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AFTER RECESS

(The committee reconvened at 2:10 p.m., Senator Long presiding.)

The Chairman. net me just get a thing or two straight in my mind and hope everybody else's mind about how these table work.

Now I suppose you can see whether it is the best improvement over the existing law where it makes a big bit of difference.

Now let's look a minimum tax example number 8. When you come down here to the item Itemized Deductions, look at Minimum Tax Exempt, look at $2,250,000 under this proposal. Now do those itemized deductions include business deductions that come above the line or below the line?

Mr. Shapiro. Itemized deductions are deductions below the line.

The Chairman. The deductions in that area that we are talking about, in fact can you give me on that return what the itemized deductions were.

Mr. Shapiro. $2,067,000. Let me break them down for you. It is the charitable $999,000 total contributions, almost a million. Almost one-half of the itemized deductions are charitable contributions.

Interest is $40,408,749.

The only other big item is taxes which is $158,300.

The Chairman. In this proposal do you have the taxes itemized.

Mr. Shapiro. The taxes are included in the $2 million but they are not included in the excess itemized deductions as a preference, they were taken out.

The Chairman. All right. How much are the taxes?

Mr. Shapiro. The taxes are $158,000.

The Chairman. $158,000. All right. That is the State and local taxes, right?

Mr. Shapiro. That is right.

The Chairman. All right. Now excess itemized deductions, you get $808,000. Now that is the extent to which that exceeds 60 percent, is that correct?

Mr. Shapiro. Yes, the extent to which that exceeds 60 percent of adjusted gross income. Remember now we are talking about a 77 percent exclusion of capital gross incomes which would be less under the present law.

The Chairman. Then because you got a larger capital gains exclusion that puts more into the minimum tax.

Mr. Shapiro. That is correct. Remember, the itemized deductions do not include taxes. This individual did not have any medical.

The Chairman. You say you got taxable income, you got a minus $80,000. In other words just on his regular tax I guess that is on the capital gains part that you have taken credit for.

Mr. Shapiro. Yes.

The Chairman. Will you go to compute how the minimum tax would work? Would you show me how you compute that now? First you are adding into adjusted gross income, I take it, you are adding in the excluded part of the capital gains and the other preference items.

Mr. Shapiro. That is correct.

Senator Packwood. I thought you added the taxable income.

Mr. Shapiro. You add into that $518,000 and that is the excluded capita, gains and that is under the 70 percent rule. There are no other preferences other than the excess itemized deductions and the excess itemized deductions is $808,000.

Senator Packwood. What happens to the other preference items?

Mr. Shapiro. The only preference items are capital gains and itemized deductions.

Senator Packwood. What is that, other preference items? I am confused.

Mr. Shapiro. What we are showing you in this case is that other preference items in that will include itemized deductions. The only time they are not the same is when there are preferences other than the itemized deductions. It is the same amount which means that in this particular case that the other preference items is the only excess itemized deductions. There may be cases, for example, where other preference items may be $820,000 and $12,000 will be accelerated appreciation.

I think in view of the fact that the committee members expressed a concern as to the way to work itemized deductions we wanted to show that separately.

The Chairman. It looks to me as though you come down to what you might consider the expanded income figure which would add up to about $1,236,000, is that right?

Mr. Shapiro. It actually adds up to $,245,200.

Senator Packwood. Why is that? Is that because you have added this other item? I got the same figure you do, Russell.

The Chairman. Show us how you arrived at that.

Mr. Shapiro. Okay.

The Chairman. How did you get that figure? What are you adding?

Mr. Shapiro. We rounded off. Instead of $80,800 in your table you see $80,000. In our computation it is really $80,800. We just rounded that zero so if you take a minus $8,800 and add to that $518,000, which is excluded capital gains, then you add to it your excess itemized deductions which is $808,000. That totals $1,245,200.

The Chairman. Having done that --

Mr. Shapiro. You take your 20,000 exemption and subtract the $20,000 and you end up with $1,245,200.

The Chairman. Then you take --

Mr. Shapiro. Ten percent of the first $40,000 and 20 percent of the next $40,000 and then 25 percent of the balance.

The Chairman. Then you take 25 percent of what is left.

Mr. Shapiro. That is correct. In fact, that means 25 percent of everything over $100,000, and the net total is $298,300.

Senator Packwood. Mr. Chairman, he has lost me on that. I got the $4,000 and the $8,000 and you are taking 25 percent of the excess over $80,000?

Mr. Shapiro. No, excess over $100,000.

Senator Packwood. Why is that if the minimum tax is 20 percent on the first $40,000 and 20 percent on the next $40,000?

Mr. Shapiro. Since we have already taken out the $20,000, what you do is you take 10 percent of the first $40,000 and then 20 percent of the next $40,000 and then you take 25 percent of $1,145,200.

Senator Packwood. All right. I am all right then. Thank you.

The Chairman. Now in that case I would think that if just for the sake of argument that charitable contribution was in appreciated property, that is property that was appreciated in value and no tax paid on the appreciation, and if that investment interest expense were one that, say, a person borrows money and if he buys an asset that is appreciating in value but he is not going to pay a tax until he seels it that could conceivably be a case where you really try to scream out abou the justice and equity that person is getting off paying less than 10 percent and that would move that person up to roughly 14 percent.

Mr. Shapiro. That is right.

The Chairman. So that that would be one of the cases where we would have an argument for better tax adjustment and tax equity is done.

You are raising less money with that so would it be fair to assume that in the great majority of cases that people who pay a minimum tax there would be more of them that would get a tax cut than a tax increase under this proposal?

Mr. Shapiro. That would be the case, Senator, because this is a reduction of the present law of minimum tax. In addition to that, we are increasing the exemption level by making it an alternative tax so the effect of that is there will be more taxpayers with the tax cut and many of these would pay less.

However, it may be in other cases that those who are paying minimum tax under the present law would be paying more under this proposal.

Mr. Lubick. Mr. Chairman, I think the effect is that those who have very high incomes, very large capital gains and who had been escaping tax or paying only a small amount would indeed be taxed more heavily under this alternative program. I think what does concern us is that there are a large number of taxpayers and it is not so much in the capital gains side but you will have examples of executives who have fairly large salary income who will be able to engage in some sheltering activities than they have been able to do under the existing law.

I think basically that comes about because the sheltering devices are thrown in and then there is a total pool in the sheltering devices which I think are somewhat different from capital gains. Capital gain is paying some tax on a portion of it and then we are taking the excluded part and regarding that as a preference in the same category as, let's say, fast depreciation.

I think the effect will be that there will be many more persons who will be able to shelter more of their income and go into these tax sheltered devices than is true under the existing law.

We have made a little schedule to perhaps illustrate how this works which tries to state the impact in terms of economic income. If I mitht pass that out to you.

In effect, under the alternative tax we try to demonstrate what portion of one's economic income is subject to taxation at the regular rates. Basically when you add back to adjusted income the tax preferences and apply a tax to it, the adjusted income plus the tax preferences we find is economic income.

If you look at the taxpayer who has $30,000 of economic income, the alternative minimum tax under the schedule you have been looking at is $1,000 and that is the equivalent tax which a taxpayer with $9600 of fully taxed income would be taxed at so that means that 32 percent of the $30,000 economic income is being hit by this minimum tax.

You will notice at $200,000 it reaches an impact of 46 percent of economic income being subject to tax and then it starts to tail down at $2 million. It is 37 percent.

I think one of the problesm is that if the rate tops out at 25 percent, that means when you get taxpayers with very large astronomic incomes the portion of their total economic income that is being subject to taxation is reduced. In effect, at $2 million you are saying that the taxpayer can shelter 63 percent of his income from tax, be it by accelerated depreciation or percentage depletion in excess of cost.

So I think what our problems with the tax has suggested is the concept. The idea is quite good with respect to capital gains in particular, although we think that perhaps a more reasonable target for the committee to seek would be to say that every taxpayer ought to be paying tax on half his economic income. That would mean thatif you had an executive who had a large salary and still had capital gains he would only be paying, under the committee's bill, a tax of 21 percent of the capital gains even though he was paying a greater amount in his salary.

If he had large dividends and large interest that he was paying tax on, he would only be paying it at 21 percent on his capital gains but if you had a person whose income, let's say, was $2 million and exclusively capital gains it seems to us in that situation he should pay a larger portion of his economic income in taxes and if $2 million of economic income was entirely accelerated depreciation or depletion in excess of costs, why again we think that a much greater portion of his economic income should be subject to tax.

The Chairman. But now in economic income you are counting inflation, aren't you?

In other words, if you buy something for, let's say, $100,000 and it comes along 10 years later when it would take $200,000 to make that $400,000 and he sells that, I mean you are counting that $100,000 of economic income, were you not, in this title?

Mr. Lubick. That is right, Mr. Chairman, there are two points to be made there. We are not only talking about capital gains. I think the same thing applies to accelerated depreciation or depletion or any of the other preferences and that does not really involve inflation and you are permitting taxpayers to perhaps shelter two-thirds of their income through accelerated depreciation but even with respect to the inflationary capital gains it is our understanding that the justification for the preferential rate of capital gains is in large part resting on the case that we are taxing at a lower inclusion percentage in order to accommodate the impact of inflation.

The Chairman. Here is where I come in and out on this minimum tax concept. We take your study that you gave us and that I asked you to do further refining on that study of these taxpayers who are paying between one and five percent of their income.

By the way, you would calculate it in income because it seems to me as though that is the group that we ought to be targeting in on.

Now a lot of those people may be people that don't owe us anything. Just like take those 22. Those are not abuses. It may be that those people in the one to five are not abuse cases.

Now this fellow came in and did this study. This economist used to work over there in Treasury, seemed to be a very sensible fellow. He testified that what people are actually paying at a percentage of tends to work out to a rate of about zero up to 35 by class.

You look at capital gains and all the different things that you are talking about.

Now you take your study. You came up to about 5 percent, pay less than 5 percent. It looks like about 5 percent pay less and 10 percent. So many pay less than 25 percent. Then you bunched all the other people making over $200,000 in the file cabinet there which is about 75 percent of them who pay more than 25 percent of their economic income the way you have figured income in terms of taxes.

Well, now what I am talking about the minimum tax it seems to me that I am not trying to zero in on those people who by your bracket are in the last group, people paying more than 25 percent. It looks to me as though we better go after this 25 percent who pay less than 25 percent before we try to zero in on the people who are already paying 25 percent of their economic income in taxes.

Now it seems when I look at your chart I still don't fully understand it. As you know, I was a little tired that night trying to figure this thing out and never could understand it and so when I look back at it I find myself saying, well, it looks to me like what you are trying to do is to move those people into a bracket where they are all paying bout what you would think the average of the people in the file group would be paying where I should think we ought to be reasonably happy if we move them in a situation where we get them up well above those lower brackets, the 5 and the 10 percent categories.

Mr. Lubick. I don't think what we are trying to do is to move everybody up to the average but I think basically what we are saying is that we are taking for this chart your concept of alternative taxable income as the equivalent of economic income. I think we accept that certainly for this purpose. We are saying that the altnerative taxable income is economic income.

I think what we are suggesting is that we can recognize that the preferences are in the law for a purpose, they are designed to encourage some kind of economic activity, otherwise there would not be accelerated depreciation, there would not be percentage depletion if you did not intend to accomplish something by that but at the same time I think you have also recognized that while we do want to encourage investment and economic activity to move in the direction that these deductions encouraged them to move in, at the same time we don't want to have a lot of people around who are not making any contribution or who are not paying any tax at all.

Therefore, we say that everyone ought to pay some tax on a portion of his income.

I think in this income is the alternative taxable income or the economic income and I think the basic question is for you to decide what percentage of one's income ought to be subject to the tax.

I think what this chart indicates is that we have some variations under the schedule of rates that you suggested. It can run as high as a man paying on 46 percent at the regular rate schedule applied to 46 percent of his income as you get in the higher amounts of economic income that declines.

The Chairman. Well, I am going to let you spent five minutes trying to explain what this is but you spent a lot longer than that trying to explain what that is to me. I could not understand it. I don't think I am the dumbest man I never met but if you can get this committee to understand what this thing is, maybe you can get them to vote for it.

I must say I am still not clear as to just what this chart does mean and what you would like to advocate. For example, by the time you get through explaining this, if you will tell me what you would like to do. Do you want to have a higher tax rate, is that what it is?

Mr. Lubick. Yes, sir.

The Chairman. At least that is something we can understand. (Laughter)

Mr. Lubick. I think if you look on the chart --

Senator Bentsen. May I ask a question.

When you talk about taxable income on a Form 1040, are you referring to line 34, page 2? Is that right?

Mr. Lubick. Basically, Senator Bentsen, I think what we are talking about --

Senator Bentsen. I want to be sure --

Mr. Lubick. I think what we are talking about is fully paying taxable income.

Senator Bentsen. But you use the term "taxable income." I assume that is the one you are referring to plus the preferences added back in, is that correct?

Mr. Lubick. For economic income we mean basically the adjusted gross income plus the preferences.

Senator Bentsen. Adjusted gross income?

Mr. Lubick. And taxable income plus preferences.

Senator Bentsen. Then you are back to line 34, page 2 of the 1040.

Mr. Lubick. Yes.

Senator Bentsen. So if we try to achieve some of these economic objectives for the country, what we are trying to avoid is that fellow using so much of those preferences he finally pays no tax.

Now in these competing objectives one of our problems is obviously if you then go too far in saying that he pays a substantial tax, then you thwart what we are trying to do on the other side.

Mr. Lubick. Yes.

Senator Bentsen. So there is some balance we are trying to arrive at here.

Mr. Lubick. Yes.

Senator Bentsen. Now the House has passed theirs, as I understand it. You referred to it as the Secretary did as a many microeconomic --

Mr. Lubick. Micro mini.

Senator Bentsen. Now that was a 10 percent or, as you all preferred to interpret it, a 5 percent overall. Now the staff has recommended here what gets up to finally 25 percent which is a substantial increase over the House. Now you are trying to take us on what, to 35?

Mr. Lubick. Well, I am suggesting two things, Senator Bentsen. One is I am suggesting that there may be a difference between capital gains and the other preferences which are essentially deferral items.

Senator Bentsen. That is right.

Mr. Lubick. And the House bill applied only to capital gains.

Senator Bentsen. Yes.

Mr. Lubick. It left the existing tax applicable to the other preferences.

One of the possibilities that we see arising from this type of tax is that for some persons you are being much tougher and --

Senator Bentsen. That is the way it has always been.

Mr. Lubick. If through their shelter they are able to save larger amounts of income but for other people who are

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paying substantial tax you are encouraging them to engage in a lot more tax sheltering to reduce their tax, and I think as far as capital gains is concerned that maybe that is the direction you want to move in.

I think when you adopted a number of these taxes it was your intention to say that doctors and lawyers and executives, etc., should be spending their time making investments which produce capital gains. That is probably pretty good but there should be less encouragement for them to enter into these artificial transactions that produce all kinds of artificial deductions without economic reality.

Those preferences are on a different scale.

Now I think by lumping them together in addition to encouraging the capital gains you are going beyond that, you are permitting somebody -- if you take your $2 million taxpayer here, he can have 63 percent of his income in accelerated depreciation on railroad cars or something like that without any of it being subject to any minimum tax as he would be subject under existing law.

Now that I think is a very different thing from saying that that particular $2 million taxpayers capital gains ought to have preference. I think you yourself were making the argument that this minimum tax is more than going after these preferences, it is a disguised tax on capital gains. I think that distinction that I am trying to point out is

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perhaps gain being obliterated in this particular type of text.

So I think basically what we have been looking at is in addition to that aspect of it the question of just what portion of the taxpayers economic income ought to be taxed and accepting taxable income plus the preferences as the economic income, we then compute it in the second column from the left. First you have the economic income, then we computed the minimum tax under the rate schedule and then we translated roughly that amount of tax to the taxable income in the schedule and then determined from that what percentage of the man's economic income was being subject to tax at the regular schedule rates and I think that it shows that the impact of the alternative tax varies as indicated in the fourth column with the size of your income and the reason that it tails off as income goes up is that the top rate is 25 percent.

If the top rate were 35 percent, which is half of the regular rate of 70, it would reach a level peak and then would be even more for the rest of the time.

The Chairman. Let me show you what is wrong about your study. You see, to some extent, if I understand, at the bottom you are indicating that a smaller percentage of one income is being taxed at the ordinary rate. All right. Now when you get up above the $100,000 figure you are getting into the 70 percent bracket.

Mr. Lubick. That is right.

The Chairman. Then you are in that 70 percent bracket, I understand it,from there on up. That is quite correct, isn't it?

Mr. Lubick. That is correct.

The Chairman. Now when you move up into those categories that tend to prove your case then to the $500,000, the $1 million and the $2 million brackets, how do people get there? Usually they get there by a big capital gains transaction more often than not.

Mr. Lubick. I think a number of them get there through accelerated depreciation on real estate. I think we saw a lot of those in the studies that we made.

The Chairman. Now on real estate you don't mean the land, you mean the buildings on the land.

Mr. Lubick. That is correct.

The Chairman. If that is a capital gain transaction, I would think that would have to be the majority of it.

Mr. Lubick. I think that has to be right because the minimum tax produced most of its revenue from capital gains.

The Chairman. If that is the case, people in that situation with the kind of capital gains we have now, they are not going to realize that income, they are just not going to sign the contract unless they have made some plans that are going to either make a big charitable contribution or they have got something in that plan that is going to shelter some of that income because otherwise when they make the transaction they are paying so much of it out in taxes that any lawyer or tax planner would advise them against that and so in some situations there the higher tax rate is producing the consequence that you are showing on the other end.

The very highest of 70 percent tax rate or even a high capital gains tax rate is dictating that that transaction should not be undertaken from a lawyer's point of view or from a tax planner's point of view unless you have got yourself a big deduction to put on the same tax return with it which is the kind of thing that Bob Shapiro just got through giving us in example number 8.

This fellow in that year, this man has a charitable contribution of $1 million and he has an investment interest expense of $400,000. Now if he didn't have those, he would not have done the other thing but he had a million dollars capital gains transaction. If he had not had the rest of that to go with it, he would not have done that.

Now it seems to me that what is down at the bottom here is being dictated by a very high tax rate on the other end. I just find myself saying, well, perhaps a capital gains tax but at a much lower rate. The taxpayer would respond entirely differently to it even though he didn't have the very large charitable contribution to allay against that.

Now it is all right to me if you want to vote on that 30 or 35 percent. How much do you think you will raise with that?

Mr. Lubick. I beg your pardon.

The Chairman. How much do you think we will raise if we go up to 30 and then to 35 percent.

Mr. Lubick. About $600 million more, Mr. Chairman.

The Chairman. Do you think you would raise that much more?

Senator Packwood. How do you do that when I thougth we had $1 billion or $1 billion 2? There can't be that much at the higher levels, can there?

The Chairman. I find myself asking with the relatively small number of people that you are talking about here how you would hope to raise that much money.

Senator Gravel. Mr. Chairman --

The Chairman. Let me tell you one more problem that gives us thought. If we go up to a 35 percent minimum tax rate, a 35 percent rate on all of it over $300,000, to the business community that is not going to sound like any minimum tax.

In other words, you know, you can call it an alternative tax but I think you better drop that word "minimum" by the time you get that rate up to 35 percent. So it becomes 35 percent if the people who are in those categories -- according to the Treasury study that is the average of what you are getting from people in those categories.

Senator Gravel. Just a question. What would be the impact if you drop the 70 percent rate to a flat 50 percent? Would that affect this in any way? Certainly it would alter your goals but would it affect the method?

The Chairman. Oh, sure. If you dropped it from the top tax rate from 70 percent down to 50 percent, of course it would.

Senator Gravel. It would take a lot of the incentive away.

The Chairman. Yes, and Treasury would be more than unhappy about that.

Senator Gravel. What would that cost, just out of curiosity? I just think it is wrong philosophically to tax people at 50 percent, period.

Senator Hansen. Mr. Chairman, I thought that the whole wave of the testimony -- and you have alluded this morning to the different witnesses we have had -- made a very persuasive case in hearing capital gains taxes and the experience we had early on in 1969 and thereafter. At least while I recognize many factors converged and you cannot say with absolute certainly that one thing happened but I think generally the reaction in the business community and the economists and other professions was that when we made the taxes so oppressive we actually discouraged capital gains transactions and as a consequence while one might have expected an ecstatic economy

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that the Treasury receipts would have gone up. They did precisely the opposite and I see no reason, based upon the testimony, to move back in that same direction again.

I think that this staff rate schedule here -- no tax on the first $20,000 capital gains, 10 percent on the next $40,000 and a 20 percent on the next $40,000 with everything above that being taxed at 25 percent -- seems to me to insure that there won't be the situation arising that fair people cried out against, that people with a great amount of income were paying no taxes.

Under this proposal anyone is going to be paying a very substantial amount of taxes but I do not find justification to substitute those schedules for these that are on the Treasury pass out here.

The Chairman. Let's just take a look at one or two of them now. If you move that from 35 percent, it would not make much difference in example 14 there. That is the case where you more than double.

Mr. Shapiro. Mr. Chairman, the example you are looking at, number 8, you would file a new rate schedule on a quick calculation showing that it would be approximately $403,000 compared to the $298,000 that is shown there.

Mr. Lubick. That would be about 19 percent. I think we have to differentiate, Senator Long. We were talking about average rates of 35 percent. This is a marginal rate; it is not the top rate, it is not the average rate. I think, Senator Hansen, when we were talking about why persons who -- let's assume they have substantial income from interest and dividents. Indeed that would contribute some very high income to their taxation and, therefore, they would indeed get the benefit of the committee's action of the 21 percent marginal rate on capital gains. The minimum tax would not cut in.

We differ, of course, with the committee's decision on the exclusion but let's leave that aside and operate within that framework of a capital gains exclusion of 70 percent. I think it is your objective that all taxpayers pay some minimum amount on their total economic income and we were suggesting that one ought to be piad a regular rate schedule on half of his income that that might be fair. You may differ. You may think some lower amount is that. I want to point out that this does have a different effect for, let's say, the man whose $2 million of annual income is exclusively from capital gains. His rate of tax is going to be substantially smaller than the man who has $2 million of income of, let's say, $1 million that comes from dividends and salary and $1 million from capital gains.

We are suggesting that the latter person is bearing a substantial tax on his income and that the purpose of the additional exclusion for capital gains can still be served to encourage a favorable rate of return on his investments on its capital but at the same time assuring that everyone is paying a certain amount of tax on his economic income. Of course adjusting for that purpose, paying the regular rates as applied to half your income as a minimum is equitable and fair.

The Chairman. You are talking about a 35 percent rate though. I don't know what the average amount is. Most of what we are talking about is capital gain and I would think that at least half of what you are taxing in capital gains is inflation, and when you put a 35 percent rate onto it and if half of it is an illusory gain, then you put the 70 percent tax on what the actual gain is discounted for inflation.

Now I started out supporting the minimum tax and claiming it was fair and defending the justice of it and all that and then when it got to where you could not deduct the taxes on it, you could only subtract half the taxes from the amount which is to be applied.

So you could not subtract any tax that you paid and the House got far enough. If the tax of the House is in it saying you could not subtract any tax, there would not be a prayer for the minimum tax right now, it would be just like we the voters appeared to get voted out of office.

Fortunately, they say we would not go along and they say, well, you can subtract half of the tax from the amount which is to be applied.

Now it seems to me that in the account of cases such as example number 14 or example number 8 on this list we are increasing that minimum tax by very drastic -- we are increasing it on some of those people by almost 100 percent -- well, 50 percent in one case, over 100 percent in the other case -- and in the cases where that really indicates that we ought to bear down harder on those people it seems to me that we are doing quite a bit.

What I suspect, Mr. Lubick, is that if we try to do what you want to do we are going to wind up not achieving anything.

Mr. Lubick. Basically, Mr. Chairman, what we are suggesting is very much in line with your 1964 suggestion which is put everything into income and then you apply a separate rate schedule that assured that a certain portion of everyone's economic income be taxed at a separate rate schedule.

The Chairman. I think you have my 25 percent rate in pretty good shape. I think at the moment until you brought up the 25 percent rate I thought 35. We had to pass the 25 percent.

If anybody wants to vote, I will pass. In fact it is hard enough to agree with a 25 percent tax. On the floor somebody might like to offer the 35 percent rate and more power to them but that in my view is some of the things we have done out there on the floor. We do it one time and the next time the people see it coming and they won't vote for it. They have a chance to do that. It seems to me that is as far as they are willing

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to go.

Well, could we vote on just tentatively approving what the staff has here and which I think is as far as we can go for now?

Senator Hansen. I so move it, Mr. Chairman.

Senator Byrd. Mr. Chairman, I should say for the record I don't fully understand it. I want to vote for a minimum tax. I don't fully understand how the staff proposal is going to work. I suppose at the moment the only thing I can do is vote for it but I would like the option of maybe making some further suggestions.

The Chairman. With your input, Senator, because there has been a substantial change made in it based on one of the points you made which I think is well taken. Why don't we vote.

Senator Gravel. I just want to ask one question. What effect does this have on the at risk or does this really obviate any need to alter the at risk provision?

Mr. Shapiro. Senator, this is not directly involved with that particular provision.

Senator Gravel. But we pick up those people who would have gained.

Mr. Shapiro. The at risk pertains to when someone does get the benefit, the minimum tax picks them up. Those covered by the at risk provision would not be helpful for the preference item if they do not have a basis and, therefore, would not be subject to minimum tax.

Senator Gravel. But if they did have some benefit by not being at risk, we would pick them up with a minimum tax, wouldn't we?

Mr. Shapiro. No, they are mutually exclusive in most cases. If the at risk provision applies to them, the other would not.

Senator Gravel. Or would the converse be true, that if they did escape the taxation as a result of not being at risk, this would be the net that would pick them up?

Mr. Shapiro. No, the at risk provision applies meaning that they do not get the benefit of financing because those deductions then would not be treated as preferences and, therefore, the minimum tax would not apply.

The only way it is a preference item is when they are at risk; then they are eligible for the preference items and the minimum tax would apply.

The Chairman. Let me ask is this not also true? If as a result of reducing the rate on capital gains -- that is, reducing the amount which is applied -- we have a great increase in the number of transactions, then you would also have a corresponding increase in this minimum tax, would you not?

Mr. Shapiro. That would be correct.

The Chairman. So the 1.2 could yield to 1.8 because you have a great many more capital gains.

Mr. Shapiro. Yes.

Senator Hansen. Then if I could just volunteer, and I do so with a certain hesitancy because I think when Senator Byrd says he does not understand something he probably understands it far better than I ever shall. When you are talking about the staff rates here, I think essentially --

The Chairman. Are you talking about the Treasury chart?

Senator Hansen. I am talking about the staff rate schedule as was offered which is in the upper lefthand corner and that is what is before the committee now, as I understand it.

What this does, Senator Byrd, as I understand, is to bring a real measure of relief to small taxpayers on the first $20,000 capital gains. If a person is selling a little business or whatever, it may be a little piece of property or a home or whatever, that would not be subject to any tax. Am I right about that, Mr. Lubick?

Mr. Lubick. Yes.

Senator Hansen. Then from $20,000 to $60,000 whatever amount of capital gains would fall in that bracket would be subject to a rate of 10 percent and between $60,000 and $100,000, 20 percent and then everything over $100,000, 25 percent. So I think we have gone the extra mile in meeting the President's objective in making certain that these tax law changes would bring real meaningful relief to small taxpayers. Isn't that a fair statement, Mr. Chairman?

Senator Byrd. I think that is correct and I understand that aspect of it. I got mixed up, however, when I started going over these examples.

Senator Hansen. Yes.

The Chairman. All in favor then --

Senator Dole. Could I just ask a question first. Could you use the general jobs credit to offset the alternative minimum tax?

Mr. Shapiro. The only one that would be used is the foreign tax credits.

Senator Dole. You cannot use the others to offset the alternative tax?

Mr. Shapiro. That is not figured in this.

The Chairman. Do I understand --

Senator Dole. If you can offset the regular tax, why can't you offset the --

The Chairman. The minimum tax does not apply to your State and local taxes.

Senator Dole. No.

The Chairman. You reduce the figure by that and then you work from there. Obviously you get a credit against the foreign tax, whether it is against the minimum tax or the other, is that right?

Mr. Shapiro. Yes. You have the regular tax. One of the guidelines the committee mentioned to the staff was from the fiscal standpoint to make sure that everyone paid some form of tax. I think Senator Dole raised a question. What was contemplated there is you don't want a taxpayer to lose a benefit, and, therefore, to the extent the alternative tax would be imposed rather than regular tax, that instead of losing any investment tax credit that could be treated as a carryover in a subsequent year so that they would not lose the benefit of the investment tax credit.

Senator Dole. But you would not use it that year.

Mr. Shapiro. No.

The Chairman. Basically the main thing we are trying to do is to avoid these people coming in with no tax or with the tax so small that really it will be cited as a case of tax avoidance. That is what we are trying to avoid. Now we can still amend this. Treasury might have some ideas about how to use the straight line depreciation to get away with something.

If they can show how to correct it, that will be considered but for now I think it is the best we can do for the moment. Maybe we can improve on it later on.

All in favor; opposed. The ayes have it.

Senator Curtis. I would like to ask the Treasury about a matter. If my understanding is correct, we created some time back small business investment companies to help these local groups that are trying to promote industry and jobs and the small investment company is not subject to the corporate tax if they serve as a pass-through for 90 percent of their income but somewhere along the line we made a mistake and if they would fail by one dollar or any small amount or any amount why the whole thing becomes subject to the corporate tax.

Senator Nelson introduced a bill which I co-sponsored. I understand the Ways and Means Committee approved the principle and the Ways and Means staff.

Mr. Shapiro. Essentially this is SBICs they had the pass-through. The problem arises in cases where you would have an SBIC that has to distribute a certain amount of their income, I think it is 90 percent, in order to qualify. There are times that they may distribute 90 or 95 percent of their income and fully believe they are complying with the law but in a subsequent year they may be audited and have different attributes as to some of the income where they thought they followed the law.

After this audit changed their taxable income structure it may only have been 85 percent which would retroactively disquality them for a prior year. The Congress would review this situation in a case of real estate investment trusts and where it is provided as a deficiency dividend procedure which means that if this situation should arise they can actually make

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a dividend distribution to qualify for that in the next year.

Senator Curtis. Is that 120 days?

Mr. Shapiro. Yes. That procedure is also available for mutual funds but is not available for SBICs. The Ways and Means Committee has agreed to provide that in the case of SBICs.

Senator Curtis. Did the Treasury concur with that?

Mr. Lubick. Yes. We wanted to go further. I think the committee did that, too.

Mr. Shapiro. It was extended to qualify in all cases as I understand. It is all regulated investment companies which invest in SBICs and other investment companies.

The Chairman. And you recommend it go the other way?

Mr. Lubick. Yes, sir, so we don't have a problem in some other years.

Senator Talmadge. Recommended by you and the Treasury.

Senator Curtis. The Treasury is going to give more thought to it.

Senator Talmadge (presiding). Here is another item I understand the Treasury recommends. The Treasury prefers that in the welfare tax credit the non-deductibility for wages provision be adopted by the committee be changed and the deduction of wages reduced to the credit. This would reduce the amount of credit from 85 percent in the first year to 75 percent, the 80 percent in the second year to 65 percent and

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the 75 percent in the third year to 55 percent and the balance of 25 percent in wages in the first year, 35 percent in the second year, 45 percent in the third year would be deductible.

Did you cover that, Mr. Lubick?

Mr. Lubick. Yes, Senator Talmadge. The reason we had second thoughts about the flat credit was we wanted to give the same percentage reduction to all wage payers and I think this accomplishes even a little bit more generously the benefit from most taxpayers which it applies evenly.

Senator Talmadge. Any objection?

The objection is agreed to.

Mr. Byrd.

Senator Byrd. Mr. Chairman, I would like to call up an amendment which the committee has already approved some time ago and that is for a thorough study before we carry over basic provisions of the estate tax law until the period of December 31, 1979. The committee approved that some months ago but I think that this committee has an obligation to do something in regard to that proposal because it is totally unworkable and everyone admits that.

I think that if we don't put it on this bill that it will make it very difficult to accomplish anything in this regard so I would like to propose that it be added as an amendment.

Senator Talmadge. As I recall that it was agreed to be inserted in 8200.

Senator Hansen. I fully support the Senator from Virginia and his recommendation. I do raise this question and I would solicit a response from Treasury.

The Chairman. Will you suspend until we have order in the chambers. The visitors will be reminded they are visitors and are asked to refrain from talking so the members and staff may be heard.

Senator Hansen. It is my understanding that there are a few cases where in anticipation of the effective date of this law -- of course it has been postponed now -- some taxpayers have in good conscience tried to comply with the law and asked could Senator Byrd's proposal be adopted with the proviso that for those taxpayers who may have gone to a lot of trouble in trying to comply with the law be given the option either of choosing to ignore it or to go forward with a procedure that would have been in conformance with the laws that were passed.

Senator Talmadge. Would you modify your amendment accordingly?

Mr. Shapiro. We understand there have been cases that come from taxpayers who have died who find it in more advantageous in their particular situations or otherwise to have used it and would like to have the opportunity to stay with it because that was the existing law.

What Senator Hansen is proposing is that the taxpayer can have a choice, that if the committee can elect to continue under prior law or if they choose to continue under the existing law which is the carryover basis. That is the law today on the carryover basis. They complied with the State tax provisions and took into account the existing law which is what some taxpayers would like to have the opportunity to stay with that at their option.

Senator Byrd. Would it cause any --

Senator Hansen. That is what I was wondering about.

Mr. Lubick. Basically these are situations, Senator Byrd and Senator Hansen, where a taxpayer in most of these cases refrained from taking action for making the sale because he thought he would be entitled to a greater loss because he had a higher carryover basis whereas under the pre-1976 law he would have sold and realized the loss during the lifetime because it would have not been available to him if he died and would have gotten a new basis as of the date of death.

We indicated to those taxpayers back when we were discussing this matter before your subcommittee that we certainly thought that no matter what happened with respect to this provision that those taxpayers who wanted to have carryover basis and wanted to do it on an elected basis should be able to,do it because indeed they did rely on the law as it is on the books.

Senator Curtis. You mean that in the event the Congress either delayed or changed the carryover basis that these taxpayers had acted on the basis that the carryover had become law could so elect?

Mr. Lubick. Yes, regardless of what action you should ultimately take, which I hope you won't do, to repeal the carryover basis. I think these taxpayers did rely on the law that is on the books and they ought certainly to be protected by electing to comply with that law.

Senator Byrd. That sounds reasonable and for the other taxpayers the applicable date would be the first of the three years.

Senator Talmadge. Do you modify your amendment accordingly?

Senator Byrd. I so amend.

Mr. Shapiro. I would like to answer the one question. The reason why this suggestion that Senator Hansen had that individuals died after 1976 and relied on the existing law, do you want to have this option for the entire three year period or just maybe for the two years this year?

In other words, taxpayers who died, for example, after the Congress passed the bill or on the notice that the carryover does not apply until after 1979?

Senator Hansen. I would assume that any dead taxpayer has already made a final choice.

Mr. Shapiro. That is what I say. After the date of enactment or after 1978 it would just be the deferrals.

Mr. Lubick. I think it would be preferable to adopt their suggestion because we are trying to deal with questions of alliance.

Senator Hansen. Your suggestion, Mr. Shapiro, is what?

Mr. Shapiro. To say that this option is only available to those during the period that the carrier basis is in the law but if you could say that it is up to the date of enactment or until the end of this year. But any taxpayer filing after this year, for example, they have no reason to rely on the carryover basis.

Senator Hansen. That would seem reasonable to me.

Does Senator Byrd agree with that?

Senator Byrd. Yes.

Senator Talmadge. Mr. Lubick.

Mr. Lubick. I believe you are aware, Senator Byrd, we vigorously opposed the extension because we thought it was problems that we are aware of that could be solved by a series of fix-up provisions to make the provisions of a carryover basis more workable. Indeed I think we concurred with Senator Byrd saying that this is an area of undue complexity. I think our difference was whether it could be fixed up. I think we would urge upon you again that even if there is to be a deferral that it is very important that at least it be placed on the books so that taxpayers can study those clean-up provisions on which essentially we are all agreed on.

I think many of them, for example, are in Senator Byrd's legislation and in Senator Dole's bill as well. I think one of the problems with the carryover basis was that the general estate planning public at large and the accountants at large didn't know what was to become the law until it was thrust upon them and if indeed during any period of moratorium the clean-up provisions are enacted and are placed on the books, even though they don't become effective, they will be widely distributed among the Bar and the accounting profession and taxpayers as a whole will have an opportunity to see exactly what the impact will be and will be able to respond to you and to the Congress and to us in this regard.

So we would suggest that if you do move in this direction that at the very least the clean-up provisions which Senator Hathaway introduced as a minimum be added at the same time.

The Chairman. Let's vote.

Mr. Lubick. We are talking about putting them on the books and there can be further implementation so that there can be further hearings if you wish next year.

Senator Hansen. Mr. Chairman, if I can speak to that,

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I understand or I think I do what Mr. Lubick is saying but I think it is much more complicated and difficult than simply the fact that people were confronted with a new law that they didn't understand. The accountants with whom I have spoken and the lawyers with whom I have talked say this law is so difficult when you go back and try to find the cost basis and pick up the things that may have affected that along the way it just becomes practically impossible to administer.

I would hope that we would not take the step my good friend has suggested.

Mr. Lubick. Senator Hansen, we did work very hard and very diligently with various Bar Associations and members of the accounting profession and I think we have gotten a very wide measure of agreement that with these changes the serious inequities and the serious difficulties would be removed. I would like to point out one thing that I think is --

The Chairman. Could I make a suggestion. I think he has a good argument and this thing ought to be resolved at some point.

Might I suggest in the spirit of compromise that we go along with your proposition, your so-called clean-up proposition, and that we go along with Mr. Byrd's idea to extend it for three years and up to that point you fellows are together. He wants to extend it three years and you want to have your clean-up but he does not necessarily agree with your clean-up.

Now that would give us the next three years to try to work out a better answer. At the end of three years if the Congress can't by a joint resolution decide whether they just want to repeal it or take your provision which is your so-called clean-up, at that point we would bypass this impasse about the executive branch. I honestly think if we take that approach sometime during the three years we will come to a much better answer than either one of you have at this moment.

Mr. Lubick. I think the original motion was three years from December 31, 1976, if I am not mistaken.

Senator Byrd. That is correct.

Senator Curtis. Let's make it three years prospective.

Mr. Lubick. I think then you are talking about five years.

Senator Hansen. It seems fair enough.

Mr. Lubick. Senator Long, I think one of the things to recognize here is if there is serious prospect with respect to the disappearance of the carryover basis the induced realizations that I think you have been talking about with respect to capital gains I think will disappear mighty fast because anybody who then has the prospect of avoiding capital gains tax entirely by holding to his death may very well not realize those gains and I think the whole revenue estimating has a very serious danger with this provision.

The Chairman. There is more than one way to answer the problem such as the one rate you have so much trouble with that the rate is so ridiculous. People try to put it into a charity or foundation rather than to pay tax. So if we drop the rate down and then you s aid that all right now if you pay the capital gains tax on it you get a credit for either all the tax or half the tax, something like that, so that there would be a lesser rate and that you get a credit for the tax you pay.

All of it or half of it so that with that type of credit it would be far more attractive than it would be if you add a tax on top of tax. I think that during the interim we ought to be able to come up with a better answer.

Senator Byrd wanted to make a comment.

Senator Byrd. Mr. Chairman, it seems to me that the logical thing to do is to defer this matter for one year which is what the proposal that I am making is. In the meantime in January and February we can hold public hearings, the Treasury can present its views, other interested parties can present their views, the American Bar Association can present its views but I don't see how we could accept today a proposal being made by Treasury or by anybody else for that matter when we have had no public hearings on this proposal, no one knows what is in it.

I don't suppose any member of the Senate committee knows what is in it. Now let me read this, if I may, it won't take

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long. It is a letter dated August 27, 1978, from the American Bar Association, Section of Real Property Probate and Trust Law, and it is signed by the Chairman, J. Thomas Eubank of Houston, Texas.

"At the annual meeting of this section earlier this month we reviewed the actual experiences that our members and their clients, the taxpayers of this country, are having with carry-over basis. We have found during the past year their initial fears have become a reality; namely, that this unfortunate law hastily enacted is essentially unworkable and incredibly in-equitable especially for the farmers and owners of family businesses, the very people Congress wanted to assist in 1976. In fact the actual problems are worse than we predicted.

"Accordingly the members of this Section directed me by overwhelming majority vote to advise you of these results and of the stormy views of this Section about carryover basis. Those views are that carryover basis should be repealed or if that is not possible that the effective date should be postponed without addition of any patch up provisions.

"This Section has approximately 24,000 members and is the second largest Section of the American Bar Association. The tax legislation at the top of your calendar, we beg to re-emphasize these earlier views and beg you to repeal this dreadful legislation." Signed J. Thomas Eubanks, Chairman.

Now what do we do in regard to this very complex problem, I would certainly for one hesitate to take a piece of legislation offered by the Treasury or anybody else for that matter without having some public hearings on it and be sure of what we are doing.

Senator Curtis. Would the Senator yield?

Senator Byrd. Yes.

Senator Curtis. I repeat, I think this ought to be repealed. I have a bill pending. I think that Senator Byrd's proposal is a fair compromise but I believe to go ahead and write something in here that no hearing has been held, there is no compromise at all. It would be better to repeal. I actually support your motion much as I would like to see it repealed.

Senator Hathaway. Mr. Chairman, in answer to Senator Byrd, the American Bar Association has endorsed the three year extension plus my clean-up bill thatwill come into effect at the end of the three year period. I don't see any reason why we cannot have the clean-up provision to take effect at the end of 1979 and hold hearings in the meantime and at least you have something hanging over your head and it is going to make up come up with something.

If we don't have anything hanging over our head, we have the same thing come up and they say, "Well, we will continue it for another three years"and we are never going to get it down at all. Besides that you have the bill on the floor, it is already on the calendar, it already has several holes in it, including my own. That means that this provision if it is entered in this tax bill is going to hold up this tax bill because there are many of us that don't see this want to go through. There are not going to be any time limitations with respect to the bill because that provision is in there.

On top of that we know that Chairman Ullman of the House Ways and Means Committee does not like this provision. He does not like the simple extension and is in favor of the clean-up so that again if we got it through the Senate is going to be tied up in Conference. Let's argue that bill that is already on the calendar now, let's fight that out on the floor as a separate issue.

Senator Hansen. Is the Senator from Maine saying he is going to filibuster the tax bill?

Senator Hathaway. I don't know what I will do now, Cliff. I put a hold on the other bill to see if Harry and I could not work out some compromise. We have not been able to work out some compromise. We have been working at it for six months. I think there is a possibility that we can still work out a compromise and I would hope that we would but so far we have not.

Senator Bentsen. Could you not fight this out on the floor if you say you are willing to fight the other one out on the floor?

Senator Hathaway. I could I think but there are others

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who are interested in this besides myself who are willing on the separate bill to hold it up indefinitely until they bot their way on it.

Now whether they would be willing to do that if it was part of a big tax bill I don't know but I think we ought to try the other one first.

Senator Byrd. I think that we in the Senate would be asked to vote on a piece of legislation on which there have been no hearings and no one knows what is in the legislation.

Senator Hathaway. It won't take effect until we have had an ample opportunity to have a hearing.

Senator Dole. The legislation is bad enough after the hearings let alone without hearing.

Mr. Lubick. We did have the hearings before your subcommittee on which we did discuss most of these provisions. There were hearings on your bill.

Senator Byrd. But your proposal is entirely different from what the hearings were held on. Different from that proposal, for example, it does not have the grandfather clause in just to mention one aspect of it but it seems to me the main thing is that we have an obligation to the people of this country, people are dying every day. And then we pass legislation.

Senator Hathaway. You cannot pass a law against them dying.

Senator Byrd. We have an unworkable law.

Senator Hathaway. There are people born every day.

Senator Byrd. What we need to do is take a reasonable proposal and defer action, hold hearings and clean it up after everybody has had an opportunity to present their case.

Senator Hansen. I agree.

Senator Curtis. Let's vote.

Senator Hansen. This is on the Byrd proposal?

Senator Hathaway. Mr. Chairman, I will offer the amendment that my provision take effect at the termination date of the expiration date. What is it, December 1979.

Senator Byrd. That we adopt something in this committee now?

Senator Hathaway. It won't take effect until 1980. We have plenty of time for hearings.

Senator Hansen. Let's vote.

The Chairman. We will vote on the Hathaway amendment first.

Senator Hathaway. Do that by a show of hands.

Senator Curtis. I ask for a roll call.

Mr. Conaghy. During the period we left it open as to whether it would be at the end of the year, the effective date when you can elect to have either the carryover provision or the --

Senator Hansen. I was agreeable to the proposal that

Mr. --

Mr. Conathy. That would be the date of enactment, just for the record.

The Chairman. Do you agree with that, Harry?

Senator Byrd. Yes, and the Treasury agreed with that.

Senator Hansen. So we don't have to vote on that.

Mr. Stern. Mr. Talmadge.

Senator Talmadge. No.

Mr. Stern. Mr. Ribicoff.

(No response.)

Mr. Stern. Mr. Byrd.

Senator Byrd. No.

Mr. Stern. Mr. Nelson.

(No response.)

Mr. Stern. Mr. Gravel.

Senator Gravel. No.

Mr. Stern. Mr. Bentsen.

Senator Bentsen. No.

Mr. Stern. Mr. Hathaway.

Senator Hathaway. Aye.

Mr. Stern. Mr. Haskell.

(No response.)

Mr. Stern. Mr. Matsunaga.

Senator Matsunaga. Aye.

Mr. Stern. Mr. Moynihan.

(No response.)

Mr. Stern. Mr. Curtis.

Senator Curtis. No.

Mr. Stern. Mr. Hansen.

Senator Hansen. No.

Mr. Stern. Mr. Dole.

Senator Dole. No.

Mr. Stern. Mr. Packwood.

Senator Packwood. No.

Mr. Stern. Mr. Roth.

Senator Roth. No.

Mr. Stern. Mr. Laxalt.

Senator Laxalt. No.

Mr. Stern. Mr. Danforth.

Senator Danforth. Aye.

Mr. Stern. Mr. Chairman.

The Chairman. No.

Three ayes and 11 nays.

Call the role on the Byrd amendment.

Mr. Stern. Mr. Talmadge.

Senator Talmadge. Aye.

Mr. Stern. Mr. Ribicoff.

(No response.)

Mr. Stern. Mr. Byrd.

Senator Byrd. Aye.

Mr. Stern. Mr. Nelson.

(No response.)

Mr. Stern. Mr. Gravel.

Senator Gravel. Aye.

Mr. Stern. Mr. Bentsen.

Senator Bentsen. Aye.

Mr. Stern. Mr. Hathaway.

Senator Hathaway. No.

Mr. Stern. Mr. Haskell.

(No response.)

Mr. Stern. Mr. Matsunaga.

Senator Matsunaga. Aye.

Mr. Stern. Mr. Moynihan.

(No response.)

Mr. Stern. Mr. Curtis.

Senator Curtis. Aye.

Mr. Stern. Mr. Hansen.

Senator Hansen. Aye.

Mr. Stern. Mr. Dole.

Senator Dole. Aye.

Mr. Stern. Mr. Packwood.

Senator Packwood. Aye.

Mr. Stern. Mr. Roth.

Senator Roth. Aye.

Mr. Stern. Mr. Laxalt.

Senator Laxalt. Aye.

Mr. Stern. Mr. Danforth.

Senator Danforth. Aye.

Mr. Stern. Mr. Chairman.

The Chairman. Aye.

Thirteen ayes and one nay.

Senator Packwood. Mr. Chairman, I have an amendment I want to offer and I am not quite sure at what stage we are going now. Are we at the stage where the whole bill is open for amendment? I am not sure we are going to get through the whole bill section by section and get to some of the provisions in the House bill that I have amendments on so I want to offer one now and I think this is not particularly controversial.

On the subject of deferred compensation which is simply an agreement between the employer and the employee to set aside part of the employee's income and it is not taxed until he receives it as deferred compensation, there is in the House bill a requirement that the election to defer your compensation must be made in the year prior to the start of the deferral.

In Oregon I have letters here from the City of Portland and Eugene, the State of Oregon and the Portland School Board. Many, many of the municipal employees defer their compensation, and as you are aware most municipal employees are not highly paid. However, if you have to defer it in the year ahead, that means if you want to defer it starting

January 1 next year and you are trying to convince an employee that is making 12 or 13 or 14 thousand dollars in March to make that deferral starting in January, they simply don't think that far ahead. I simply want to change the language to say that all you have to do is make the decision ahead of when you want to start the deferral. If it is in March and you want to start it in April, you can.

We had a hearing on this supported by the Governors, by the Association of Counties, by the Cities and by the Mayors Conference. I think even Treasury now supports it. I don't want to speak for them but I think they support it.

I would offer that amendment.

Mr. Shapiro. As we understand the situation that has come to us, Senator Packwood, you have certain people that don't know at the beginning of the year what their financial situation will be for the whole year and if they are forced to make the decision at the beginning of the year they may not choose not to. However, if during the year they have a month-to-month basis to do it, they will be in a better position.

Senator Packwood. It is not intended to be a retroactive tax shelter.

The Chairman. Treasury?

Mr. Lubick. We have no objection to this amendment. We have some other problems in the area. I think the committee is going to be getting into this area later on.

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The Chairman. Without objection then, agreed.

Senator Matsunaga has a comment.

Senator Matsunaga. This is with reference to extension of the investment tax credit to new structures. The House bill, as you all know, extends the investment tax credit of 10 percent to rehabilitation of old structures. This is in addition to investment tax credit for machinery. of course, under the present law investment tax credit does not extend to structures such as farm houses, barns and retail shops, warehouses and so on.

The House bill went so far as to provide the tax to rehabilitation but in the case of rehabilitation no more than one of four walls and that is an awkward situation. There are many cases in Honolulu, as I am sure there are in other cities, where a business would like to rebuild a new building right at the same site but unless they rehabilitate rather than put a new structure they willnot have the advantage of the 10 percent investment credit under the House bill.

My proposal is to extend to new structures provided the new structure is built right on the same premise, the same site, or one adjacent thereto and only to the proportion that the new structure bears to the old structure.

For example, if the businessman decides that he wants to build a 10 story structure to replace an old two story structure, his 10 percent credit would extend only to that floor space equal to the two story strcuture. In other words, he would get a 10 percent credit only on one-fifth of the total new structure.

I think this is a fair amendment and it would simplify the amendment now in the House bill. Of course because there are cases now which have been litigaged and are under litigation as to what is machinery and what is structure, then this would also simplify the investment tax credit ruling on the part of the Internal Revenue Service.

So I propose the amendment of the House measure to include new structures with the proviso that it be on the same site or the site adjacent thereto and only to the proportion of the old structure.

The Chairman. What is the estimated revenue cost?

Mr. Shapiro. The revenue cost in the calendar year of 1979 is $2 million above and on a fiscal year $74 billion above the House bill.

The Chairman. What would be the cost?

Mr. Shapiro. In 1983 it would be 313 above the House bill. Approximately $300 million above the House bill in 1983. The total cost is approximately $650 million.

Senator Dole. Does Treasury support it?

Senator Matsunaga. So it is not a major lsos and it would be something which would simplify the tax law and I think it is an equitable one.

The Chairman. What is the Treasury's position?

Mr. Lubick. We originally made a proposal last January to increase the industrial structures only to encourage the modernization of plant which has not kept pace generally. Then the House did not accept that, they went instead for an investment credit for rehabilitation which is essentially aiming at a different purpose. It was more a distressed areas type thing although it is not limited to rehabilitation in distressed areas.

Now I think the problem with Senator Matsunaga's amendment is that you are in effect giving it credit for real estate but only where there has previously been some improvement on the real estate and I think that is a rather serious step for the committee to take.

At the present time real estate does have a number of special advantages in the code. They have favorable depreciation. Favorable lives to recapture provisions are not applied in full with respect to real estate and I think to move to the direction of giving an investment credit for new real estate, in particular real estate by a warranty, is essentially commercial and not industrial. It is not primarily an incentive as our original proposal was to modernize the industrial plants of the country.

I think that probably is a step which ought not to be taken at this time.

We oppose the proposal.

Senator Matsunaga. As I understand it, though, the Administration did recommend that structures be in the investment tax credit. Right now you do have problems in distinguishing what is structure and what is machinery.

Mr. Lubick. Your proposal would indeed make it easier to establish what is rehabilitation and what is new and from that point of view it would simplify things but I think policy-wise and revenue-wise there is not room for this. I think we will be glad to put it in with our study with your other proposal as well on the cost recovery and report back to you next year.

Senator Matsunaga. Because the longer we delay this and, as has been noted by the Administration, while there has been a rapid increase because of the incentives provided in replacement of machinery, we have permitted structures which house machinery to deterioriate and this is going on I am sure in many, many cities as structures, and especially industrial structures, have not kept pace with the machinery investment.

Mr. Lubick. Would you limit this, Senator, to industrial structures as opposed to commercial?

Senator Matsunaga. Well, I did have in mind extending it to all new structures but I limited it to those built on the same site or adjacent thereto in order to cut down the revenue loss. Of course I feel that farmers, for example, who build new barns would be as much entitled to this as industrial office structures, retail utility structures. I don't know how much difference there would be if there was a revenue loss.

Mr. Lubick. I think we get into some very serious tax shelter problems in commercial real estate. Those are normally the buildings that are sold before the expiration of their physical lives and I think it is different from a measure that is designed to stimulate industrial expansion of our plant. This was the focus of the President's original proposal in January.

I think it is a very serious step to extend this to commercial structures. I think we would be hard pressed to justify the revenue expenditure at this time for that type of incentive.

The Chairman. Let me ask you now. Would this apply to grocery stores and shopping centers generally?

Mr. Lubick. Department stores, office buildings.

Senator Matsunaga. Only if built on the same site.

The Chairman. Why put that qualification in there? How could we both say that we are going to let you have this if you build these shopping centers and grocery stores and various things on the same site as the old one? How can you justify saying that you can do it there but you cannot do it if you build a shopping center, period?

Senator Matsunaga. My primary concern, of course, was to keep the tax loss low and then, of course, we have a big program in urban renewal and this would fit right in with the Urban Renewal Program Administration which is now in progress. Many of the retail shops, many of the old, old business establishments are unwilling to put new structures but new structures would be much more reasonable than to try to rehabilitate the old structures. Under the House bill if they rehabilitated the old structure, they would get credit but if they tore down, if they raze the old structure and build what would be considered a new structure and a much better structure, even for business expansion purposes they get no credit at all under the House bill.

The Chairman. I am not convinced that we ought to do what the House bill says, I am not even sold on that. It seems to me that this idea of rehabilitating those structures, I thought that was probably for some people who feared to sell some of their old industry, some of their old payrolls might move away and, therefore, they wanted to put a tax advantage to rehabilitate them.

But for those to say whether it is a better thing for a community, someone moves away from a city, clears some land, makes a shopping center, for example, a nice place to shop, it is a beautiful shopping center that someone in that city has moved, he just moved in an area where it was not too far from what is now the population center of the community but it is far away from what the old business district was and they had plenty of land, good transportation connections, no one going to bother you once you step inside the mall, parking space all the way around it and it has the old thing beat so bad that one would wonder why you want to go down to the old part of town and sweat and drive down there when the new thing is so far superior.

Now a lot of cities are doing that, and who are we to pass judgment to say that we will provide a tax incentive if you build it in the old part of town but not if you build something new and more convenient and more modern somewhere else?

Senator Matsunaga. Well, as a matter of fact, I fully agree with you, Mr. Chairman, and my original intent wat to preclude all new structures and give them the 10 percent credit but because of the limitation on the revenue loss which concerns everyone here, then I thought at least we could help the start by giving credit to those who build new structures on old sites to replace the existing buildings which are in use now and it was, I thought, one step better than the House bill towards giving credit for all new structures but my concern was that it would cost us.

The Chairman. Well, it would seem that if you are going to apply it to all structures the cost would be prohibitive and if you don't apply it to all structures it is discriminatory and it would lead me to feel would you not be better off to take the view that if and when we do it you ought to do it for everybody rather than some because otherwise you get started and then the other people say, "Well, you did it for them, now you ought to do it for us."

It seems to me we ought not to do it, period.

Senator Hansen. Is that a motion?

Senator Packwood. Is it a motion to knock out the house credit?

The Chairman. I think we ought to first vote on Senator Matsunaga's proposal and it seems to me that we ought not to do it, period.

Senator Matsunaga. I would move the adoption of my amendment, but failing that if I can get support extend it to all new structures.

The Chairman. It would cost too much.

Will those in favor of the Senator's amendment let it be known by saying aye.

Opposed, no.

The Noes appear to have it.

Senator Matsunaga. I offer, Mr. Chairman, an amendment to restrict it to industrial structures as was suggested by --

The Chairman. You mean all industrial structures?

Mr. Lubick. I think you are going to run into some revenue problems there. I just ask a question simply to point up the policy matter. I think our original proposal for investment credit for industrial structures had a revenue impact of close to a billion dollars and again --

Senator Matsunaga. How could that be when with my proposal it would have been $74 million in addition to the House?

Mr. Lubick. I understand but I think Senator Long has established the question whether you want to distinguish between industrial structures built on one site as opposed to those built in all areas.

Senator Matsunaga. Right now you have in litigation a number of cases I understand because you can make a distinction between structure and machinery, and machinery gets the 10 percent.

Mr. Lubick. I think Senator Talmadge took care of that the other day.

Senator Talmadge. Yes.

Senator Matsunaga. You have taken care of that?

The Chairman. Those in favor of extending it to all of them say Aye.

Opposed, no.

The Noes have it.

I move we move to strike the things in the House bill.

Senator Packwood. Aye.

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Mr. Shapiro. I think we should make it clear that when we had the previous discussion you said you are working from a clean substitute and so there is no motion to put it into the committee substitute.

The Chairman. I just think that the House bill that is down the road is going to cost a tremendous amount.

Senator Gravel.

Senator Gravel. I would like to follow on with something similar to what Harry did. There is an item that passed the committee and the Senate, and my best intelligence tells me it is a dead letter but it is something that was broad support and I think there is no grave consequence and that is the 2 percent reduction for foundations. We have passed this once before, it has been accepted by the Housep it just got over-loaded with baggage.

Senator Curtis. I think the Treasury supports that.

Mr. Shapiro. This is the original bill which produced foundation facts. Second, it included the provision offered by Senator Laxalt with regard to the slot machines and, third, it had a provision dealing with scholarship grants.

Those three provisions were agreed to by the committee and I think they were all non-controversial. Then on the House floor they asked that the insulation and solar provisions to be relating to the energy tax provisions. As of right now that bill is being held up in the House possibly to use if the energy tax bill does not come out of Conference, and if it is done that way the thinking as of right now is that those three provisions will be stripped from the bill and they will use H.R. 112 only for purposes of the residential tax credit provisions.

So if that is the case and that this H.R. 112 will be held by the House for possible future use and if it is used, it would be without these three committee amendments. The committee may want to include these three amendments either on this bill or another bill.

Senator Curtis. The foundation tax reduction passed the Senate twice.

Mr. Shapiro. Yes, and the slot machine amendment that Senator Laxalt supported in the committee and the one dealing with scholarships. The committee had agreed to all three.

Senator Curtis. Let's include them all.

Senator Gravel. I would amend my suggestion to include all three of those items. I think that you are correct on the others being non-controversial.

The Chairman. If you are going to include those, you might as well include the fourth one.

Senator Gravel. No, the fourth one was the whole tax energy package.

The Chairman. Have a lot of support.

Senator Packwood. If we do that, I want to go back to geothermal, Mr. Chairman.

Mr. Shapiro. I think that since you have an energy tax conference this Friday that the outcome of that conference as to what is going to come out may determine what future action has done either in the House or Senate with regard to any of the tax provisions and that was probably --

Senator Gravel. I think there would be no harm in putting this in this bill and that solves the issue. We will be dealing extensively with the energy issues.

The Chairman. Shall we vote on the three of them?

Senator Gravel. Keep them as a package, non-controversial.

The Chairman. Those in favor, say aye.

Those opposed, no.

The Ayes have it.

There is one matter that bothers me. We have in this provision a 1 percent investment tax credit for employers' tax ownership claim and that seems to be very well accepted and to be popular with industry and probably requires some interest in the companies for which they work. I would make "permanent" or at least to extent it indefinitely the 10 percent investment tax credit. If we do that, I think that the provision that we have would be 1 percent for the employer and a half percent for the employee. If you want to match the half, it ought to be extended the same way. The same with the investment tax credit for the 10 percent maximum.

Senator Curtis. You would take the existing law and have it apply to our new 10 percent rate?

The Chairman. Extend it the same way as investment tax credit.

Mr. Shapiro. You know there has been made available an additional 10 percent if the employer contributes that to an ESOP. In addition there is a one-half percent investment credit that would also be made available in addition to that 1 percent if the employee matches the one-half percent but Senator Long is suggesting to make those provisions which would expire in 1980 permanent.

Now there are also a series of technical modifications that need to be discussed. What I would like to do if the committee wants to agree, this is a substantive change, make it permanent. We would like to make some suggested revisions, technical modifications to the ESOP provisions and bring that back to you either tomorrow or Wednesday.

Senator Gravel. Mr. Chairman, could I answer that? I feel very strongly about that and I want to offer this as a suggestion on top of that.

One of the limitations when we had testimony on this for two days was that you can ohnly put in 25 percent of the wages for this and that stretches it out in many cases to 10, 20 years and pepole never really see the benefit of this. So if we could accelerate that to 50 percent of wages, then people can see some benefit, feel the benefit. So I wonder if staff might include that in that proposal.

Mr. Shapiro. Senator, in connection with the modification we will bring that up for discussion and I want to bring back the other.

Senator Gravel. I want to make sure that is satisfactory to the Chairman.

The Chairman. I don't understand that now but suppose you review that with the technical changes and we will consider that when we come back.

Mr. Shapiro. The committee is extending this to make it permanent.

Senator Danforth. Have you finished?

The Chairman. All in favor, say aye.

Yes.

Mr. Danforth.

Senator Danforth. Mr. Chairman, I have an amendment to offer with respect to municipal bonds. The Administration has addressed itself to the question of tax free municipal bonds. The concept which we have now makes the purchase of municipal bonds attractive only to taxpayers who are in fairly high tax brackets and as I understand it the analysis that has been made points out that municipal bonds are really attractive to people who are in the upper brackets but when you get down below the 40 percent bracket the purchase of tax free municipal bonds is not really attractive.

The Administration has proposed the taxable bond proposal but it is my understanding that local governments have been very critical of this because they believe that when the Federal Government gets into the business of direct subsidies through the payment of cash that eventually all kinds of strings can be attached to those subsidies so in an effort to accomplish the basic objective of the Administration of making the acquisition of municipal bonds attractive to people who are in lower tax brackets without all of the strings attached to it I have a proposal which would give the taxpayer an option of either excluding municipal bond interest from income as he can do now or in the alternative a partial tax credit which he could claim by grossing up his bond interest received and reporting that as income and then receiving a tax credit for interest paid.

The effect of this would be to make municipal bonds attractive for purchasers who are in the 40 percent bracket and below. It would also, insofar as it would increase the market for municipal bonds, expand the market for municipal bonds and presumably benefit municipalities by reducing the amount of interest that they would have to pay in order to make their bonds attractive.

We have tried this on a variety of people -- representatives

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of the municipalities, Finance Officers Association, the National Governors Conference, the National League of Cities, a number of municipal bond attorneys and municipal bond brokers and the Treasury Department and it has been I think very well received and widely received by all we have tried it on.

It would be effective January 1, 1980,and the reason for that would be to give people who were in this business a chance to acquaint themselves with it and prepare for it.

I am very mindful of your concern stated several weeks ago as we began the markup of this bill about any tampering with municipal bonds and for that reason we have tried it out on a variety of people who were in this business, and as I say they have felt very favorably about it but I wanted to bring it out at this point in the markup. If there is anything other than acceptance of it, I would be the first to lead the fight to withdraw it or to amend it on the floor but I do think this is a move in the direction that the Administration would want to go.

I do believe that as a tax reform measure which would make the bill significantly more desirable from the Administration's point it would have very little revenue impact -- zero in FY 1979, $10 million in calendar year 1979, $38 million in calendar year 1980. The same effect as the Administration's taxable.

The Chairman. Does Treasury favor that?

Mr. Lubick. We think the idea is a really ingenious one because it seems to get around some of the formalistic technical obstacles that were raised with respect to our original proposal and we think this accomplishes exactly what ought to be done. We have two reservations only and one is that as far as the fundability is concerned that that ought to be limited to institutions like pension funds and exempt organizations and that it ought not to be extended to industrial development funds, it ought to be for those financings that are genuine governmental financings rather than the private type of financing.

Other than that we think the idea is really in ingenious way out of the problems that we have been facing and trying to assuage the forebodings of the municipal community. I think it accomplishes exactly the same result.

Senator Packwood. Does it present any problems in marketing bonds?

Mr. Lubick. I think that is one of the good parts of it. The municipality now does not have to run two different types of marketing arrangements and that is one of the things we were worried about yet it accomplishes the same purpose and avoids -- they will discontinue to market the same way they have always marketed. The idea really is a very excellent way of the problems and we have been looking at them for several weeks and have not found any bugs.

The Chairman. Let me say that I am told that the municipal bond officers oppose this. Now we have not had any hearing on it. The last time we had this type of thing before us the Treasury favored it, in fact I fought very hard for this type thing down through the years. The taxing of State and municipal bonds would be an alternative and all that.

The municipal finance officers and the State governments and the banks have generally looked upon this as an effort to tax their State through municipal bonds. I just don't think we ought to do this unless we can provide these people an opportunity to come in here and testify to it and tell us how they feel about it.

Now it might sound a little better to them that this is publicly proposed becuase they thing the public is not trying to do this but I tried to explain to them that the fiasco they have to care about them and the Curtis amendment that they look at that.

You know how they came to get that thing in the law, a conservative Republican trying to help small businessmen and farmers, and he offered this amendment to give them a little consideration on inheritance tax and this is what we end up with. I really think that it would be best to hold back on that and wait and see, give the other people a chance to come up here before the committee, let them know we are considering it. That is what I found the last time we had that kind of thing before us.

Senator Danforth. Mr. Chairman, I just want to reiterate what this is and what it is not. It is not the taxable bond proposal that the Administration has had. It is not a payment of a supplement for bond interest which is made by the Federal Government. What it is is an option which is in the bond holder -- not in the State but in the bond holder -- to make a decision whether the bond holder wants to exclude the interst received from his income or in lieu of the exclusion to receive a partial tax credit.

So the bond holder has the option and I don't know of anybody who is opposed to it.

Senator Packwood. Does it have the effect of --

The Chairman. Would you make them all report their bond income? Would it do that?

Senator Danforth. No, not necessarily. If they wanted the exclusion, they would not have to report it.

Senator Packwood. Does it have the effect of a dual rate so the taxpayer can look at his tax return and know which is more favorable to him?

Senator Danforth. Yes, the taxpayers below the 40 percent tax bracket it would be more favorable. It is a purely mathematical computation.

Senator Packwood. I don't quite understand how it works, I guess.

Senator Danforth. If the taxpayer is in a bracket above 40 percent, it would be to his economic advantage to exclude from income the interest received.

Senator Packwood. I understand that.

Senator Danforth. On the other hand if he is in a tax bracket below 40 percent, it would be to his economic advantage to gross it up, include it in income nad receive a tax credit.

Senator Packwood. How much of a tax credit?

Mr. Stern. How much?

Senator Danforth. You would gross it up to 167 percent and receive a 67 percent tax credit so you would include in income 167 and have a tax credit in the amount of 67 percent.

Senator Packwood. What is it you included in income?

Senator Danforth. 167 percent of interest received.

Senator Packwood. Then you receive a credit of 67 percent of the interest received.

Senator Danforth. Yes. The effect is the same. It accomplishes the same result as the Administration would accomplish by its taxable bond option without any strings attached to it.

Mr. Chairman, I would like to do this. What I would like to do is withdraw this at this time. I take it we will be in markup for at least a couple more days. Withdraw it at this time. I am sure there are people in the audience who would like to think about it, I am sure there are staff people and Senators who would like to think about it, and just see how it flies because I think that the members of the committee would feel better about it if they have time to reflect on it for the same reasons you stated.

The Chairman. Mr. Moynihan.

Mr. Moynihan. I was going to speak for the proposal, Mr. Chairman, but in the circumstances I would be happy to wait.

Senator Packwood. Mr. Chairman.

The Chairman. Yes, sir.

Senator Packwood. I have another amendment.

The Chairman. Senator Dole was asking for recognition.

Senator Dole. I just have a little million dollar one, I can tkae it up any time. I think, Bob, you may be familiar with it. Apparently in 1976 we passed legislation which gave manufacturers and lessors of railroad freight cars the same tax treatment under Sections 46 and 47 as we granted the railroads and for some reason in Conference it was restricted without any explanation that the credit on so-called Section 38 property for investment tax credit applied only to railroads and we got this massive freight car shortage. We have had hearings in the Senate committee. I am not certain that this would suddenly mean a lot of relief but it would encourage, I understand, the production of about 4,000 freight cars. It is also my understanding that it is not expected to cost in excess of $1.6 million. It treats the manufacturers of the railroad rolling stock in the same manner as railroads for purpose of so-called Section 38 property for investment tax credit purposes.

Mr. Shapiro. I am a little hazy on the background. I think you were refreshed a little bit with regard to the situation.

Senator Dole. It was in the Senate version in 1976. It was dropped from the Conference.

Mr. Shapiro. On the Senate floor. You had a provision which made available the investment tax credit to lessees of railroad rolling stock. There is a limitation to the extent certainly that the lessor situation would have vanished. I think in Conference there may have been a concern about the potential tax sheltering situation if you make it generally available. Since the Senate rate was for railroads, the idea was to make it available for railroads. I think that there was not any consideration focused on the manufacturers in this case. I do not have a clear recollection at this point of that.

As to why it was limited in general, however, your suggestion is to me it should be expanded to include the manufacturers.

Senator Dole. Manufacturers and lessors. I don't recall what happened in Conference, I was not in Conference, but it was included without any objection in the Senate bill. My amendment by the way was dropped in the Conference and I don't know whether the Treasury objects or not.

Mr. Lubick. We concur with this amendment, Senator. This is limited to manufacturers who are also lessors and they should be in the same position as the railroads. There is really no difference.

The Chairman. All in favor, say aye.

Senator Dole. I can provide the language.

Senator Packwood. Mr. Chairman.

The Chairman. I had told Mr. Laxalt I was going to call on him. I will start with you.

Senator Packwood. It is a very simple one. Are we working from the clean bill or from the House bill?

The Chairman. We are working on the substitute.

Senator Packwood. This has to do with political contributions. The House, at the moment you can have a $25 credit or a $50 deduction. The House dropped the deduction. I would really use the credit and encourage more lower income people to give, but in exchange for dropping the deduction which is a $6 million gain I would like to double the credit to $50 which is an $8 million loss. If I thought we could just hold that in Conference I would offer it that way but if we drop the deduction and go to Conference, we have no deduction at all to bargain with and we have only the credit. What I wanted to simply offer is to raise the credit to $50 from the present $25 and it has not been raised from 1975 with the full agreement that I will be willing to drop the deduction when I go to Conference if the House will go to the $50 credit and the difference is only $2 million next year because the $6 million gain and the doubliqq of the credit is a $8 million loss.

The Chairman. I get a little confused. Tell us first what you are proposing.

Senator Packwood. Double the credit from $25 to $50 for a political contribution and that is what I prefer and if the House would accept that I would be happy to eliminate the deduction.

The Chairman. So in other words the deduction --

Senator Packwood. The deduction is currently --

The Chairman. The deduction is allowed now.

Senator Packwood. They seek to repeal the deduction. I want to go to Conference with us having repealed the deduction and then having them not accept the increase in the credit.

Mr. Shapiro. Under the present law you have both a deduction and a credit and the taxpayer can take his choice, it is $100 and $200. The credit is $25 and $50 return. The House eliminated the deduction but continued the credit so

Senator Packwood is suggesting that he could support the eliminating of the deduction but as a quid pro quo would like to double the credit so when the credit is present on $25 and $50 he would increase that to $50 and $100 in case of a joint return that would have that as a package.

So if you go to Conference with their deduction and the Senate package of a deduction plus the doubling --

The Chairman. The idea being that what we would pass, our bill would not propose to repeal the deduction but the Senate proposition in Conference would be that if he would be willing to drop it, let them provide the double credit.

Mr. Shapiro. Senator Packwood, do you want the deduction? Do you want the package in the bill?

Senator Packwood. I want the package in the bill because we go to the House and neither one of us have the deduction. Then I don't want to get stuck with the credit. If that is the choice, I would rather keep what we have.

Mr. Shapiro. In other words, you don't want to eliminate it in your bill?

Senator Packwood. Not in the Senate.

The Chairman. If he had to do it, if you are voting on amendment to the House bill, he would move to strike the elimination of the deduction and double the credit. That is what he would propose to do.

Mr. Shapiro. That is correct.

The Chairman. All right. But assuming that our bill will be added with this, he would propose that we go to Conference without the deduction.

So if we pass the substitute bill, what you said that we are working on now, we would be in the position that our bill would double the credit and then their bill would repeal the deduction.

In Conference he would be willing to appeal the deduction provided they would let us double the credit.

Senator Packwood. That is exactly it.

Mr. Shapiro. The way you are proceeding, your vote on Senator Packwood's motion would be just to double the credit.

The Chairman. Do you want a moment on that, Mr. Lubick?

Mr. Lubick. Yes, Senator. We urged originally the abolition of the deduction because first of all it is very confusing to the taxpayers to have the choice between a deduction and the credit and I think everybody is agreed on that. The deduction also operates inequitably. It means that a taxpayer with very high income is getting more political bang for his $200 than a taxpayer with lower income. So there is general agreement.

Senator Packwood has indicated himself that the deduction is not an appropriate way to proceed. You get down basically to the question as to whether the doubling of the credit is appropriate. The equivalent increase in the to compensate revenue-wise in the loss of the deduction would be an increase of $5.00 rather than the doubling but basically the question which the committee has to decide is whether the credit is an effective way to stimulate participation in political activity.

We have had hearings on that matter. We put forth at those hearings studies that had been made with respect to political credits, not only the Federal political credits but those in a number of the States that indicated that the credit had very little impact in stimulating the additional gimmick.

Basically the credit simply was a reward for those persons who are going to give anyway and in the benefits largely went to the higher income contributors based upon the study of those persons who were availing themselves of it. We would suggest that you not double the credit but maintain the situation as it is but we would concur that you should go along with the House bill and eliminate the deduction.

Senator Packwood. Mr. Chairman, the figures from the Joint Committee are at the moment that half of the distribution of the credit, half of it goes to incomes of $20,000 or less. Thss is not a high-income item but I would also say that any kind of political fund raising that has gone before is different from what we are seeing now with the effort towards soliciting donations of $10, $15, $25. Donations are $100 or less and the availability of credit and a number of the States have credit which is a very, very significant selling item when properly used.

If you give $100 for your candidate, you can take $50 off your income tax. That is not what those that give $5,000 are concerned about, they are going to give $5,000 to the party or the candidate or whether the credit is there or not but if somebody gives you twenty bucks, fifty bucks, it is a whale of an incentive. It has never been used by poltical parties, it never has been sold properly, but it can be one of the incentives for small donations that this Congress could undertake.

Senator Matsunaga. If the Senator would yield, you do intend to retain the provision that is up to 50 years.

Senator Packwood. Yes. If you give $100, you take a $50 credit. I didn't mean dollar for dollar.

Senator Matsunaga. The maximum would be $50.

Senator Packwood. The maximum would be $100 for a joint, $50 for an individual. So, frankly, Sparky, it is not an incentive to give $5,000 or $1,000. They are giving for whatever reasons but it is not for the credit.

The Chairman. It seems to me if Treasury takes a different view. If you believe in the credit approach rather than the deduction approach, what is wrong with doing a little more of it?

Senator Curtis. Let's give full credit for any one.

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The Chairman. I have no objection.

All in favor, say aye.

Opposed, no.

The Ayes have it.

Mr. Laxalt and then Mr. Bentsen.

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Mr. Laxalt. Mr. Chairman and members of the committee, I would like to discuss for a moment or so the proposed amendment relating to charge account tips. This was thoroughly considered by the committee, passed by the Senate and was eventually lost in conference on the basis that the House should familiarize itself further with the contents of the legislation. I might indicate the House has thoroughly considered it and has passed this.

As a matter of background to the newer members of the committee, under present law employees are required to report to their employers all tips received and retained after any tip pooling or splitting arrangement. This income is subject to income tax and social security withholding and is reported to the IRS by employers on the employee's W-2 forms.

However, in 1975 the Service attempted to change that. Revenue Rulings 75-400 and later 76-231 held that all charge account tips, whether or not reported by the employee to the employer, must be reported by the employer. The employer's reporting was to be used as a check against the amount reported by the employee. In the event that the employee's amount differed from the total amount of tips reported by the employer, the employee would be required to explain the difference in an attachment to his own return.

Now obviously, members of the committee, this has occasioned a number of problems. Certainly additional and burdensome recordkeeping requirements figure prominently among these. The principal problem, however, is that because of tip splitting and tip pooling arrangements the employer will not have any clear mechanism for breaking down the total on a per employee basis even if he is aware of the total amount.

Now in 1976, as I indicated, the Finance Committee effectively nullified the two Rulings. Under the committee version of the Tax Reform Act, which subsequently passed the Senate, the only employee tips which the employer would have to report were those reported by the employee Also employers would not have to maintain a running tabulation of the allocation of total charge account tips on a per employee basis. The only records which employees would have to retain in connection with charge account tips would be the statement of tips as furnished by the employees and the charge account receipts.

Unfortunately, the Senate provision nullifying the Rulings was dropped in conference but in its place the conferees did agree to postpone the effective date of the Ruling in order to give the House time to consider it.

On June 10, 1977, I introduced S. 1674 which is identical to the language which passed the Senate in 1976. S. 1674 currently has co-sponsors Senators Bentsen, Dole, Curtis and myself. I am happy to say that the House is also seriously considering this matter and we have recently learned they have adopted it.

In essence, Mr. Chairman, S. 1764, which I would now like to offer as an amendment to the Revenue Act, merely preserves the status quo. It reverses IRS 75-400 and IRS 76-231 by placing the burden of reporting charge card tips on employees where Congress intended it.

There is no reason to turn employers into an enforcement arm of the Internal Revenue Service on this matter and that is basically what we are doing. The employee knows how much he received in tip income so he is the best person to report it and no undue burdens are placed upon him by so doing. Under my amendment the employer would be relieved of the paperwork burden that would be created by the Rulings and the tip reporting issue would not impung the honesty of employees or be injected into labor management disputes in the recreation, lodging and food service industries.

I thank the Chairman.

Mr. Shapiro. In 1965 and 1976, as Senator Laxalt indicated, the Internal Revenue Service changed these. The Finance Committee in the 1976 Act postponed the application of that ruling if the Congress gave an opportunity to review. There was a great deal of concern that was expressed to the committee as a result of the effect of that ruling. The amendment posed by Senator Laxalt has essentially continued. The Ways and Means Committee has considered this matter, has held a hearing and has agreed to offer the same provision. It has the effect of restoring generally the provisions prior to the rulings which were issued by the Internal

Revenue Service in 1975 and 1976.

The Chairman. Mr. Lubick.

Mr. Lubick. Mr. Chairman, we think this is a very serious condemnation of non-compliance. Basically I don't think it restores the law to what it was before the rulings. The persons involved started a piece of litigation to enjoin the applicability of the rulings and the court, although it said that they didn't have jurisdiction to enjoin the Service in a ruling, did say that -- this is dictum for the lawyers in the audience but I think strong dictum -- the rulings were in accord with the code. I don't think that is so important as the question of whether we want to condone very seriously non-compliance with the income tax.

The Service has made studies in this area which indicate -- one study in the Baltimore district that only 31 percent of tips are being reported by employees and the other study in Reno only 15 percent is the standard of compliance. This one analysis of the club's records revealed that $370,000 has been paid to employees as their share of charge tips only -- not charge tips, cash tips, and the employees had reported on the $137,000 as both cash and charge tips. I have a myriad of illustrations but basically this is simply an attempt to condone the avoidance of taxation by this group of employees.

As far as the reporting is concerned under the charge tips, the charge tips are usually available to the employer each night from records that he has to keep anyway, it is no additional burden to him. He pays the employees immediately.

As far as the splitting is concerned, the Internal Revenue Service has issued the ruling that says that with respect to the employee's voluntary reporting of the cash tips they can reduce that amount by any splitting that is involved in charged tips so as a result there is no extra burden on employers, there is no extra burden on employees. All that we have is the result that a number of taxpayers will be paying some measure of taxes on so much that they receive. I think basically that that is the question here, that the report has held that this is in compliance with the laws. We discovered no real administrative burden either for employers or employees, it is basically a question as to whether we want to condone very serious non-compliance with the reporting of income.

The Chairman. Now the tax chisler is the waiter, the bellboy, the people who work I guess in restaurants and hotels and that sort of thing. You are not accusing the hotel manager of being the tax chisler in this case, are you?

Mr. Lubick. No, Mr. Chairman. The onus is indeed on the employee but the burden that you are putting upon the employer is no burden at all. All employers are required to withhold -- in fact, most employers have to withhold. This is no greater burden on the hotel industry than it is on any other employer. As a matter of fact, it is easier; the records are there, the charge books are there. They pay off every night to the particular employees so the obligation which is being placed upon the employers is the same obligation which every other employer in the United States has to undertake.

The Chairman. In this case though you are not calling on him to report the income that he paid somebody, you are calling on him to report the income that one of his customers paid him.

Mr. Lubick. This is income that he has paid out of his cash receipts. His charge slips are turned in to him and he totals them up and makes payment on the basis of those totals out of his funds and his cash register.

Senator Laxalt. Mr. Chairman, the interpretation of the situation as recited by Treasury is wholly at variance with what the witnesses testified to during the course of the hearing. They have indicated that this would place a tremendous administrative burden on them from the standpoint of recordkeeping alone. Secondly, they are an arbiter in the nature of many disputes that arise in tip pooling and tip splitting in these big places. It is a tremendous job.

I might say in my own state of Nevada, which probably has more experience with this than any place else, employers normally disassociate themselves from the tip scene because it is an internally vexing problem. So I would say that the action of this committee should be consistent with the actions previously taken. The only road block we had two years ago was adequate consideration by the House and that has been completed. They have conducted the hearings, they have approved this amendment, and I would recommend to the committee favorable consideration and adoption of the amendment.

Mr. Lubick. Mr. Chairman, there is no additional paper that is required by any employer, it is the same 1099 Miscellaneous that he has to file anyway and there just has been no evidence of any real burden on any employer, not that that really should make a difference in any event. Here is a chance to secure some appliance and fair sharing of the burden by all employees and this one would think that the employers would be very glad to undertake that.

The Chairman. All in favor say Aye; opposed No.

The Ayes appear to haveit. The Ayes have it.

Senator Bentsen.

Senator Bentsen. Mr. Chairman, I don't know how many of you read Spencer Richards' article in the Post on the number of people that have never collected their pension because of the lack of supportability. What I am proposing here is an amendment for a simplified pension plan that provides the best of the Keogh plan and IRA, and I understand it is also supported by Treasury. I don't know of anyone in opposition to it.

It provides another avenue, an option for business to set up pensions where they could make deductions up to $7500 under Keogh and they would also have non-discrimination rules and investing rules. The interesting point about it, too, once they set this up the employee where the contributions are made to this man would have supportability and he could take it with him as he goes. It does not require a separate trust. The contributions are specifically into his segregated account.

Senator Curtis. Someone can roll over in IRA and you would have that available in Keogh, is that it?

Senator Bentsen. Yes.

Mr. Curtis. When would this be available?

Senator Bentsen. They can set up a plan, establish a pension plan, and then make the contributions to it under the rules of Keogh and under the non-discrimination rules. They would have immediate vestment so I would think principally it would be used by small businessmen because it has a minimum of red tape.

I would ask the Treasury if they would like to comment on it.

Senator Curtis. How would it affect the --

Senator Bentsen. It would have no effect.

Mr. Shapiro. Under present law you have the Keogh plans and then you have IRA and then you have a pension plan. There are some employees that may not fund as much as $1500 benefit for employees on one of the pension plans and maybe some people would not have a pension plan because it is too much paper work and cost. Senator Bentsen says to have a combination which would allow the employer to set up an IRA for the benefit of his employees and then what you would do is you could not exceed the limits of the

IRA which is 15 percent up to $7500, and in addition if he --

Senator Curtis. That is not the limit on IRA, that is the limit on Keogh.

Mr. Shapiro. Yes. What you would do, the employee could build up the difference so long as he does not go over the --

Senator Bentsen. Up to $1500.

Mr. Shapiro. Up to $1500.

Senator Curtis. Would that take care of the case also where there is a pension plan and it provides a minimum amount less than $1500? Would it make IRA available so the individual could take the --

Mr. Shapiro. That is referred to as a LIRA and Senator Dole has mentioned that. This is separate from that. This would have an effect on that in the sense that those employers that would elect this, their employees could combine the two. The proposal Senator Dole had would apply to those employers who would continue their pension plan and allow their employees to set up a separate IRA.

Senator Curtis. What is the revenue cost of this?

Mr. Shapiro. You will have some cases where the employee would put into the IRA and we have approximately $6 million for fiscal 1979. In 1983 it gets up to under $50 million.

Senator Bentsen. I think Treasury supported it.

Mr. Halperin. Yes, we have supported this.

The Chairman. All in favor say Aye; opposed No.

The Ayes have it.

Senator Bentsen. I wanted to have an amendment that allows these public pension plans to use a funding by life insurance companies where they can now do it in banks and mutual funds and the rest of it and I understand Treasury supports this, too.

The Chairman. Is that correct, Treasury?

Mr. Halperin. Senator Long, just in connection with the funding of state and local pension plans we have testified that we would have no objection if there were no tax on a trust set up and we wanted those plans even if the trusts were not qualified. If that were the rule, then of course it would follow that the reserves under the life insurance contract should be non-taxable as well. This just makes the life insurance reserve non-taxable but if the trust were set up and the claim were not qualified, I guess that would continue to be taxable. So these kinds of movements are discrimination in the other direction. Right now the banks have an advantage over the insurance companies and I think in this amendment the insurance companies might have an advantage over the bank. I think we would prefer to take care of both problems at the same time.

Senator Curtis. This relates to public employees?

Senator Bentsen. Yes.

Senator Curtis. I think the proposal is a good one.

Senator Dole. I wonder if we might add to that --

Senator Bentsen. And it involves no revenue loss.

Senator Dole. Bob, we also have a proposal that would permit a pension plus an IRA. I don't know whether Treasury has any objection to this but it is sort of in this same area and maybe we could deal with that, too.

Mr. Shapiro. That is what we call a LIRA, a limited IRA. You can go up to $1500 or there are various proposals. Now in the past when the Congress has considered that in the Senate Finance Committee there has been a great deal of support for that provision and the problem each time has had the ripple effect in the neighborhood of half a million dollars. That is the only reason this provision has not been agreed to in the past, because both have been sympathetic to the form of a limited IRA and because the budget restrictions have had difficulty in agreeing to the very situation that sits on the budget resolution.

Senator Curtis. May I see if I understand it correctly. There are company pensions started that never are funded or provide very much of a pension, it is a low amount. At the same time to qualify for IRA under the original law you could not be involved in any of these other pension plans; namely, the Act. What the Dole proposal would do is if someone had a pension, was the beneficiary of a pension plan that was a very small amount, that he could have a limited IRA to bring it up to the IRA limit of $1500 a year, is that correct?

Mr. Shapiro. Yes, Senator.

Senator Dole. It is not a half billion? Is it that high?

Mr. Shapiro. There are various versions of it. It gets up to over a half billion dollars.

Senator Dole. Does that include Government employees?

Mr. Shapiro. Yes.

Senator Dole. What if you eliminate Government employees?

Mr. Shapiro. I am sorry. I think the half billion dollars included Government employees.

Senator Dole. So if you eliminated Government employees, that would reduce the revenue?

Mr. Lubick. About 700 is our estimate excluding Government employees.

The Chairman. We will agree to Senator Bentsen's thing and we will hold that one off until tomorrow which will give us a chance to look at it overnight.

Senator Dole. All right.

The Chairman. This thing about letting the insurance company handle it, that does not make any particular revenue difference one way or the other.

Senator Bentsen. No.

The Chairman. All in favor say Aye; opposed No.

The Ayes have it.

Now Senator Hathaway has an amendment and Senator Laxalt. I hope we can get those two done and that will be all for today.

Senator Hathaway. Mr. Chairman, I would like to offer an amendment on the small business incentive plan which has been discussed and I think that the staff paper has been distributed to all the members but I will go over it briefly. This provides for 10 percent credit up to $750 for a single person and $1500 for a married couple for investment in certain qualified small business corporations. There are protective devices in the bill to make sure that this does not include the members of the corporations themselves and there is a recapture provision so that it has to be held for at least a year. The revenue loss would be $70 million.

I understand Treasury has no objection to it. I don't know whether they will endorse it or not but I don't know whether they have any objection.

Mr. Lubick. Senator Hathaway, we thought that there was considerably more merit to the Senate exclusion. It seems to us that that has given a considerable incentive to investment in stocks and we would find it hard to see the two in there. If you would like to substitute it for the 1977 exclusion -- (laughter).

Senator Bentsen. I am not sure I would have too much chance. Maybe we should consider it independently without the 70 percent. You would favor it or just have no objection to it?

Senator Hansen. Wouldn't the better alternative be to come on board with the capital gains provision?

The Chairman. Join in co-sponsoring the capital gains amendment which we have already agreed to.

Senator Hathaway. This at least concentrates money in the small business corporation which the small businesses need, which are more competitive users than the bigger businesses, and it would help them out considerably. Also, it gives a tax break to every investor. I think the number of people that actually get involved in the investment of stocks is not that large. If you increase it from 50 to 70 percent, it is not going to attract that many new investments in the field. You get a 70 percent tax credit whether you win or lose in investment in small business. You get a smaller investment. Even somebody that invests $100 will get a $10 return.

The Chairman. I have put a lot of money into small business and I have lost every nickel but here at least you get ten cents back from the dollar.

Do you agree with that? Does Treasury have the cost?

Mr. Lubick. We have just simply taken the staff estimates. I am not sure we have an independent one.

Senator Dole. Is this the same bill that Senator Weicker has? The Weicker plan in Connecticut and the Hathaway plan in Maine?

Senator Hathaway. Yes. Actually it is the American Stock Exchange plan, not that they have any control over it.

The Chairman. The way I read this it looks like you get $750 tax credit.

Senator Hathaway. Maximum.

The Chairman. For putting $700 into one of these small companies in a new stock issue.

Senator Hathaway. Yes.

Senator Curtis. Do you have to hold it a year?

Senator Hathaway. Yes.

The Chairman. What if you sold it after a year?

Senator Hathaway. If you sold it after a year, that is fine but you would get the credit.

The Chairman. Could you sell it after a year and then do it all over again?

Senator Hathaway. No.

Senator Dole. One shot.

Senator Hathaway. Original issue.

Senator Curtis. Find another original issue.

Mr. Shapiro. You are not limited. One $750 each year for a new issue.

Senator Hathaway. Yes.

Senator Gravel. This would have a real impact on the amount of tax.

The Chairman. It is $750 available to you for investing in stock if you can find something you think is a pretty good issue. How many people would take full advantage of it? How many people would have to take advantage of 70 million people? I don't see how you arrive at the conclusion that it would cost that, Mr. Shapiro.

Mr. Shapiro. While they are checking on that, Mr. Chairman,

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there have only been a handful of these new issues in the last couple of years and that is the reason why the estimate is small and it is not anticipated there will be that many more in the future.

The Chairman. How do you do it? You are going to give them $750 to $1500 to buy the stock. That estimate makes me think of the estimate they gave us when they had the Medicaid amendment. They had to assume that you are going to give somebody 3 for 1 matching and assume they are not going to match it and put up only what they got the year before. It is like the social security services, it is not going to cost $40 million assuming that is what the people are doing at that moment but the minute they saw 75 percent matching it would wind up costing too much. I don't know why people would not come in and take advantage of it.

Mr. Shapiro. In a particular company when you have additional issues it has a tendency to dilute the stock of the existing shareholders and then you also would not issue new stock unless there is a reason for doing so. In the past several years there have been so few issues that would go to this. Looking into what would be in the future, it would not appear that even with this that there will be that many more new issues as this inducement for those taxpayers, that there would be new issues.

What the American Stock Exchange is saying is that if a company actually makes this new issue, this money should be used for productivity, for more investment, and they feel that that will be stimulative and the effect would be worthwhile. The estimate is based on what is believed to be existing issues and forecast. As you just said, if there are a significant number of new issues, the cost would increase.

Senator Danforth. Mr. Chairman, I have a question about this limiting it to 10 percent of the first $750. It seems to me that the effect of this would be to make it very appealing to small investors and I wonder if when you are talking about venture capital, when you are talking about people who are to invest in new issues by small corporations, whether the people you really want to go into that kind of an operation are the samll investors or whether this seeks the people who can afford it the least to go into the riskiest types of investment.

Senator Hathaway. Well, one of the reasons is to have concentration of stock in the large institutions in the large investment and any movement on their part can affect the market considerably whereas if you broaden the base you are going to have a more orderly market. You won't have a broad base effect if you allowed this for any kind of investment on any listed stock.

The Chairman. It seems to me, Senator Hathaway, if you are going to do something like this you would do a lot better to put it into some phase of the energy investment where you would encourage people to do something in the energy area. There is where we have a big shortage. We try to get something done. New issues in that area I think would seem to have priority.

Senator Hathaway. This does not preclude that.

Senator Gravel. They are trying to get as broad a base as possible. They have lost five million people in the market that just got out in the last five years and these are basically small people, they are one shotters. They got a little burned and didn't go back because of the recession and now they are trying to get these people back into the marketplace and this is the incentive to do it.

Senator Danforth. I would like to see small investors invest in large diversified stable companies and people who can afford to take the investment invest in the smaller risky new ventures.

Senator Gravel. I once invested in some large stable companies and lost my shirt.

Senator Danforth. What was that?

Senator Gravel. I once invested in some large stable companies and lost my shirt. It is where the person wants to go. If the person wants to make it with a small issue, an exciting issue, a growth issue, fine.

Senator Danforth. What this does is say that the Government is going to try to steer new investors into venture type operations and I am must wondering whether that is where we want this small investor to be.

Senator Hathaway. Well, not necessarily small investment because some of them take a $1500 credit and that is not a really small credit. He gets protected.

The Chairman. Is this protected by the SEC?

Senator Hathaway. Yes.

The Chairman. This would be approved by the SEC?

Senator Hathaway. Yes, and a five year sunset provision. You can review at the end of five years.

The Chairman. Well, all in favor say Aye; opposed No.

Senator Hathaway. Who won? The Ayes were much louder than the Nos.

The Chairman. Well, will those in favor raise your hand. Those opposed.

Senator Hathaway. Four to four, right?

The Chairman. It fails to carry at this point. Why don't you submit it when we have a full attendance and we can vote on it again.

Senator Hathaway. How much longer will we be in session?

The Chairman. Another day.

Senator Hathaway. Tuesday.

Senator Dole. Will you be here tomorrow? We had that one to put in to liberalize for the elderly.

Senator Hathaway. I have three more amendments but I don't know whether the Chairman wants to take them up at this time.

Senator Dole. That has already been passed by the committee and we will put it on this bill.

Senator Hathaway. It has also been passed by the House Ways and Means Committee.

Senator Dole. It was approved here on August 8 and Bobby has a memo on it.

Mr. Shapiro. Is this the credit bill?

Senator Dole. Yes.

I assume it is, Mr. Hathaway.

Senator Hathaway. Yes, and put Mr. Matsunaga on it also as a co-sponsor.

Mr. Shapiro. It increases the maximum amount of income held to the elderly credit from $2500 to $3000 for single persons and from $3750 to $4500 for married couples. In addition to that the phaseout amount is increased. Under present law it is increased from $7500 to $15,000 for single persons and from $10,000 to $17,500 for married couples. This has a calendar revenue effect of $278 million but a fiscal year effect of approximately $40 million to $50 million for purposes of the budget. This is the proposal that the committee had agreed to earlier.

The Chairman. Any objection?

Without objection, agreed.

Senator Laxalt.

Senator Laxalt. Mr. Chairman and members of the committee, I would like to offer an amendment relating to the contributions in aid of construction.

This would amend Section 118 of the Internal Revenue Code to return contributions in aid of construction paid to gas and electric utilities to the tax free status that existed for over 50 years prior to the issuance of Revenue Ruling 75-557. In a time of soaring utility bills and skyrocketing construction costs, this is not the place for the Internal Revenue Service to seek additional revenue.

Prior to 1975, for over 50 years, amounts paid to regulated utilities for new service and to relocate old services were considered by the Service to be tax-free contributions to capital. These funds were not included in the utility's rate base, and facilities could not be depreciated for future tax consequences. This longstanding treatment was accepted by the courts, Congress and even the IRS in Revenue Ruling 58-555 which held that contributions to unregulated utilities should be taxed as providing services while contributions to regulated utilities should remain untaxed.

In 1975 the IRS broke completely with the past and handed down Revenue Ruling 75-557 which held that all contributions in aid of construction should be considered taxable income to the utility. Yet these contributions, or the facilities they are used to construct, are still not allowed to be considered in the basis for determining the rate base, nor can they be depreciated for tax purposes. In other words, the IRS is proposing to tax contributions to capital for service lines which, once built, cannot be used to raise revenue or be depreciated for replacement. In addition, if service lines are moved, changed or extended at a customer's request, a second taxable contribution to capital would be required.

This result seems to me to be grossly unfair. The tax treatment of such contributions as income was expressly negated by the Tax Reform Act of 1976, but only for water and sewage disposal public utilities. The purpose of my bill, which I would like to offer as an amendment to the Revenue Act, is simply to provide the same treatment for gas and electric utilities and thereby confirm the historical treatment of these amounts as non-taxable. Because these utilities traditionally have not been including these contributions in gross income, my proposal would not create a revenue loss to the U.S. Treasury. As of yet, even after Revenue Ruling 75-557, no new revenue has been collected as the utility companies have decided not to pay the tax and to litigate the issue if the IRS issues deficiency notices. However, it has been estimated by the Joint Committee staff that if the Ruling is overturned, it will cost approximately $150 million.

But more importantly, Mr. Chairman, consider the adverse consequences if the ruling is allowed to stand. If tax liability is successfully imposed by the IRS on gas and electric utilities, utility rates will have to be increased, thereby forcing all utility users to effectively subsidize new projects. However, if the liability is not recovered through a general rate increase by the utility, the contribution amount in most cases will have to be approximately doubled to pay the tax liability on the contribution and still complete the construction work. This is also not acceptable because it would lead to increases in the front end costs of builders to assure utility service for new housing and make it increasingly difficult for the average American family to afford a new home.

In short, Revenue Ruling 75-557 goes against a 50 year tax history when the issue was litigated several times and is already causing serious difficulties in the building industry, as we heard in the subcommittee hearings.

The Chairman. Would the Senator yield for an observation?

Senator Laxalt. Yes.

The Chairman. Are you finished?

Senator Laxalt. Just one moment if the Chairman will permit.

The partial repeal carried out in the Tax Reform Act of 1976 should be completed so that gas and electric utilities are exempt, as well as water and sewage utilities. The need for this action has been recognized by the House when on September 12 the Ways and Means Committee passed an identical bill, H.R. 11741.

Mr. Chairman, in my view S. 3176 is a necessary bill and I strongly urge its adoption as an amendment to the Revenue Act.

I yield to the Senator from Nebraska.

Senator Curtis. I wish to support the amendment very much. It involves this. Suppose a farmer needs a natural gas line extended to his premises to run his irrigation well. The gas company says, we will extend it if you will make a contribution to the cost of $2,000. Prior to the recent revenue ruling that $2,000 was not income to the gas company, neither could the gas company take depreciation on it, neither could they use it in their rate making.

Now when the Internal Revenue Service and Treasury propose to make that $2,000 taxable to the gas company near the 50 percent bracket they have to charge the farmer $4,000 to get to that. We are discriminating against the only public utilities that relate to energy. We do this for water and sewer but not for gas and electricity.

There are also situations where a city because of street improvements will require the moving of some lines and they agree on a given exchange maybe to pay $10,000 of the cost of it. Without his amendment the utilities would have to pay taxes on the $10,000 as income so the city if they were going to take their share of the $10,000 cost would have to put in $20,000. As I say, the utility company cannot depreciate that, they cannot take depreciation on it. To add it into the income leaves one of two things: either they have to collect a greater contribution from the customer or from a city or a municipality or they have to put it in their rates.

Senator Laxalt. Would the Senator yield?

Senator Curtis. I am through and I yield.

Senator Laxalt. I might say this is already occurring. In my own state of Nevada the connection fees as a result of this ruling have already doubled. For example, the U.S. Navy requested Pacific Power Company to extend service to serve a microwave station in San Bernardino, California, which is just over the hill from us. The cost of extension was estimated at $175,000 but they were forced to request $300,000. The Southern Pacific Development Company in 1977 decided to build a development park in Sparks, Nevada. The cost will be increased from $1.2 million to $2.3 million.

So you are roughly talking, as the Senator indicated, in doubling the cost of these front end connections which is going to add to the problem all the way around. We had strong testimony from various segments of the housing industry throughout the country indicating that the force of this ruling is going to cause an additional burden on the housing problems that we already have.

Senator Gravel. It is my amendment to the last Act that created the situation for the water companies and I want to endorse this. I thought of doing the other and not for lack of justice but thought it was just too much.

Senator Curtis. There was a lack of votes. I offered it on the floor.

Senator Gravel. I would hope to do that and maybe we could expend it to let utility companies have a drafted amortization which we now have under the Clean Air Act and the Clean Water Act

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with respect to all government.

The Chairman. Let us just vote on this one at the moment.

Senator Matsunaga. I would like to support the Senator. I would like to support Senator Laxalt's amendment. I think it is the only solution to the equities to the utilities.

Mr. Shapiro. This matter was considered by the Ways and Means Committee, they held a hearing on it and reported this measure out. As he indicated, where it really goes to, as an example, you can see we have a subdivision of homes and you have the pipes that go into subdivisions and essentially those charges are paid by the purchaser of the home. Prior to 1975 that was always treated as a contribution in aid of construction, meaning that the utility did not take that contribution by the purchaser in income, also the utility did not get depreciated or get the investment credit on it.

Senator Curtis. Or include it in his rate structure.

Mr. Shapiro. That is right. That had been the long standing rule of the IRS that was developed from early case law in the early stages of the development of tax laws. In 1975 the IRS issued a ruling changing that history and in a sense they revoked a 1958 ruling which endorsed the court decisions and that ruling would have taken into account -- actually it provides that the contributions would be treated as income to the utility.

Last year, as Senator Gravel indicated, he sponsored this provision which did not apply the rulings to public water and

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sewage utilities. The issue before you right now is whether or not the electric and gas should get the same treatment that the water and sewage utilities got in 1976 which would mean that any of the contributions made by the purchasers would be treated as contributions to capital by the utility and would not be treated as income.

The Chairman. Let me ask with regard to a situation I am familiar with. If someone is extending a water line past a home so the home is set well back from the highway and when we go by the person says, "If you will, I want you to extend the pipe to me," and they say, "No, that is a substantial amount of money to do that, you have to pay something to get it done." Now in that case perhaps you are paying, say, $1,000 to extend that pipe on back.

Now in some cases it is cheaper just to go ahead and pay somebody to lay the pipe and then they will connect it up if you will lay the pipe out. But if they are going to have to pay a tax on that, then it would be a lot cheaper because if all you do is pay somebody -- suppose you are hiaring the same contractor they are hiring. You hire the same contractor. He does not have to pay the tax except on the profit in laying that pipe for you. So in that case it would be a lot cheaper for you to go ahead and pay a private contractor than if the company had to pay the tax. We will say the company does not pay the tax on it now.

Mr. Shapiro. This has been the practice in the past and the

Internal Revenue Service has issued a ruling of saying they would be liable to pay tax on it, that they would have that ruling in 1975. It is being contested, and presumably if it is not it will be in the courts as to whether or not that ruling is valid.

The Chairman. Now all these hearings in the district, the companies have had to relocate their lines to build a metro. Metro goes through. They are entitled to be paid for it but the question is that then is a cost of relocating those lines. Do you pay taxes on the cost of relocating those lines?

Mr. Shapiro. That is part of this basic issue, Senator. Let me just take a typical case. When you have a subsidivsion and let's say you have a pipe going down the middle of the street, the pipe that goes down in the middle of the street, that is what the subdivision builder in effect pays for work, allocates the cost to each home and after it is laid throughout the subdivision donated to the utility. Now the connection between the home and the middle of the street, it runs from the home to the middle of the street to the main connection, is treated as income. It is the main pipe that goes down the middle of the street.

After the subdivision is finished, all the pipes in that subdivision are in fact donated to the utility and that is what prior to 1975 was treated, and the Internal Revenue accepted, as a contribution in aid of construction. The builder laid it and after this subdivision was underway and all of the homes were built then that was donated to the utility who maintained it from there on.

The Chairman. But he does not pay a tax on that part of it.

Mr. Shapiro. Prior to 1975 the IRS accepted the prior case law on it and said that the utility did not pay a tax on the amount that was donated by the builder to the utility.

Senator Matsunaga. Now they are merely trying to extend that to electric utilities.

Mr. Shapiro. Electric and gas.

The Chairman. Mr. Lubick.

Mr. Lubick. Mr. Chairman, this is an extremely complex problem and we think perhaps the position in the present law is the position of over taxes and the position stated by Mr. Laxalt of under taxes. We are having a hearing this week on the regulations under existing law. We had a hearing before Senator Byrd earlier and I think that when we went through this whole subject with him that we, Treasury, and he agreed that this is a matter that requires more precision to work out and we ought to come back and get a recommendation for you early next year to get the taxation to the right amount.

Basically if you go with Senator Laxalt's approach, you are giving the utility the equivalent of a current deduction for some new investment and we think that is not appropriate. What we would like to do is to have the hearings, see what the outsiders say and come up with a recommendation for you early next year along the lines that we did with Senator Laxalt.

The Chairman. It seems to me that when Senator Laxalt is saying is that the old law prior to the time you started trying to change it by regulation just is right and that if you want to change it come up here and show what you think the change ought to be, but frankly the change does not make much sense to me if somebody is going to put improvements in and then donate it for the benefit of the service. As I understand it, the company is not depreciating it.

Mr. Shapiro. The company will not depreciate it.

The Chairman. They put these pipes down and they get the service. They are not going to add to their rate base, they are not going to depreciate and get any investment credit on it. It is there. Now the Treasury wants to tax that. Why, I don't understand. I just don't see the point of it.

Mr. Lubick. If it is taxed, they would get the depreciation and the investment credit.

The Chairman. You are offering them something that it is all the same.

Mr. Lubick. Basically.

The Chairman. That sounds tome like the way the ordinary guy reacts to the pooling. Like I have been trying to claim to some of my friends down there, just a man on the street. They are putting the tax on you and then when you send the money to Washington we are going to send you back a check. He said: "Well, let me ask you one question. What is wrong with just leaving me with my money to begin with?"

Now this thing falls in that sort of category. Now you have to tax a fellow so you can give him a depreciation. I prefer you just to leave me alone, I am happy the way it is now.

Well, let's vote on the amendment. All in favor say Aye; opposed No.

The Ayes have it.

That concludes today's session. We will reconvene at ten o'clock tomorrow morning.

(Whereupon, at 5:15 p.m., the committee recessed, to reconvene at 10:00 a.m., Tuesday, September 26, 1978.)

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