income.	TYBOA 1/1/86.
4.02 Repeal political contribution credit.	TYBOA 1/1/86.
4.03 Repeal presidential campaign check-off.	Effective for tax liability with respect to TYBOA 1/1/86.
4.04 Repeal deduction for adoption expenses for children with special needs, and replace with a direct expenditure program.	TYBOA 1/1/87, but allow continued deduction for qualified expenses incurred after 1/1/87 by taxpayers who incurred qualified expenses before 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
4.05 Repeal income averaging.	TYBOA 1/1/86.
4.06 Simplify penalty provisions.	
a. Simplify information return penalties.	Applies to returns due on or after 1/1/86.
b. Repeal maximum limits on penalties.	Applies to returns due on or after 1/1/86.
c. Replace failure-to-pay penalty with a cost of collection charge.	Applies to returns due on or after 1/1/86.
5. <u>Simplify the System of Filing</u>	
5.01 Implement a non-filing system, in which IRS would compute taxes for many tax payers.	Unspecified.
II. BUSINESS AND CAPITAL INCOME TAXES	
6. <u>Revise the Taxation of Corporate Income</u>	
6.01 Reduce corporate income tax rates.	
a. Reduce maximum corporate rate to 33 percent.	Effective 7/1/86.
b. Revise graduated corporate rate structure.	Effective 7/1/86.
6.02 Reduce double taxation of distributed corporate earnings by allowing a 10 percent dividends-paid deduction. Allow 90 percent intercorporate dividends-received deduction.	Effective 1/1/87. Qualified Dividend Account includes taxable income only for TYBOA 1/1/87.
6.03 Repeal $100/$200 exclusion of dividend income.	TYBOA 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
7. Revise Taxation of Business Property and Capital Assets	
7.01 Adopt a new capital cost recovery system (CCRS) which indexes depreciation allowances for inflation and adjusts depreciation schedules.	Effective for property placed in service on or after 1/1/86.
7.02 Repeal investment tax credit.	Effective for property placed in service on or after 1/1/86.
7.03 Revise tax treatment of capital gains.	
a. Allow individuals a 50 percent exclusion for capital gains; retain 28 percent rate for corporations.	Effective for assets sold on or after 7/1/86.
b. Tax gains on depreciable assets (which will have indexed basis) as ordinary income. Repeal capital gains treatment of livestock and unharvested crops (see 9.04 for changes in treatment of timber, coal and iron ore).	TYBOA 1/1/86, with grandfathering for assets placed in service before 1/1/86.
c. Allow an indexing option as an alternative to the 50 percent exclusion on non-depreciable capital assets beginning 1/1/91.	Effective for assets sold on or after 1/1/91.
7.04 Allow indexed-FIFO and repeal LIFO conformity requirement.	TYBOA 1/1/87.
7.05 Retain expensing of the first $5,000 of depreciable business property but repeal currently scheduled increases in the $5,000 limit.	No change in current law, except that scheduled increase in $5,000 level would be eliminated.
7.06 Repeal rapid amortization rules.	
a. Repeal five-year amortization of trademark expenses, certified pollution control facilities, and rehabilitation of low income housing. Repeal 50 year amortization of qualified railroad grading and tunnel bores. Repeal expensing of certain soil and water conservation and preparation expenditures. Repeal seven-year amortization of reforestation expenditures.	Effective for expenditures paid or incurred on or after 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
b. Delete expired rules permitting five-year amortization of qualified child care facilities and railroad rolling stock.	Repeal as deadwood.
7.07 Apply a rate reduction recapture rule to depreciable assets placed in service between 1/1/80 and 12/31/85; the rule specifies an income inclusion that will prevent the benefit which would otherwise occur due to accelerated depreciation deductions taken at high pre-reform tax rates when the associated deferred tax liability is repaid at low post-reform tax rates.	12 percent of the income inclusion would occur in 1986, 12 percent in 1987 and 16 percent in 1988.
8. Measure Income Properly 8.01 Revise accounting rules for production costs of multiperiod production, including all cost-plus contracts.	Effective for expenses and interest paid or incurred on or after 1/1/86. Old rules apply to long-term contracts entered into before 1/1/86. Production costs (including interest) attributable to timber planted before 1/1/86 that are not capitalized under present law would be capitalized under 10-year phase in (10 percent of such costs capitalized in 1986, 20 percent in 1987, etc.). Inventory change would begin TYBOA 1/1/86, with income increase due to change spread evenly over up to 6 years. The new rules would not apply to self-constructed assets where substantial construction had begun before 1986.
8.02 Recognize gain on pledges of installment obligations when receivables are pledged, with exception for certain short-term receivables.	Effective for installment notes pledged as security after 1985. As of 1/1/91, applies to installment notes pledged before 1986.
8.03 Limit use of cash method of accounting.	TYBOA 1/1/86, with income increase due to change spread evenly over up to 6 years.
8.04 Repeal reserve method for bad debt deductions, and limit deductions to actual loan losses.	TYBOA 1/1/86, with draw down of existing reserves includable in taxable income ratably over 10 years.
8.05 Repeal mining and solid waste reclamation and closing cost deduction.	Effective with respect to mining or production activity occurring on or after 1/1/86.
9. Revise Taxation of Energy and Natural Resources 9.01 Repeal energy tax credits.	
a. Terminate (or allow to expire) energy investment tax credits.	Credits terminated or allowed to expire on 12/31/85, but affirmative commitment rules would continue to apply.

Proposed Changes	Effective Dates and Transition Rules
b. Terminate production tax credits.	Production tax credits would terminate 12/31/85, but eligible fuel produced from a well drilled, or from facilities completed, before 1/1/86 and sold before 1/1/90 would continue to be eligible for credit.
c. Repeal excise tax exemptions for alcohol fuel mixtures and alcohol fuels.	Excise tax exemptions would terminate 12/31/85.
d. Terminate alcohol production credit.	Alcohol fuels credit would be available for eligible alcohol fuels produced from facilities completed before 1/1/86 and sold before 1/1/93.
e. Allow excise tax exemption for fuel for certain taxicabs to expire.	Qualified taxicab refund would be allowed to expire 9/30/85.
f. Allow residential energy credit to expire.	Residential energy credits would be allowed to expire 12/31/85.
9.02 Repeal percentage depletion, except for independent stripper wells, and replace with indexed cost depletion.	5 year phase out beginning with production on or after 1/1/86 (80 percent of current percentage depletion in 1986, 60 percent in 1987, etc.).
9.03 Revise minimum tax treatment of intangible drilling costs.	Effective for expenditures paid or incurred on or after 1/1/86.
9.04 Revise taxation of timber, coal and iron ore.	
a. Repeal capital gains taxation of royalty income received from timber, coal and iron ore.	Phase out over three years. For individuals, allow a 30 percent exclusion for all royalty income received in 1986, a 20 percent exclusion in 1987, a 10 percent exclusion in 1988, and tax as ordinary income all royalty income received on or after 1/1/89. For corporations, tax at a 30 percent rate all royalty income received in 1986, a 31 percent rate in 1987, a 32 percent rate in 1988, and tax at a 33 percent rate all royalty income received on or after 1/1/89.
b. Repeal capital gains taxation of the cutting of timber by the owner of timber or the owner of a contract right to cut timber.	Phase out over three years. For individuals, allow a 30 percent exclusion for timber cut in 1986, a 20 percent exclusion in 1987, a 10 percent exclusion in 1988, and tax as ordinary income beginning 1/1/89. For corporations, tax at a 30 percent rate timber cut in 1986, a 31 percent rate in 1987, a 32 percent rate in 1988, and tax at a 33 percent rate all timber cut on or after 1/1/89.

10. Reform Taxation of Financial Institutions

Proposed Changes	Effective Dates and Transition Rules
A. Commercial Banks and Thrift Institutions	
10.01 Repeal special rules for bad debt deductions for banks and thrift institutions.	TYBOA 1/1/86, with draw down of existing tax reserves included in taxable income either in the taxable year beginning in 1986 or ratably over 10 years. Thrift reserves accumulated using the percentage of taxable income method would not be brought into taxable income to the extent they exceed the greater of the reserves computed by the percentage of eligible loan or experience methods.
10.02 Disallow 100 percent of interest expense incurred by depository institutions to carry tax-exempt bonds.	Effective for interest allocable to tax-exempt obligations acquired on or after 1/1/86. Permanent grandfathering for bonds acquired prior to 1/1/86. (Current 20-percent disallowance rule would apply for obligations acquired between 1/1/83-12/31/85.)
10.03 Repeal tax exemption of credit unions with gross assets of 5 million dollars or more.	TYBOA 1/1/86.
10.04 Repeal special reorganization rules for financially troubled thrift institutions.	Effective for acquisitions occurring on or after 1/1/91.
10.05 Repeal special rules for carryover of net operating losses of depository institutions.	Effective for net operating losses incurred in TYBOA 1/1/86. Old rules would apply to net operating losses incurred in taxable years before 1/1/86.
B. Life Insurance Companies and Products	
10.06 Impose current taxation on inside interest build-up income in life insurance policies.	TYBOA 1/1/86 for inside interest build-up credited to policies issued on or after the date of Committee action.
10.07 Impose current taxation on deferred annuity investment income.	TYBOA 1/1/86 for investment income credited to policies issued on or after the date of Committee action.
10.08 Limit life insurance company reserve deduction to the increase in the policyholder's cash surrender value.	Effective for policies sold on or after 1/1/86.
10.09 Repeal special life insurance company deductions.	TYBOA 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
C. Property and Casualty Insurance Companies	
10.10 Revise treatment of losses by property and casualty insurance companies and allow their policyholders to elect to deduct losses as they occur with insurance proceeds taxable when received.	Effective for unpaid losses incurred in TYBOA 1/1/86 with respect to policies issued on or after 1/1/86.
10.11 Repeal mutual property and casualty insurance companies' deduction for additions to protection against loss accounts.	TYBOA 1/1/86, with amounts currently in the account includable in taxable income ratably over 5 years.
10.12 Repeal special tax exemptions, rate reductions, and deductions of small mutual property and casualty insurance companies.	TYBOA 1/1/86, phased in over 5 years.
10.13 Limit mutual property and casualty insurance companies' deduction for policyholder dividends.	TYBOA 1/1/86.
11. Reform Treatment of State and Local Government Debt and Investments	
11.01 Repeal tax exemption of non-governmental purpose tax-exempt bonds.	Effective for obligations issued on or after 1/1/86. A transition rule would be provided for certain refundings of outstanding obligations.
11.02 Tighten restrictions on tax arbitrage and advance refunding for tax-exempt bonds.	Effective for obligations issued on or after 1/1/86.
11.03 Repeal General Stock Ownership Corporation provisions.	Effective as of 1/1/84, the sunset date for creation of General Stock Ownership Corporations.
12. Modify Other Specific Subsidies	
12.01 Repeal tax credit for qualified rehabilitation expenditures.	Effective for expenditures incurred on or after 1/1/86.
12.02 Repeal special rules for returns of magazines and paperback books and for qualified discount coupons.	TYBOA 1/1/86, with balance of suspense account deductible in first year.
12.03 Extend and modify the incremental research and experimentation credit.	Effective for expenditures incurred on or after 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
12.04 Repeal special treatment of merchant marine capital construction fund exclusion.	No further tax-free contributions could be made after 12/31/85, except with respect to qualified agreement vessels that the taxpayer owned on 1/1/86, or with respect to which the taxpayer had performed (or had caused to be performed) a substantial amount of construction or reconstruction before 1/1/86. To the extent that fund assets exceeded amounts designated under the agreement to be used with respect to such qualified vessels, earnings on such excess attributable to the period beginning on 1/1/86 would be subject to tax. Any withdrawals from a fund on or after 1/1/86, other than with respect to such qualified vessels, would be treated as nonqualified withdrawals, except that no interest charge would apply. Any amounts remaining in a capital construction fund on 1/1/96 would be treated as withdrawn at that time.
12.05 Repeal possessions tax credit and replace with a wage credit.	Wage credit would replace existing credit for TYBOA 1/1/86. Corporations making an election prior to 1/1/86 may elect prior rules for five years for income on products produced as of that date.
12.06 Revise rules for leveraged employee stock ownership plans (ESOP).	
a. Revise limits on deductions for contributions to an ESOP.	Applies to loans incurred on or after 1/1/86; grandfather securities acquisition loans entered into before 1/1/86.
b. Require distribution of ESOP stock as becomes vested.	Applies to stock financed with loans incurred on or after 1/1/86.
c. Revise special treatment of ESOP dividends.	Applies to dividends paid on or after 1/1/86.
d. Allow PAYSOP credit to expire.	Credit expires 12/31/87.
13. Curtail Tax Shelters	
13.01 Disallow most current interest deductions (with carry forward) in excess of the sum of mortgage interest on the taxpayer's principal residence, investment income, income from limited partnerships and S corporations, and $5,000.	TYBOA 1/1/86, but with ten year phase-in for expanded definition of investment interest (10% of newly included interest -- consumer interest, interest expense of S corporation where taxpayer does not participate in management, interest expense of limited partnership where taxpayer is a limited partner -- would be subject to the limitation in TYBOA 1/1/86, 20% in TYBOA 1/1/87, etc.). The current $10,000 limit would be maintained for taxable years beginning before 1/1/88.
13.02 Extend the at-risk limitations to real estate.	Applies to property acquired on or after 1/1/86.
13.03 Revise the alternative minimum tax for noncorporate taxpayers.	TYBOA 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
13.04 Change present corporate add-on minimum tax to a new alternative corporate minimum tax.	TYBOA 1/1/86.
14. Revise Treatment of Retirement Savings	
14.01 Make IRAs of up to $2,000 each available both to employees and their spouses working in the home.	TYBOA 1/1/86.
14.02 Unify rules for distributions from tax-favored retirement plans.	
a. Subject all tax-favored retirement plans to uniform minimum distribution rules and apply a 50 percent sanction on difference between the required and actual annual distribution.	Applies generally to TYBOA 1/1/86. Grandfather tax-sheltered annuities with no contributions made on or after 1/1/86.
b. Repeal capital gain and ten-year averaging for lump sum distributions.	Repeal applies to preretirement lump sum distributions on or after 1/1/86. Repeal applies to retirement lump sum distributions on or after 1/1/86 and is phased-in over six years (5 percent of lump sum received in 1987, 25 percent in 1988, 50 percent in 1989, 75 percent in 1990, and 100 percent in 1991).
c. Eliminate deferred inclusion of unrealized appreciation on employer securities.	Applies to individual TYBOA 1/1/86, with same six-year phase-out as in (b).
d. Eliminate special basis recovery rules for qualified plan distributions.	Applies generally to distributions on or after 1/1/86. For distributions made before the annuity starting date, grandfather benefits accrued as of 1/1/86. Grandfather annuity distributions after the annuity starting date for benefits in pay status as of 1/1/86.
e. Subject early distributions generally to an additional tax of 20 percent, but apply only a 10 percent tax if used for college expenses or first home purchase, or if during a period of unemployment following the termination of unemployment benefits.	Applies to early distributions on or after 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
14.03 Modify deduction rules for tax-favored retirement plans.	
a. Replace 15 percent of aggregate compensation limit for profit sharing and stock bonus plans with 15 percent of individual compensation limits; apply 25 percent of aggregate compensation limit to combined defined contribution and defined benefit plans.	Applies to employer's TYBOA 1/1/86. For certain "retirement-type" profit sharing and stock bonus plans, a special rule would permit deductions in excess of 15 percent of an individual's compensation where annual contributions of less than 15 percent had been made on behalf of such individuals before 1/1/86.
b. Subject excess contributions to an annual 6 percent tax.	Applies to excess contributions for employer's TYBOA 1/1/86.
c. Repeal special deduction limits for ESOP contributions, and allow PAYSOP tax credit to expire.	Applies to employer's TYBOA 1/1/86, with grandfathering for contributions to discharge ESOP loans outstanding on 12/31/85. PAYSOP credit expires 12/31/87.
14.04 Modify annual limits on contributions and benefits under tax-favored plans.	
a. Repeal overall plan limit for non-top-heavy plans.	Applies to plan limitation years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract.
b. Apply a 10 percent tax to annual distributions in excess of 1.25 times the defined benefit dollar limit.	Applies to individual TYBOA 1/1/86.
c. Include one-half of employee contributions as annual additions to defined contribution plans under the annual contribution limits.	Applies to plan limitation years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract.
d. Phase in defined benefit dollar limit over ten years of plan participation, rather than merely ten years of service.	For limitation years beginning in 1986, the applicable dollar limit is subject to a two years of participation phase-in; for years beginning in 1987, a three years of participation phase-in, etc., until for years beginning on or after 1/1/94, a ten years of participation phase-in rule would apply.
14.05 Apply a recapture tax of 10 percent on plan funds reverting to an employer upon plan termination.	Applies to asset reversions pursuant to plan terminations occurring on or after 1/1/86.

Proposed Changes	Effective Dates and Transition Rules
14.06 Revise cash or deferred arrangements by imposing an $8,000 annual limit and counting contributions against IRA limits, and tighten nondiscrimination rules for cash or deferred arrangements and employer matching contributions.	Applies to plan years beginning on or after 1/1/86. For collectively bargained plans, applies to years beginning after termination of collective bargaining contract.
14.07 Permit use of benefits forfeited by a separated employee to increase benefits of other employees.	Applies to plan years ending on or after 1/1/86.
14.08 Modify plan loan rules to reduce the $50,000 loan limit by the highest outstanding loan balance during the prior 12 month period.	Applies to amounts received as loans on or after 1/1/86.
14.09 Apply objective nondiscriminatory coverage test to all qualified plans; permit 125 percent disparity between prohibited group coverage and coverage of other employees.	Applies to plan years beginning on or after 1/1/87. For collectively bargained plans, applies to year beginning after termination of collective bargaining contract.
14.10 Unify rules for unfunded deferred compensation for employees of public sector employers, and employees of tax-exempt employers.	Applies to individual TYBOA 1/1/86.
15. Reform International Taxation	
15.01 Reform foreign tax credit.	
a. Change foreign tax credit limitation to a separate per country limitation.	TYBOA 1/1/86. Five-year carryforward of prior excess credits without per country limitation.
b. Modify the calculation of the deemed-paid credit.	TYBOA 1/1/86. Changes do not apply to dividends paid out of earnings and profits of taxable years beginning prior to 1/1/86.
15.02 Modify sourcing rules for income and deductions.	
a. Modify rules defining sources of income derived from sales of inventory-type property, manufactured goods, and intangible property.	TYBOA 1/1/86. Transitional rules would be provided for sales made under unrelated party contracts executed before 1/1/86.

	Proposed Changes	Effective Dates and Transition Rules
	b. Repeal special sourcing rules for interest and dividend income of 80-20 corporations.	TYBOA 1/1/86, with modification of source rule for interest income received from 80-20 corporations effective only for interest on debt obligations incurred after 1/1/86.
	c. Repeal special source rules for income derived from U.S. built vessels and aircraft.	TYBOA 1/1/86, but old rules apply to income derived from vessels or aircraft owned by the taxpayer on 1/1/86 and leased before 1/1/86.
	d. Allocate interest expense on a combined group basis, rather than a separate company basis.	TYBOA 1/1/86.
	e. Disregard tax-exempt income in allocating interest expense.	TYBOA 1/1/86 for tax-exempt income derived from assets acquired on or after 1/1/86.
15.03	Replace second dividend tax with a branch profits tax and the second tax on interest with a branch interest tax.	TYBOA 1/1/86.
15.04	Revise taxation of foreign exchange gains and losses.	Effective for transactions entered into after 1/1/86, with grandfathering of certain transactions that are open as of 1/1/86. Translation rules effective for TYBOA 1/1/86.
15.05	Reform the mirror system of taxation for the United States possessions.	TYBOA 1/1/86; certain provisions would remain in effect until necessary changes are made in territorial laws.

APPENDIX C

Fundamental Tax Reform
Change in Receipts by Source

($billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS 1/					
A. Rate Reduction					
Rate schedules (see Note B at end of table).................	-11.1	-49.5	-60.6	-66.7	-72.7
B. Fairness for Families					
Increase the Zero Bracket Amount 2/..........................	-4.4	-6.2	-6.6	-7.1	-7.6
Repeal the additional exemption for the blind and elderly; increase the taxpayer and dependent exemption to $2000.....	-18.8	-39.1	-42.1	-45.1	-48.0
Expand the credit for the elderly and the disabled..........	-.2	-1.1	-1.1	-1.2	-1.3
Repeal second earner deduction...............................	1.6	7.1	7.7	8.3	9.0
Expand and index earned income tax credit 3/................	-*	-1.4	-1.6	-1.7	-1.9
Replace child and dependent care credit with a deduction from gross income..............................	-*	-.3	-.3	-.3	-.3
Fairness to Families, subtotal...............................	-21.8	-40.9	-44.0	-47.1	-50.1
C. Fair and Neutral Taxation					
Excluded Sources of Income:					
Include a portion of employer provided health insurance in taxable income ($10/individual;$25/family per month).......	2.4	3.5	3.7	3.8	4.0
Repeal exclusion of employer provided death benefits........	*	*	*	*	.1
Repeal exclusion of employee awards.........................	*	*	*	*	*
Repeal tax exempt threshold for unemployment compensation...	--	.4	1.2	1.1	1.1
Repeal exclusion of workers' compensation and black lung benefits (net of credit).................................	--	.2	1.3	1.5	1.8
Limit exclusion of scholarships and fellowships.............	*	.1	.2	.2	.2
Repeal exclusion of prizes and awards.......................	*	*	*	*	*
Extend exemption of contributions to group legal plans......	-.1	-.1	-.2	-.2	-.3
Extend exemption of contributions for educational assistance	-.1	-.1	-.2	-.2	-.2
Discrimination rules for employee benefits other than retirement benefits......................................	*	.1	.2	.2	.2
Excluded Sources of Income, subtotal........................	2.3	4.0	6.1	6.5	6.9
Preferred Uses of Income:					
Repeal deduction for state and local taxes..................	4.5	33.3	34.1	37.0	40.0
Accelerate expiration of charitable contributions deduction for non-itemizers..	.4	2.7	--	--	--
Preferred Uses of Income, subtotal..........................	5.0	36.0	34.1	37.0	40.0
D. Tax Abuses					
Restrict entertainment expense deductions and limit deductions for business meals (50% over $25 per meal)					
Individual...	.3	.6	.7	.8	.9
Corporate..	.3	.6	.8	.9	1.0
Limit temporary assignments to 1 year					
Individual...	*	*	*	*	*

($billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Deny deduction for education travel					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Deny deduction for cruise ship seminars					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Limit deduction for luxury water travel					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Tighten grantor trust rules					
Individual	*	*	*	*	*
Revise taxation of trusts and estates					
Individual	.2	.5	.6	.7	.8
Tax unearned income of children under 14 at parent's rate					
Individual	.1	.4	.5	.5	.6
Tax abuses, subtotal:					
Individual	.6	1.6	1.8	2.1	2.3
Corporate	.3	.6	.8	.9	1.0
E. Further Simplification					
Implement return-free system	--	--	--	--	--
Revise the alternative minimum tax	.1	.3	.3	.3	.3
Move miscellaneous deductions above the line and combine with employee business expense subject to a 1% of AGI floor	.2	1.5	1.7	1.8	1.9
Repeal political contribution credit	*	.3	.3	.3	.4
Repeal presidential campaign checkoff	--	--	--	--	--
Repeal deduction for special needs adoption expenses	--	4/	4/	4/	4/
Repeal income averaging	1.0	3.9	4.3	4.6	4.9
Simplification, subtotal	1.3	6.0	6.6	7.0	7.6
BASIC TAXATION OF CAPITAL AND BUSINESS INCOME					
A. Revise Corporate Tax Rates					
Reduce maximum corporate rate to 33%					
Corporate	-9.8	-26.9	-36.1	-39.2	-42.0
Revise graduated corporate rate structure					
Corporate	-.2	-.4	-.4	-.5	-.5
Revise corporate minimum tax					
Corporate	--	.7	.7	.7	.8
Reduce corporate tax rates, subtotal:					
Corporate	-10.0	-26.7	-35.9	-39.0	-41.8
B. Taxing Real Economic Income					
Capital gains					
Individual- (50% exclusion rate)	.6	2.9	4.6	5.0	5.4
Corporate	--	-*	-*	-*	-*

($billions)

	Fiscal Years 1986	1987	1988	1989	1990
Adjust depreciation schedules and index for inflation					
Individual	.1	.3	1.3	3.6	5.8
Corporate	.3	-.7	2.3	8.7	15.4
Repeal investment tax credit					
Individual	1.7	4.8	5.6	6.4	7.2
Corporate	14.0	25.6	29.4	33.3	37.4
Allow expensing of first $5,000 of depreciable business property, repeal scheduled increases					
Individual	--	--	.1	.3	.3
Corporate	--	--	.2	.3	.4
Allow indexed FIFO, repeal conformity					
Individual	--	-.1	-.2	-.2	-.2
Corporate	--	-2.4	-4.5	-4.5	-4.5
Taxing real economic income, subtotal:					
Individual	2.4	7.9	11.4	15.0	18.5
Corporate	14.3	22.5	27.4	37.8	48.7
C. Recapture of Rate Differential on Accelerated Depreciation					
Individual	*	.3	.3	.5	--
Corporate	7.6	19.4	20.4	9.1	--
D. Retirement Saving					
Increase spousal IRA limit to $2,000					
Individual	-.3	-.8	-.9	-1.0	-1.1
Uniform distribution requirements					
Individual	*	*	*	*	*
Excise	--	*	*	*	*
Tax on pre-retirement distributions, uniform basis recovery rules					
Individual	-.1	-.2	.1	.5	.9
Tax on qualified plan reversions					
Corporate	*	*	*	*	*
Repeal 10 year averaging of lump sum distributions					
Individual	.5	.7	.6	.6	.7
Repeal 3 year basis recovery rule for contributory plans					
Individual	.8	2.1	2.8	2.8	2.8
Eliminate deferral of appreciation on employer retirement securities					
Individual	--	*	*	*	.1
Simplify contribution deduction limits					
Individual	*	.1	.1	.1	.1
Excise tax on excess retirement contributions					
Individual	*	*	*	*	*
Excise	--	*	*	*	*
Repeal combined plan limit for non-topheavy plans					
Individual	-.1	-.3	-.3	-.3	-.4
Tax on retirement distributions in excess of ceiling					
Individual	*	*	*	*	*

($billions)

	Fiscal Years 1986	1987	1988	1989	1990
Modify rules for deductions of ESOP contributions, allow PAYSOP credit to expire					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Modify cash and deferred arrangements (CODAs)					
Individual	1.1	1.8	2.1	2.4	2.8
Modify CODA and non-CODA discrimination rules					
Individual	--	*	*	*	*
Retirement saving, subtotal:					
Individual	1.9	3.4	4.5	5.0	5.8
Corporate	*	*	*	*	*
Excise	--	*	*	*	*
E. Neutrality Toward the Form of Business Organization					
10% dividends paid deduction, 90% intercorporate dividends received deduction					
Individual	--	-.2	-.3	.6	1.3
Corporate	--	-3.4	-6.2	-7.2	-8.0
Repeal $100/$200 dividend exclusion					
Individual	.2	.6	.6	.6	.7
Neutrality toward business organization, subtotal:					
Individual	.2	.4	.3	1.2	1.9
Corporate	--	-3.4	-6.2	-7.2	-8.0
INDUSTRY SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES					
A. Other General Issues of Income Measurement					
Match expense and income from multiperiod production: completed contracts					
Individual	.1	.3	.7	1.0	1.1
Corporate	.5	1.9	3.6	4.8	4.4
Match expense and income from multiperiod production: other					
Individual	*	.2	.3	.3	.3
Corporate	1.8	3.2	4.6	6.6	8.3
Restrict use of cash accounting method					
Individual	.1	.2	.3	.3	.3
Corporate	.4	.7	.8	.8	.8
Limit bad debt deductions to actual loss					
Individual	*	.1	.1	.1	.1
Corporate	.7	1.1	1.2	1.2	1.3
Treat pledges of installment obligations as payments					
Individual	*	.1	.2	.3	.4
Corporate	*	.1	.1	.2	.3
Income measurement, subtotal:					
Individual	.2	.9	1.5	1.9	2.1
Corporate	3.3	6.9	10.3	13.6	15.0

($billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
B. Subsidies for Specific Industries					
Energy Subsidies:					
Repeal business energy credits, limit gasahol exemption					
Individual..	-*	-.1	-.1	-.1	-.1
Corporate..	-.2	-.3	-.3	-.3	-.3
Excise..	.2	.3	.3	.4	.4
Phase out percentage depletion except for stripper wells					
Individual..	.1	.2	.4	.6	.8
Corporate..	.1	.2	.3	.6	.9
Index basis of certain depletable assets					
Individual..	--	-*	-*	-*	-*
Corporate..	--	-*	-.1	-.1	-.2
Repeal special treatment of royalty income					
Individual..	*	*	.1	.1	.2
Corporate..	*	*	*	*	*
Repeal of capital gains treatment for timber income					
Individual..	*	*	*	*	*
Corporate..	*	.1	.1	.2	.2
Repeal special rules for mining reclamation reserves					
Individual..	*	*	*	*	*
Corporate..	*	.1	.1	.1	.1
Energy, subtotal:					
Individual..	*	.2	.5	.7	.9
Corporate..	-*	.1	.2	.4	.7
Excise..	.2	.3	.3	.4	.4
Financial Institutions:					
Repeal depository institution's bad debt reserve deductions					
Corporate..	.7	1.3	1.1	.9	1.1
Disallow interest incurred to carry tax exempts 5/					
Individual..	-*	-.2	-.4	-.6	-.8
Corporate..	.1	.2	.4	.6	.9
Repeal tax exemption of large credit unions					
Corporate..	.2	.3	.4	.4	.4
Repeal special carryover rules for depository institutions					
Corporate..	*	*	*	*	*
Repeal special reorganization rules for troubled thrifts					
Corporate..	--	--	--	--	--
Limit life insurance reserve deductions					
Corporate..	.4	.7	.7	.8	.8
Repeal special percentage of taxable income deduction for life insurance companies and repeal exemption of certain small life insurance companies					
Corporate..	.5	.9	1.0	1.0	1.1
Limit P&C reserves					
Individual..	-.1	-.3	-.1	-.1	-.1
Corporate..	.1	.4	1.0	1.7	2.4

($billions)

	Fiscal Years 1986	1987	1988	1989	1990
Repeal P&C insurance company deduction for addition to protection against loss accounts					
Corporate	.1	.1	.1	.1	.1
Limit deductibility of P&C dividends					
Corporate	.1	.1	.1	.1	.1
Repeal special tax exemption, rate reductions, and deductions of small mutual P&C companies					
Corporate	*	*	*	*	*
Financial institutions, subtotal:					
Individual	-.2	-.5	-.5	-.7	-.9
Corporate	2.1	4.2	4.9	5.7	6.9
Insurance Investment Income:					
Repeal exclusion of inside buildup					
Individual	--	--	--	*	.2
Repeal exclusion of current annuity income					
Individual	*	.1	.2	.3	.4
Insurance investment income, subtotal:					
Individual	*	.1	.2	.4	.6
State and Local Government Debt and Investments:					
Repeal exemption for nongovernmental bonds					
Individual	.4	1.8	3.5	4.7	5.5
Corporate	-.1	-.3	-.6	-.9	-1.0
Tighten restrictions on tax exempt bond arbitrage					
Individual	.1	.2	.2	.2	.2
Corporate	*	*	*	*	*
State and local government, subtotal:					
Individual	.5	2.0	3.7	4.8	5.7
Corporate	*	-.3	-.6	-.8	-1.0
Special Expensing and Amortization Rules:					
Repeal expensing of conservation expenditures and farmers fertilizer and field clearing					
Individual	.4	.9	.1	.1	.1
Corporate	.4	.3	.1	.1	.1
Repeal 5 year amortization of expenditures for rehabilitation of low income rental housing					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Repeal 5 year amortization of pollution control					
Corporate	*	*	*	*	*
Repeal 50 year amortization of railroad tunnels and bores					
Corporate	*	*	*	*	*
Repeal 5 year amortization of trademark expenses					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*

($billions)

	Fiscal Years 1986	1987	1988	1989	1990
Repeal 84 month amortization, 10% credit for reforestation					
Individual..........	*	*	*	*	*
Corporate..........	*	*	*	*	*
Special expensing and amortization, subtotal:					
Individual..........	.4	.9	.1	.1	.2
Corporate..........	.4	.3	.1	.1	.1
Other Specific Subsidies:					
Repeal rehabilitation tax credits					
Individual..........	.1	.3	.9	1.6	2.1
Corporate..........	*	.1	.3	.5	.6
Repeal special rules for returns of magazines etc and qualified discount coupons					
Corporate..........	.2	.1	*	*	*
Repeal exclusion of Merchant Marine Capital Construction Fund					
Corporate..........	*	.1	.1	.1	.1
Extend credit for research and experimentation					
Individual..........	-*	-*	-*	-*	-*
Corporate..........	-.6	-1.2	-1.5	-1.7	-1.9
Require employers to make nondeductible payments to employees who receive ESOP dividends					
Individual..........	*	*	*	*	*
Corporate..........	*	*	*	*	*
Other subsidies, subtotal:					
Individual..........	.1	.3	.9	1.6	2.1
Corporate..........	-.3	-.9	-1.0	-1.1	-1.2
C. Further Curtailment of Tax Shelters					
Repeal deduction for nonbusiness interest other than principal home mortgages ($5,000 limitation)					
Individual..........	*	.2	.4	1.0	1.5
Limit artificial losses (at risk rules)					
Individual..........	.1	.2	.3	.4	.5
Corporate..........	-.1	-.2	-.3	-.3	-.4
Tax shelters, subtotal:					
Individual..........	.1	.4	.7	1.4	1.9
Corporate..........	-.1	-.2	-.3	-.3	-.4
D. International Issues					
Use per country limitation for foreign tax credit					
Corporate..........	.9	2.5	3.0	3.3	3.6
Modify rules concerning source of income and allocation of deductions					
Corporate..........	.4	.9	1.1	1.2	1.3

($billions)

	Fiscal Years 1986	1987	1988	1989	1990
Replace secondary dividend rule with branch profit tax					
Corporate	*	*	*	*	*
Possessions tax credit					
Corporate	-*	-*	*	.1	.2
Treat foreign exchange gains or losses as adjustments in interest					
Corporate	*	*	*	*	*
Rationalize tax treatment of U.S. territories					
Corporate	*	*	*	*	*
International Issues, subtotal:					
Corporate	1.3	3.4	4.1	4.6	5.1
E. Other Related Tax Issues					
Penalties:					
Simplify information return penalties					
Individual	--	--	--	--	--
Corporate	--	--	--	--	--
Repeal maximum limits for penalties					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Estate and gift	*	*	*	*	*
Excise	*	*	*	*	*
Change failure-to-pay penalty to cost-of-collection charge					
Individual	.3	.3	.3	.3	.3
Corporate	*	*	*	*	*
Estate and gift	*	*	*	*	*
Excise	*	*	*	*	*
Penalties, subtotal:					
Individual	.3	.3	.3	.3	.3
Corporate	*	*	*	*	*
Estate and gift	*	*	*	*	*
Excise	*	*	*	*	*

($billions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Total Change in Receipts:					
Individual	-17.9	-26.0	-32.0	-29.0	-26.9
Corporate	18.9	26.1	24.3	23.9	25.2
Estate and gift	*	*	*	*	*
Excise	.2	.3	.4	.4	.4
Total	1.2	.4	-7.3	-4.6	-1.2
Current Service April Update Receipts:					
Individual	358.9	395.9	436.1	479.2	517.8
Corporate	76.9	90.3	100.3	106.2	110.8
Estate and gift	5.3	5.0	4.7	4.7	5.1
Excise	34.3	34.3	32.9	32.3	32.6
Total	475.5	525.5	574.1	622.4	666.2
Unified Budget Receipts - Tax Reform:					
Individual	341.0	369.9	404.2	450.3	490.9
Corporate	95.8	116.4	124.6	130.2	136.0
Estate and gift	5.4	5.0	4.7	4.7	5.1
Excise	34.5	34.6	33.2	32.6	33.0
Total	476.7	525.9	566.7	617.8	665.0

Office of the Secretary of the Treasury
Office of Tax Analysis

May 24, 1985

* - negligible Detail may not add to total due to rounding.

1/ Individual unless otherwise noted.

2/ Zero Bracket Amounts are increased to (in 1986 dollars): $2,900 for single filers, $3,600 for heads of households, and $4,000 for joint filers.

3/ Includes outlays associated with the refundable portion of the credit.

4/ The effect of the repeal of these provisions is assumed to be offset by increased expenditures. The receipts generated by these provisions are not shown in this table.

5/ The proposal would effectively eliminate the use of deposits by banks for leveraged holdings of tax exempt bonds. These bonds would then be held primarily by individuals.

Note A: The estimates are based on the April Update of the 1986 Budget. The effects of the reduced corporate and individual rates are estimated assuming all other provisions are enacted. The revenue effects of all other provisions reflect current law tax rates. These estimates do not include the revenue impact of delaying the date of announcement.

Note B: The individual rate schedule estimate assumes that the relationship between collections and tax liability is unchanged from current law. The 1986 level revenue effect may be significantly altered depending on the prescribed changes in the withholding tables and the estimated tax rules.

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