

REVENUE ACT OF 1978

HEARINGS BEFORE THE COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13511

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954
TO REDUCE INCOME TAXES, AND FOR OTHER PURPOSES

AUGUST 17, 21, 22, 23, 24, 25, AND SEPTEMBER 6, 1978

PART 1 OF 6 PARTS

(AUGUST 17, 1978)

Printed for the use of the Committee on Finance



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(iii)

REVENUE ACT OF 1978

AUGUST 17, 1978

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Ribicoff, Byrd, Jr., of Virginia, Nelson, Bentsen, Haskell, Hathaway, Curtis, Hansen, Dole, Packwood, Roth, Jr., Laxalt, and Danforth.

[The press releases announcing these hearings and the bill H.R. 13511 follow:]

PRESS RELEASE OF COMMITTEE ON FINANCE U.S. SENATE

AUGUST 2, 1978.

FINANCE COMMITTEE ANNOUNCES HEARINGS ON TAX CUT BILL

The Honorable Russell B. Long (D., La.), Chairman, today announced that the Committee on Finance will hold hearings on the President's tax cut bill beginning August 21. Although the House has not yet completed work on this bill, in view of the shortness of time and in anticipation of House passage of that measure by mid-August, hearings are now being set.

The hearings will begin at 10:00 A.M. in Room 2221 of the Dirksen Senate Office Building

The Chairman noted that hearings have previously been held on the subjects of capital gains tax cuts, the Roth-Kemp income tax cut bill, the jobs tax credit, indexing of the tax system, and Employee Stock Ownership Plans. He pointed out that testimony presented at the earlier hearings is a part of the record, and expressed his hope that testimony presented at the upcoming hearings would not duplicate the information previously submitted concerning these issues.

Witnesses who desire to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510 by no later than the close of business on August 14, 1978.

Legislative Reorganization Act.—Senator Long stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committee of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should limit their testimony to these tax sections of the Act and should comply with the following rules:

- (1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.
- (2) All witnesses must include with their written statement a summary of the principal points included in the statement.
- (3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statement to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Long stated that the Committee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by September 6, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

PRESS RELEASE OF U.S. SENATE COMMITTEE ON FINANCE

AUGUST 11, 1978.

FINANCE COMMITTEE TO HEAR SECRETARY BLUMENTHAL ON TAX CUT LEGISLATION

The Honorable Russell B. Long (D., La.), Chairman, today announced that the Committee on Finance will hold a hearing on Thursday, August 17, 1978, at which the Honorable W. Michael Blumenthal, Secretary of the Treasury, will appear to present the views of the Administration on the tax cut legislation (H.R. 13511), which has now been passed by the House of Representatives. The hearing will be held in Room 2221 Dirksen Senate Office Building and will begin at 10:00 a.m.

The Chairman noted that this hearing to receive testimony from Secretary Blumenthal is in addition to the previously announced hearings on the tax cut bill, which are scheduled to begin on August 21. Information concerning those hearings is contained in Press Release #56, issued on August 2, 1978. A copy of that press release may be obtained from the Committee office, 2227 Dirksen Senate Office Building.

PRESS RELEASE OF U.S. SENATE COMMITTEE ON FINANCE

AUGUST 24, 1978.

FINANCE COMMITTEE TO HEAR FEDERAL RESERVE BOARD CHAIRMAN MILLER
ON TAX CUT BILL

The Honorable Russell B. Long (D., La.), Chairman of the Committee on Finance, announced today that the Committee would extend for one day its hearings on H.R. 13511, the House-passed tax reduction bill, in order to hear the Honorable G. William Miller, Chairman of the Board of Governors of the Federal Reserve System. The hearing will begin at 10:00 a.m. Wednesday, September 6, 1978 in Room 2221 Dirksen Senate Office Building.

95TH CONGRESS
2D SESSION

H. R. 13511

IN THE SENATE OF THE UNITED STATES

AUGUST 14 (legislative day, MAY 17), 1978

Read twice and referred to the Committee on Finance

AN ACT

To amend the Internal Revenue Code of 1954 to reduce income taxes, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled.*

3 SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

4 (a) SHORT TITLE.—This Act may be cited as the “Rev-
5 enue Act of 1978”.

II

1 (b) TABLE OF CONTENTS.—

- Sec. 1. Short title; table of contents.
 Sec. 2. Amendment of 1954 Code.

**TITLE I—PROVISIONS PRIMARILY AFFECTING
 INDIVIDUAL INCOME TAX**

Subtitle A—Tax Reductions and Extensions

- Sec. 101. Widening of brackets; rate cuts in certain brackets; increase in zero bracket amounts.
 Sec. 102. Personal exemptions increased to \$1,000.
 Sec. 103. Earned income credit made permanent.
 Sec. 104. Simplification of the earned income tax credit.
 Sec. 105. Application of certain changes in the case of fiscal year taxpayers.

Subtitle B—Itemized Deductions

- Sec. 111. Repeal of deduction for State and local taxes on gasoline and other motor fuels.
 Sec. 112. Revision of deduction for medical, dental, etc., expenses.
 Sec. 113. Repeal of deduction for political contributions.
 Sec. 114. Taxation of unemployment compensation benefits at certain income levels.
 Sec. 115. Effective date.

Subtitle C—Deferred Compensation

- Sec. 121. Deferred compensation plans with respect to service for State and local governments.
 Sec. 122. Certain private deferred compensation plans.
 Sec. 123. Clarification of deductibility of payments of deferred compensation, etc., to independent contractors.
 Sec. 124. Tax treatment of cafeteria plans.
 Sec. 125. Administration of 1954 Code in the case of certain cash or deferred arrangements.

TITLE II—TAX SHELTER PROVISIONS

Subtitle A—Provisions Related to at Risk Rules

- Sec. 201. Extension of section 465 at risk rules to all activities other than real estate.
 Sec. 202. Extension of at risk provisions to closely held corporations.
 Sec. 203. Recapture of losses where amount at risk is less than zero.
 Sec. 204. Effective dates.

Subtitle B—Partnership Provisions

- Sec. 211. Penalty for failure to file partnership return.
 Sec. 212. Extension of statute of limitations in the case of partnership items.

**TITLE III—PROVISIONS PRIMARILY AFFECTING
 BUSINESS INCOME TAX**

Subtitle A—Corporate Rate Reductions

- Sec. 301. Corporate rate reductions.

**TITLE III—PROVISIONS PRIMARILY AFFECTING
BUSINESS INCOME TAX—Continued**

Subtitle B—Credits

- Sec. 311. 10-percent investment tax credit and \$100,000 limitation on used property made permanent.
- Sec. 312. Increase in limitation on investment credit to 90 percent of tax liability.
- Sec. 313. Investment credit for pollution control facilities.
- Sec. 314. Investment credit allowed for certain rehabilitated buildings.
- Sec. 315. Targeted jobs credit.

Subtitle C—Miscellaneous Provisions

- Sec. 321. Increase in limit on small issues of IDB's to \$10,000,000.
- Sec. 322. Three-year extension of provision for 60-month depreciation of expenditures to rehabilitate low-income rental housing.

Subtitle D—Small Business Provisions

PART I—PROVISIONS RELATING TO SUBCHAPTER S

- Sec. 331. Subchapter S corporations allowed 15 shareholders.
- Sec. 332. Permitted shareholders of subchapter S corporations.
- Sec. 333. Three-year extension of period for making subchapter S elections.
- Sec. 334. Effective date.

PART II—OTHER PROVISIONS

- Sec. 335. Small business corporation stock.
- Sec. 336. Special depreciation rules for small business.

Subtitle E—Accounting Provisions

- Sec. 341. Treatment of certain closely held farm corporations for purposes of rule requiring accrual accounting.
- Sec. 342. Accounting for growing crops.

TITLE IV—CAPITAL GAINS

- Sec. 401. Repeal of alternative tax on capital gains of individuals.
- Sec. 402. Removal of capital gains from items of tax preference for purposes of minimum and maximum tax.
- Sec. 403. Separate minimum tax on capital gains.
- Sec. 404. Indexing of certain assets for purposes of determining gain or loss.
- Sec. 405. One-time exclusion of gain from sale of principal residence.
- Sec. 406. Waiver of certain 18-month rules of section 1084 when sale of residence is connected with commencing work at new place.
- Sec. 407. Study of effects of changes in the tax treatment of capital gains on stimulating investment and economic growth.

1 SEC. 2. AMENDMENT OF 1954 CODE.

- 2 Except as otherwise expressly provided, whenever in**
- 3 this Act an amendment or repeal is expressed in terms of**

1 an amendment to, or repeal of, a section or other provision,
2 the reference shall be considered to be made to a section or
3 other provision of the Internal Revenue Code of 1954.

4 **TITLE I—PROVISIONS PRIMARILY**
5 **AFFECTING INDIVIDUAL IN-**
6 **COME TAX**

7 **Subtitle A—Tax Reductions and**
8 **Extensions**

9 **SEC. 101. WIDENING OF BRACKETS; RATE CUTS IN CER-**
10 **TAIN BRACKETS; INCREASE IN ZERO BRACKET**
11 **AMOUNTS.**

12 (a) **RATE REDUCTION.**—Section 1 (relating to tax
13 imposed) is amended to read as follows:

14 **“SECTION 1. TAX IMPOSED.**

15 **“(a) MARRIED INDIVIDUALS FILING JOINT RETURNS**
16 **AND SURVIVING SPOUSES.**—There is hereby imposed on
17 the taxable income of—

18 **“(1) every married individual (as defined in sec-**
19 **tion 143) who makes a single return jointly with his**
20 **spouse under section 6013, and**

21 **“(2) every surviving spouse (as defined in section**
22 **2(a)),**

23 **a tax determined in accordance with the following table:**

If the taxable income is	The tax is:
Not over \$3,400.....	No tax.
Over \$3,400 but not over \$4,460.....	14% of the excess over \$3,400.
Over \$4,460 but not over \$5,520.....	\$148.40, plus 15% of excess over \$4,460.
Over \$5,520 but not over \$6,580.....	\$307.40, plus 16% of excess over \$5,520..
Over \$6,580 but not over \$7,640.....	\$477, plus 17% of excess over \$6,580.
Over \$7,640 but not over \$11,880.....	\$657.20, plus 18% of excess over \$7,640.
Over \$11,880 but not over \$16,120....	\$1,420.40, plus 21% of excess over \$11,880.
Over \$16,120 but not over \$20,360....	\$2,310.80, plus 24% of excess over \$16,120.
Over \$20,360 but not over \$24,600....	\$3,328.40, plus 28% of excess over \$20,360.
Over \$24,600 but not over \$28,840....	\$4,515.60, plus 32% of excess over \$24,600.
Over \$28,840 but not over \$33,080....	\$5,872.40, plus 36% of excess over \$28,840.
Over \$33,080 but not over \$37,320....	\$7,398.80, plus 39% of excess over \$33,080.
Over \$37,320 but not over \$41,560....	\$9,052.40, plus 42% of excess over \$37,320.
Over \$41,560 but not over \$45,800....	\$10,833.20, plus 45% of excess over \$41,560.
Over \$45,800 but not over \$50,040....	\$12,741.20, plus 48% of excess over \$45,800.
Over \$50,040 but not over \$58,520....	\$14,776.40, plus 50% of excess over \$50,040.
Over \$58,520 but not over \$71,240....	\$19,016.40, plus 53% of excess over \$58,520.
Over \$71,240 but not over \$83,960....	\$25,758, plus 55% of excess over \$71,240.
Over \$83,960 but not over \$96,680....	\$32,754, plus 58% of excess over \$83,960.
Over \$96,680 but not over \$109,400....	\$40,131.60, plus 60% of excess over \$96,680.
Over \$109,400 but not over \$130,600..	\$47,763.60, plus 62% of excess over \$109,400.
Over \$130,600 but not over \$151,800..	\$60,907.60, plus 64% of excess over \$130,600.
Over \$151,800 but not over \$173,000..	\$74,475.60, plus 66% of excess over \$151,800.
Over \$173,000 but not over \$194,200..	\$88,467.60, plus 68% of excess over \$173,000.
Over \$194,200 but not over \$215,400..	\$102,833.60, plus 69% of excess over \$194,200.
Over \$215,400.....	\$117,511.60, plus 70% of excess over \$215,400.

1 “(b) HEADS OF HOUSEHOLDS.—There is hereby im-
 2 posed on the taxable income of every individual who is the
 3 head of a household (as defined in section 2 (b)) a tax
 4 determined in accordance with the following table:

“If the taxable income is:	The tax is:
Not over \$2,300-----	No tax.
Over \$2,300 but not over \$3,360-----	14% of the excess over \$2,300.
Over \$3,360 but not over \$4,420-----	\$148.40, plus 16% of excess over \$3,360.
Over \$4,420 but not over \$6,540-----	\$318, plus 17% of excess over \$4,420.
Over \$6,540 but not over \$8,660-----	\$678.40, plus 18% of excess over \$6,540.
Over \$8,660 but not over \$10,780-----	\$1,060, plus 20% of excess over \$8,660.
Over \$10,780 but not over \$12,900-----	\$1,484, plus 22% of excess over \$10,780.
Over \$12,900 but not over \$15,020-----	\$1,950.40, plus 25% of excess over \$12,900.
Over \$15,020 but not over \$17,140-----	\$2,480.40, plus 27% of excess over \$15,020.
Over \$17,140 but not over \$19,260-----	\$3,052.80, plus 28% of excess over \$17,140.
Over \$19,260 but not over \$21,380-----	\$3,646.40, plus 31% of excess over \$19,260.
Over \$21,380 but not over \$23,500-----	\$4,303.60, plus 32% of excess over \$21,380.
Over \$23,500 but not over \$25,620-----	\$4,982, plus 35% of excess over \$23,500.
Over \$25,620 but not over \$27,740-----	\$5,724, plus 36% of excess over \$25,620.
Over \$27,740 but not over \$29,860-----	\$6,487.20, plus 38% of excess over \$27,740.
Over \$29,860 but not over \$31,980-----	\$7,292.80, plus 41% of excess over \$29,860.
Over \$31,980 but not over \$36,220-----	\$8,162, plus 42% of excess over \$31,980.
Over \$36,220 but not over \$40,460-----	\$9,942.80, plus 45% of excess over \$36,220.
Over \$40,460 but not over \$42,580-----	\$11,850.80, plus 48% of excess over \$40,460.
Over \$42,580 but not over \$44,700-----	\$12,868.40, plus 51% of excess over \$42,580.
Over \$44,700 but not over \$48,940-----	\$13,949.60, plus 52% of excess over \$44,700.
Over \$48,940 but not over \$55,300-----	\$16,154.40, plus 55% of excess over \$48,940.

"If the taxable income is:	The tax is:
Over \$55,800 but not over \$57,420.....	\$19,852.40, plus 56% of excess over \$55,800.
Over \$57,420 but not over \$70,140.....	\$20,839.60, plus 58% of excess over \$57,420.
Over \$70,140 but not over \$76,500.....	\$28,217.20, plus 59% of excess over \$70,140.
Over \$76,500 but not over \$82,860.....	\$31,969.60, plus 61% of excess over \$76,500.
Over \$82,860 but not over \$87,100.....	\$35,849.20, plus 62% of excess over \$82,860.
Over \$87,100 but not over \$95,580.....	\$38,478, plus 63% of excess over \$87,100.
Over \$95,580 but not over \$108,300....	\$43,820.40, plus 64% of excess over \$95,580.
Over \$108,300 but not over \$129,500..	\$51,961.20, plus 66% of excess over \$108,300.
Over \$129,500 but not over \$150,700..	\$55,953.20, plus 67% of excess over \$129,500.
Over \$150,700 but not over \$171,900..	\$80,157.20, plus 68% of excess over \$150,700.
Over \$171,900 but not over \$193,100..	\$94,573.20, plus 69% of excess over \$171,900.
Over \$193,100.....	\$109,201.20, plus 70% of excess over \$193,100.

1 “(c) UNMARRIED INDIVIDUALS (OTHER THAN SUB-
2 VIVING SPOUSES AND HEADS OF HOUSEHOLDS).—There
3 is hereby imposed on the taxable income of every individual
4 (other than a surviving spouse as defined in section 2 (a)
5 or the head of a household as defined in section 2 (b)) who
6 is not a married individual (as defined in section 143) a tax
7 determined in accordance with the following table:

"If the taxable income is:	The tax is:
Not over \$2,300.....	No tax.
Over \$2,300 but not over \$2,830.....	14% of the excess over \$2,300.
Over \$2,830 but not over \$3,360.....	\$74.20, plus 15% of excess over \$2,830.
Over \$3,360 but not over \$3,890.....	\$153.70, plus 16% of excess over \$3,360.
Over \$3,890 but not over \$4,420.....	\$238.50, plus 17% of excess over \$3,890.
Over \$4,420 but not over \$6,540.....	\$328.60, plus 18% of excess over \$4,420.

"If the taxable income is:	The tax is:
Over \$6,540 but not over \$8,660.....	\$710.20, plus 19% of excess over \$6,540.
Over \$8,660 but not over \$10,780.....	\$1,113, plus 21% of excess over \$8,660.
Over \$10,780 but not over \$12,900....	\$1,558.20, plus 24% of excess over \$10,780.
Over \$12,900 but not over \$15,020....	\$2,067, plus 27% of excess over \$12,900.
Over \$15,020 but not over \$17,140....	\$2,639.40, plus 29% of excess over \$15,020.
Over \$17,140 but not over \$19,260....	\$3,254.20, plus 31% of excess over \$17,140.
Over \$19,260 but not over \$21,380....	\$3,911.40, plus 34% of excess over \$19,260.
Over \$21,380 but not over \$23,500....	\$4,632.20, plus 36% of excess over \$21,380.
Over \$23,500 but not over \$25,620....	\$5,395.40, plus 38% of excess over \$23,500.
Over \$25,620 but not over \$29,860....	\$6,201, plus 40% of excess over \$25,620.
Over \$29,860 but not over \$36,220....	\$7,897, plus 45% of excess over \$29,860.
Over \$36,220 but not over \$42,580....	\$10,759, plus 50% of excess over \$36,220.
Over \$42,580 but not over \$48,940....	\$13,939, plus 55% of excess over \$42,580.
Over \$48,940 but not over \$55,300....	\$17,437, plus 60% of excess over \$48,940.
Over \$55,300 but not over \$65,900....	\$21,253, plus 62% of excess over \$55,300.
Over \$65,900 but not over \$76,500....	\$27,925, plus 64% of excess over \$65,900.
Over \$76,500 but not over \$87,100....	\$34,609, plus 66% of excess over \$76,500.
Over \$87,100 but not over \$97,700....	\$41,605, plus 68% of excess over \$87,100.
Over \$97,700 but not over \$108,300....	\$48,813, plus 69% of excess over \$97,700.
Over \$108,300.....	\$56,127, plus 70% of excess over \$108,300.

1 “(d) **MARRIED INDIVIDUALS FILING SEPARATE RE-**
2 **TURNS.**—There is hereby imposed on the taxable income of
3 every married individual (as defined in section 143) who
4 does not make a single return jointly with his spouse under
5 section 6013 a tax determined in accordance with the fol-
6 lowing table:

*If the taxable income is:	The tax is:
Not over \$1,700.....	No tax.
Over \$1,700 but not over \$2,230.....	14% of the excess over \$1,700.
Over \$2,230 but not over \$2,760.....	\$74.20, plus 15% of excess over \$2,230.
Over \$2,760 but not over \$3,290.....	\$153.70, plus 16% of excess over \$2,760.
Over \$3,290 but not over \$3,820.....	\$238.50, plus 17% of excess over \$3,290.
Over \$3,820 but not over \$5,940.....	\$328.60, plus 18% of excess over \$3,820.
Over \$5,940 but not over \$8,060.....	\$710.20, plus 21% of excess over \$5,940.
Over \$8,060 but not over \$10,180.....	\$1,155.40, plus 24% of excess over \$8,060.
Over \$10,180 but not over \$12,300.....	\$1,664.20, plus 28% of excess over \$10,180.
Over \$12,300 but not over \$14,420.....	\$2,257.80, plus 32% of excess over \$12,300.
Over \$14,420 but not over \$16,540.....	\$2,936.20, plus 36% of excess over \$14,420.
Over \$16,540 but not over \$18,660.....	\$3,699.40, plus 39% of excess over \$16,540.
Over \$18,660 but not over \$20,780.....	\$4,526.20, plus 42% of excess over \$18,660.
Over \$20,780 but not over \$22,900.....	\$5,416.60, plus 45% of excess over \$20,780.
Over \$22,900 but not over \$25,020.....	\$6,370.60, plus 48% of excess over \$22,900.
Over \$25,020 but not over \$29,260.....	\$7,388.20, plus 50% of excess over \$25,020.
Over \$29,260 but not over \$35,620.....	\$9,508.20, plus 53% of excess over \$29,260.
Over \$35,620 but not over \$41,980.....	\$12,879, plus 55% of excess over \$35,620.
Over \$41,980 but not over \$48,340.....	\$16,377, plus 58% of excess over \$41,980.
Over \$48,340 but not over \$54,700.....	\$20,066.80, plus 60% of excess over \$48,340.
Over \$54,700 but not over \$65,300.....	\$23,881.80, plus 62% of excess over \$54,700.
Over \$65,300 but not over \$75,900.....	\$30,453.80, plus 64% of excess over \$65,300.
Over \$75,900 but not over \$86,500.....	\$37,237.80, plus 66% of excess over \$75,900.
Over \$86,500 but not over \$97,100.....	\$44,233.80, plus 68% of excess over \$86,500.
Over \$97,100 but not over \$107,700.....	\$51,441.80, plus 69% of excess over \$97,100.
Over \$107,700.....	\$58,755.80, plus 70% of excess over \$107,700.

1 “(e) ESTATES AND TRUSTS.—There is hereby imposed
 2 on the taxable income of every estate and trust taxable under
 3 this subsection a tax determined in accordance with the fol-
 4 lowing table:

“If the taxable income is:	The tax is:
Not over \$530-----	14% of the taxable income.
Over \$530 but not over \$1,060-----	\$74.20, plus 15% of excess over \$530.
Over \$1,060 but not over \$1,590-----	\$153.70, plus 16% of excess over \$1,060.
Over \$1,590 but not over \$2,120-----	\$233.50, plus 17% of excess over \$1,590.
Over \$2,120 but not over \$4,240-----	\$323.60, plus 18% of excess over \$2,120.
Over \$4,240 but not over \$6,360-----	\$710.20, plus 21% of excess over \$4,240.
Over \$6,360 but not over \$8,480-----	\$1,155.40, plus 24% of excess over \$6,360.
Over \$8,480 but not over \$10,600-----	\$1,664.20, plus 28% of excess over \$8,480.
Over \$10,600 but not over \$12,720----	\$2,257.80, plus 32% of excess over \$10,600.
Over \$12,720 but not over \$14,840----	\$2,936.20, plus 36% of excess over \$12,720.
Over \$14,840 but not over \$16,960----	\$3,699.40, plus 39% of excess over \$14,840.
Over \$16,960 but not over \$19,080----	\$4,526.20, plus 42% of excess over \$16,960.
Over \$19,080 but not over \$21,200----	\$5,416.60, plus 45% of excess over \$19,080.
Over \$21,200 but not over \$23,320----	\$6,370.60, plus 48% of excess over \$21,200.
Over \$23,320 but not over \$27,560----	\$7,388.20, plus 50% of excess over \$23,320.
Over \$27,560 but not over \$33,920----	\$9,506.20, plus 53% of excess over \$27,560.
Over \$33,920 but not over \$40,280----	\$12,879, plus 55% of excess over \$33,920.
Over \$40,280 but not over \$46,640----	\$16,377, plus 58% of excess over \$40,280.
Over \$46,640 but not over \$53,000----	\$20,065.80, plus 60% of excess over \$46,640.
Over \$53,000 but not over \$63,600----	\$23,881.80, plus 62% of excess over \$53,000.
Over \$63,600 but not over \$74,200----	\$30,453.80, plus 64% of excess over \$63,600.
Over \$74,200 but not over \$84,800----	\$37,287.80, plus 66% of excess over \$74,200.

"If the taxable income is:	The tax is:
Over \$84,800 but not over \$95,400-----	\$44,233.80, plus 68% of excess over \$84,800.
Over \$95,400 but not over \$106,000....	\$51,441.80, plus 69% of excess over \$95,400.
Over \$106,000-----	\$58,755.80, plus 70% of excess over \$106,000."

1 (b) INCREASE IN ZERO BRACKET AMOUNT.—Sub-
 2 section (d) of section 63 (defining zero bracket amount) is
 3 amended—

4 (1) by striking out "\$3,200" and inserting in lieu
 5 thereof "\$3,400",

6 (2) by striking out "\$2,200" and inserting in lieu
 7 thereof "\$2,300", and

8 (3) by striking out "\$1,600" and inserting in lieu
 9 thereof "\$1,700".

10 (c) FILING REQUIREMENTS.—Paragraph (1) of sec-
 11 tion 6012 (a) (relating to persons required to make returns
 12 of income) is amended—

13 (1) by striking out "\$2,950" and inserting in lieu
 14 thereof "\$3,050",

15 (2) by striking out "\$3,950" and inserting in lieu
 16 thereof "\$4,150", and

17 (3) by striking out "\$4,700" and inserting in lieu
 18 thereof "\$4,900".

19 (d) TECHNICAL AMENDMENTS.—

20 (1) Subparagraph (C) of section 402 (e) (1) (re-
 21 lating to tax on lump sum distributions) is amended by

1 striking out "\$2,200" and inserting in lieu thereof
2 "\$2,300".

3 (2) Paragraph (3) of section 1302(b) (relating
4 to transitional rule for determining base period income)
5 is amended to read as follows:

6 " (3) TRANSITIONAL RULE FOR DETERMINING
7 BASE PERIOD INCOME.—The base period income (deter-
8 mined under paragraph (2)) for any taxable year begin-
9 ning before January 1, 1977, shall be increased by—

10 " (A) \$3,200 in the case of a joint return or a
11 surviving spouse (as defined in section 2(a)),

12 " (B) \$2,200 in the case of an individual who
13 is not married (within the meaning of section 143)
14 and is not a surviving spouse (as so defined), or

15 " (C) \$1,600 in the case of a married individ-
16 ual (within the meaning of section 143) filing a
17 separate return.

18 For purposes of this paragraph, filing status shall be de-
19 termined as of the computation year."

20 (e) WITHHOLDING AMENDMENTS.—

21 (1) WITHHOLDING TABLES.—Subsection (a) of
22 section 3402 (relating to requirement of withholding)
23 is amended by striking out the second and third sen-
24 tences and inserting in lieu thereof the following new

1 sentence: "With respect to wages paid after Decem-
 2 ber 31, 1978, the tables so prescribed shall be the same
 3 as the tables prescribed under this subsection which
 4 were in effect on January 1, 1975, except that such
 5 tables shall be modified to the extent necessary to reflect
 6 the amendments made by sections 101 and 102 of the
 7 Tax Reduction and Simplification Act of 1977 and the
 8 amendments made by section 101 of the Revenue Act
 9 of 1978."

10 (2) WITHHOLDING ALLOWANCES BASED ON ITEM-
 11 IZED DEDUCTIONS.—Subparagraph (B) of section
 12 3402(m) (1) (relating to withholding allowances based
 13 on itemized deductions) is amended—

14 (A) by striking out "\$3,200" and inserting
 15 in lieu thereof "\$3,400", and

16 (B) by striking out "\$2,200" and inserting in
 17 lieu thereof "\$2,300".

18 (f) EFFECTIVE DATES.—

19 (1) IN GENERAL.—The amendments made by sub-
 20 sections (a), (b), (c), and (d) shall apply to taxable
 21 years beginning after December 31, 1978.

22 (2) WITHHOLDING AMENDMENTS.—The amend-
 23 ments made by subsection (e) shall apply to remunera-
 24 tion paid after December 31, 1978.

1 **SEC. 162. PERSONAL EXEMPTIONS INCREASED TO \$1,000.**

2 (a) **GENERAL RULE.**—Section 151 (relating to allow-
3 ance of deductions for personal exemptions) is amended
4 by striking out “\$750” each place it appears and inserting
5 in lieu thereof “\$1,000”.

6 (b) **FILING REQUIREMENTS.**—

7 (1) Paragraph (1) of section 6012 (a) (relating
8 to persons required to make returns of income), as
9 amended by section 101 (c) of this Act, is amended by
10 striking out “\$750”, “\$3,050”, “\$4,150”, and “\$4,900”
11 each place they appear and inserting in lieu thereof
12 “\$1,000”, “\$3,300”, “\$4,400”, and “\$5,400”, re-
13 spectively.

14 (2) Subparagraph (A) of section 6013 (b) (3)
15 (relating to assessment and collection in the case of
16 certain returns of husband and wife) is amended by
17 striking out “\$750” and “\$1,500” each place they ap-
18 pear and inserting in lieu thereof “\$1,000” and “\$2,-
19 000”, respectively.

20 (c) **WITHHOLDING REQUIREMENTS.**—

21 (1) Paragraph (1) of section 3402 (b) (relating
22 to percentage method of withholding income tax at
23 source) is amended by striking out the table and in-
24 serting in lieu thereof the following:

"Percentage Method Withholding Table

"Payroll period	Amount of one withholding exemption
Weekly -----	\$19.23
Biweekly -----	88.46
Semimonthly -----	41.66
Monthly -----	88.88
Quarterly -----	250.00
Semiannual -----	500.00
Annual -----	1,000.00
Daily or miscellaneous (per day of such period) -----	2.74".

1 (2) Paragraph (1) of section 3402 (m) (relating
2 to withholding allowances based on itemized deduc-
3 tions) is amended by striking out "\$750" and insert-
4 ing in lieu thereof "\$1,000".

5 (d) EFFECTIVE DATES.—

6 (1) IN GENERAL.—The amendments made by sub-
7 sections (a) and (b) shall apply to taxable years be-
8 ginning after December 31, 1978.

9 (2) WITHHOLDING AMENDMENTS.—The amend-
10 ments made by subsection (c) shall apply with respect
11 to remuneration paid after December 31, 1978.

12 **SEC. 103. EARNED INCOME CREDIT MADE PERMANENT.**

13 (a) GENERAL RULE.—Subsection (b) of section 209
14 of the Tax Reduction Act of 1975 is amended by striking
15 out ", and before January 1, 1979".

16 (b) TECHNICAL AMENDMENT.—The second sentence
17 of section 401 (e) of the Tax Reform Act of 1976 (as
18 added by section 103 of the Tax Reduction and Simplifica-

1 tion Act of 1977) is amended by striking out “, and shall
2 cease to apply to taxable years beginning after December
3 31, 1978”.

4 **SEC. 104. SIMPLIFICATION OF THE EARNED INCOME TAX**
5 **CREDIT.**

6 (a) **REVISION OF THE LIMITATION.**—Subsection (b)
7 of section 43 (relating to earned income credit) is amended
8 to read as follows:

9 “(b) **LIMITATION.**—The amount of the credit allowable
10 to a taxpayer under subsection (a) for any taxable year
11 shall not exceed the excess (if any) of—

12 “(1) \$400, over
13 “(2) 10 percent of so much of the adjusted gross
14 income (or, if greater, the earned income) of the tax-
15 payer for the taxable year as exceeds \$4,000.”

16 (b) **AMOUNT OF CREDIT TO BE DETERMINED UNDER**
17 **TABLES.**—Section 43 is amended by adding at the end
18 thereof the following new subsection:

19 “(f) **AMOUNT OF CREDIT TO BE DETERMINED UNDER**
20 **TABLES.**—

21 “(1) **IN GENERAL.**—The amount of the credit al-
22 lowed by this section shall be determined under tables
23 prescribed by the Secretary.

24 “(2) **REQUIREMENTS FOR TABLES.**—The tables
25 prescribed under paragraph (1) shall reflect the provi-

1 sions of subsections (a) and (b) and shall have income
2 brackets of not greater than \$50 each—

3 “(A) for earned income between 0 and \$8,000,
4 and

5 “(B) for adjusted gross income between \$4,000
6 and \$8,000.”

7 (c) EXCLUDABLE EARNED INCOME TAKEN INTO AC-
8 COUNT.—Subparagraph (B) of section 43 (c) (2) (defining
9 earned income) is amended by striking out clause (i) and
10 by redesignating clauses (ii), (iii), and (iv) as clauses (i),
11 (ii), and (iii), respectively.

12 (d) DEFINITION OF ELIGIBLE INDIVIDUAL.—Para-
13 graph (1) of section 43 (c) (defining eligible individual) is
14 amended to read as follows:

15 “(1) ELIGIBLE INDIVIDUAL.—

16 “(A) IN GENERAL.—The term ‘eligible indi-
17 vidual’ means an individual who, for the taxable
18 year—

19 “(i) is married (within the meaning of
20 section 143) and is entitled to a deduction
21 under section 151 for a child (within the mean-
22 ing of section 151 (e) (3)),

23 “(ii) is a surviving spouse (as determined
24 under section 2 (a)), or

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1 " (iii) is a head of a household (as deter-
 2 mined under subsection (b) of section 2 with-
 3 out regard to subparagraphs (A) (ii) and (B)
 4 of paragraph (1) of such subsection).

5 **"(B) CHILD MUST RESIDE WITH TAXPAYER**
 6 **IN THE UNITED STATES.**—An individual shall be
 7 treated as satisfying clause (i) of subparagraph
 8 (A) only if the child has the same principal place
 9 of abode as the individual and such abode is in the
 10 United States. An individual shall be treated as
 11 satisfying clause (ii) or (iii) of subparagraph
 12 (A) only if the household in question is in the
 13 United States.

14 **"(C) INDIVIDUAL ENTITLED TO EXCLUDE**
 15 **INCOME UNDER SECTION 911 (NOT ELIGIBLE IN-**
 16 **ELIGIBLE INDIVIDUAL.**—The term 'eligible individual' does not
 17 include an individual who, for the taxable year, is
 18 entitled to exclude any amount from gross income
 19 under section 911 (relating to earned income from
 20 sources without the United States) or section 931
 21 relating to income from sources within the posses-
 22 sions of the United States).

23 **(e) EFFECTIVE DATE.**—The amendments made by this
 24 section shall apply to taxable years beginning after Decem-
 25 ber 31, 1978.

1 **SEC. 105. APPLICATION OF CERTAIN CHANGES IN THE**
 2 **CASE OF FISCAL YEAR TAXPAYERS.**

3 Section 21 (relating to effects of changes in rate of tax)
 4 is amended by adding at the end thereof the following new
 5 subsection:

6 **“(f) CHANGES MADE BY REVENUE ACT OF 1978.—**
 7 **In applying subsection (a) to a taxable year which is not**
 8 **a calendar year—**

9 **“(1) the amendments made by sections 101, 102,**
 10 **and 301 of the Revenue Act of 1978 (and no other**
 11 **amendments made by such Act), and**

12 **“(2) the expiration of section 42 (relating to gen-**
 13 **eral tax credit),**
 14 **shall be treated as a change in a rate of tax.”**

15 **Subtitle B—Itemized Deductions**

16 **SEC. 111. REPEAL OF DEDUCTION FOR STATE AND LOCAL**
 17 **TAXES ON GASOLINE AND OTHER MOTOR**
 18 **FUELS.**

19 **(a) REPEAL.—**Paragraph (5) of section 164 (a) (relat-
 20 **ing to deduction for taxes) is hereby repealed.**

21 **(b) CONFORMING AMENDMENTS.—**

22 **(1) The heading of paragraph (5) of section 164**

23 **(b) is amended by striking out “AND GASOLINE**
 24 **TAXES”.**

1 (2) The text of such paragraph (5) is amended by
2 striking out "or of any tax on the sale of gasoline, diesel
3 fuel, or other motor fuel".

4 **SEC. 112. REVISION OF DEDUCTION FOR MEDICAL, DEN-**
5 **TAL, ETC., EXPENSES.**

6 (a) **IN GENERAL.**—Subsections (a) and (b) of sec-
7 tion 213 (relating to medical, dental, etc., expenses) are
8 amended to read as follows:

9 “(a) **ALLOWANCE OF DEDUCTION.**—There shall be
10 allowed as a deduction the expenses paid during the taxable
11 year, not compensated for by insurance or otherwise, for
12 medical care of the taxpayer, his spouse, or a dependent (as
13 defined in section 152), to the extent that such expenses
14 exceed 3 percent of adjusted gross income.

15 “(b) **LIMITATION WITH RESPECT TO MEDICINE AND**
16 **DRUGS.**—An amount paid during the taxable year for medi-
17 cine or a drug shall be taken into account under subsection
18 (a) only if such medicine or drug is a prescribed drug or is
19 insulin.”

20 (b) **DEFINITION OF PRESCRIBED DRUG.**—Subsection
21 (e) of section 213 is amended by redesignating paragraphs
22 (2), (3), and (4) as paragraphs (4), (5), and (6), re-
23 spectively, and by inserting after paragraph (1) the follow-
24 ing new paragraphs:

25 “(2) **PRESCRIBED DRUG.**—The term ‘prescribed

1 drug' means a drug or biological which requires a pre-
 2 scription of a physician for its use by an individual.

3 "(3) **PHYSICIAN.**—The term 'physician' has the
 4 meaning given to such term by section 1861 (r) of the
 5 Social Security Act (42 U.S.C. 1395x (r)); except
 6 that, in the case of a doctor of dentistry or of dental or
 7 oral surgery, section 1861 (r) (2) shall be applied with-
 8 out the limitations contained in clauses (A), (B), and
 9 (C) thereof."

10 (c) **CONFORMING AMENDMENTS.**—

11 (1) Paragraph (5) of section 213 (e) (as redesign-
 12 ated by subsection (b)) is amended by striking out
 13 "paragraph (2)" and inserting in lieu thereof "para-
 14 graph (4)".

15 (2) Subsections (d), (e), and (f) of section 213
 16 are redesignated as subsections (c), (d), and (e),
 17 respectively.

18 (3) Subsection (b) of section 105 is amended by
 19 striking out "section 213 (e)" and inserting in lieu
 20 thereof "section 213 (d)".

21 **SEC. 118. REPEAL OF DEDUCTION FOR POLITICAL CON-**
 22 **TRIBUTIONS.**

23 (a) **REPEAL.**—Section 218 (relating to deduction for
 24 contributions to candidates for public office and newsletter
 25 funds) is hereby repealed.

1 (b) **CONFORMING AMENDMENTS.**—

2 — (1) The table of sections for part VII of subchap-
3 ter B of chapter 1 (relating to additional itemized de-
4 ductions for individuals) is amended by striking out the
5 item relating to section 218.

6 (2) Section 642 (relating to special rules for credits
7 and deductions of estates and trusts) is amended by
8 striking out subsection (i) and by redesignating subsec-
9 tions (j) and (k) as subsections (i) and (j), respec-
10 tively.

11 **SEC. 114. TAXATION OF UNEMPLOYMENT COMPENSATION**
12 **BENEFITS AT CERTAIN INCOME LEVELS.**

13 (a) **INCLUSION IN GROSS INCOME.**—Part II of sub-
14 chapter B of chapter 1 (relating to amounts specifically in-
15 cluded in gross income) is amended by adding at the end
16 thereof the following new section:

17 **“SEC. 85. UNEMPLOYMENT COMPENSATION.**

18 “(a) **IN GENERAL.**—If the sum for the taxable year of
19 the adjusted gross income of the taxpayer (determined with-
20 out regard to this section and without regard to section 105

21 (d)) and the unemployment compensation exceeds the base
22 amount, gross income for the taxable year includes unem-
23 ployment compensation in an amount equal to the lesser
24 of—

1 “(1) one-half of the amount of the excess of such
2 sum over the base amount, or

3 “(2) the amount of the unemployment
4 compensation.

5 “(b) **BASE AMOUNT DEFINED.**—For purposes of this
6 section, the term ‘base amount’ means—

7 “(1) except as provided in paragraphs (2) and
8 (3), \$20,000,

9 “(2) \$25,000, in the case of a joint return under
10 section 6013, or

11 “(3) zero, in the case of a taxpayer who—

12 “(A) is married at the close of the taxable
13 year (within the meaning of section 143) but does
14 not file a joint return for such year, and

15 “(B) does not live apart from his spouse at
16 all times during the taxable year.

17 “(c) **UNEMPLOYMENT COMPENSATION DEFINED.**—

18 For purposes of this section, the term ‘unemployment com-
19 pensation’ means any amount received under a law of the
20 United States or of a State which is in the nature of unem-
21 ployment compensation.”

22 “(b) **CLERICAL AMENDMENT.**—The table of sections
23 for part II of subchapter B of chapter 1 is amended by adding
24 at the end thereof the following new item:

"Sec. 88. Unemployment compensation."

1 (c) **EFFECTIVE DATE.**—The amendments made by this
2 section shall apply to payments of unemployment compensa-
3 tion made after December 31, 1978, in taxable years ending
4 after such date.

5 **SEC. 115. EFFECTIVE DATE.**

6 Except as otherwise provided, the amendments made by
7 this subtitle shall apply to taxable years beginning after
8 December 31, 1978.

9 **Subtitle C—Deferred Compensation**

10 **SEC. 121. DEFERRED COMPENSATION PLANS WITH RE-**
11 **SPECT TO SERVICE FOR STATE AND LOCAL**
12 **GOVERNMENTS.**

13 (a) **IN GENERAL.**—Subpart B of part II of subchapter
14 E of chapter 1 (relating to taxable years for which gross
15 income included) is amended by adding at the end thereof
16 the following new section:

17 "SEC. 457. DEFERRED COMPENSATION PLANS WITH RE-
18 SPECT TO SERVICE FOR STATE AND LOCAL
19 GOVERNMENTS.

20 "(a) **YEAR OF INCLUSION IN GROSS INCOME.**—In the
21 case of a participant in an eligible State deferred compensa-
22 tion plan, any amount of compensation deferred under the
23 plan, and any income attributable to the amounts so deferred,
24 shall be includible in gross income only for the taxable year

1 in which such compensation or other income is paid or other-
 2 wise made available to the participant or other beneficiary.

3 “(b) ELIGIBLE STATE DEFERRED COMPENSATION
 4 PLAN DEFINED.—For purposes of this section, the term
 5 ‘eligible State deferred compensation plan’ means a plan
 6 established and maintained by a State—

7 “(1) in which only individuals who perform serv-
 8 ice for the State may be participants,

9 “(2) which provides that (except as provided in
 10 paragraph (3)) not to exceed the lesser of—

11 “(A) \$7,500, or

12 “(B) 33 $\frac{1}{3}$ percent of the participant’s includi-
 13 ble compensation,

14 may be deferred under the plan for any taxable year,

15 “(3) which may provide that, for 1 or more of the
 16 participant’s last 3 taxable years ending before he attains
 17 normal retirement age under the plan, the ceiling set
 18 forth in paragraph (2) shall be the lesser of—

19 “(A) \$15,000, or

20 “(B) the sum of—

21 “(i) the plan ceiling established for pur-
 22 poses of paragraph (2) for the taxable year,
 23 (determined without regard to this paragraph),
 24 plus

1 “(ii) so much of the plan ceiling established
2 for purposes of paragraph (2) for taxable years
3 before the taxable year as has not theretofore
4 been used under paragraph (2) or this para-
5 graph,

6 “(4) which provides that, except in the case of
7 individuals first performing service for the State and in
8 the case of new plans, compensation will be deferred for
9 any plan year only if an agreement providing for such
10 deferral has been entered into before the beginning of
11 such year,

12 “(5) which provides that amounts payable under
13 the plan will be made available to participants or
14 other beneficiaries not earlier than when the participant
15 is separated from service with the State, retires in ac-
16 cordance with a retirement plan of the State, dies, or is
17 faced by an unforeseeable emergency (determined in the
18 manner prescribed by the Secretary by regulations), and

19 “(6) which provides that—

20 “(A) all amounts of compensation deferred
21 under the plan,

22 “(B) all property and rights purchased with
23 such amounts, and

24 “(C) all income attributable to such amounts,
25 property, or rights,

1 shall remain (until made available to the participant or
 2 other beneficiary) solely the property and rights of the
 3 State, available for the State's use for whatever pur-
 4 poses it desires, but subject to the claims of the State's
 5 general creditors.

6 A plan which is administered in a manner which is incon-
 7 sistent with the requirements of any of the preceding para-
 8 graphs shall be treated as not meeting the requirements
 9 of such paragraph effective with respect to the first plan
 10 year beginning more than 180 days after the date of
 11 notification by the Secretary of the inconsistency and failure
 12 by the State (before the first day of such plan year) to
 13 remove the inconsistency.

14 **“(e) INDIVIDUALS WHO ARE PARTICIPANTS IN MORE**
 15 **THAN ONE PLAN.—**

16 **“(1) IN GENERAL.—**The maximum amount of the
 17 compensation of any one individual which may be de-
 18 ferred under subsection (a) for any taxable year shall
 19 not exceed \$7,500 (as modified by any adjustment
 20 provided under subsection (b) (3)).

21 **“(2) COORDINATION WITH SECTION 408 (b).—**In
 22 applying paragraph (1) of this subsection and para-
 23 graphs (2) and (3) of subsection (b), an amount
 24 excluded for any taxable year under section 408 (b) shall
 25 be treated as an amount deferred under subsection (a).

1 In applying clause (ii) of section 403 (b) (2) (A), any
2 amount deferred under subsection (a) for any year of
3 service shall be taken into account as if described in such
4 clause.

5 “(d) OTHER DEFINITIONS AND SPECIAL RULES.—For
6 purposes of this section—

7 “(1) STATE.—The term ‘State’ means a State,
8 a political subdivision of a State, and an agency or
9 instrumentality of a State or political subdivision of a
10 State.

11 “(2) PERFORMANCE OF SERVICE.—The perform-
12 ance of service includes performance of service as an
13 independent contractor.

14 “(3) PARTICIPANT.—The term ‘participant’ means
15 an individual who is eligible to defer compensation
16 under the plan.

17 “(4) BENEFICIARY.—The term ‘beneficiary’ means
18 a beneficiary of the participant, his estate, or any other
19 person whose interest in the plan is derived from the
20 participant.

21 “(5) INCLUDIBLE COMPENSATION.—The term
22 ‘includible compensation’ means compensation for serv-
23 ice performed for the State which (taking into account
24 the provisions of this section but not taking into account
25 section 403 (b)) is currently includible in gross income.

1 “(6) COMPENSATION TAKEN INTO ACCOUNT AT
2 PRESENT VALUE.—Compensation shall be taken into
3 account at its present value.

4 “(7) COMMUNITY PROPERTY LAWS.—The amount
5 of includible compensation shall be determined without
6 regard to any community property laws.

7 “(8) INCOME ATTRIBUTABLE.—Gains from the
8 disposition of property shall be treated as income at-
9 tributable to such property.

10 “(9) SECTION TO APPLY TO RURAL ELECTRIC
11 COOPERATIVES.—

12 “(A) IN GENERAL.—This section shall apply
13 with respect to any participant in a plan of a rural
14 electric cooperative in the same manner and to the
15 same extent as if such plan were a plan of a State.

16 “(B) RURAL ELECTRIC COOPERATIVE DE-
17 FINED.—For purposes of subparagraph (A), the
18 term ‘rural electric cooperative’ means—

19 “(i) any organization described in section
20 501 (c) (12) which is exempt from tax under
21 section 501 (a) and which is engaged primarily
22 in providing electric service, and

23 “(ii) any organization described in section
24 501 (c) (6) which is exempt from tax under

1 section 501 (a) and all the members of which
2 are organizations described in clause (i).

3 “(e) TAX TREATMENT OF PARTICIPANTS WHERE
4 PLAN OR ARRANGEMENT OF STATE IS NOT ELIGIBLE.—

5 “(1) IN GENERAL.—In the case of a plan of a
6 State providing for a deferral of compensation, if such
7 plan is not an eligible State deferred compensation plan,
8 then—

9 “(A) the compensation shall be included in
10 the gross income of the participant or beneficiary
11 for the first taxable year in which there is no
12 substantial risk of forfeiture of the rights to such
13 compensation, and

14 “(B) the tax treatment of any amount made
15 available under the plan to a participant or bene-
16 ficiary shall be determined under section 72 (relat-
17 ing to annuities, etc.).

18 “(2) EXCEPTIONS.—Paragraph (1) shall not ap-
19 ply to—

20 “(A) a plan described in section 401 (a) which
21 includes a trust exempt from tax under section
22 501 (a),

23 “(B) an annuity plan or contract described in
24 section 403,

1 “(C) a qualified bond purchase plan described
2 in section 405 (a),

3 “(D) that portion of any plan which consists of
4 a transfer of property described in section 83 (deter-
5 mined without regard to subsection (e) thereof),
6 and

7 “(E) that portion of any plan which consists of
8 a trust to which section 402 (b) applies.

9 “(3) DEFINITIONS.—For purposes of paragraph
10 (1)—

11 “(A) PLAN INCLUDES ARRANGEMENTS,
12 ETC.—The term ‘plan’ includes any agreement or
13 arrangement.

14 “(B) SUBSTANTIAL RISK OF FORFEITURE.—
15 The rights of a person to compensation are subject
16 to a substantial risk of forfeiture if such person’s
17 rights to such compensation are conditioned upon
18 the future performance of substantial services by any
19 individual.”

20 “(b) CLERICAL AMENDMENT.—The table of sections for
21 such subpart B is amended by adding at the end thereof the
22 following:

“Sec. 457. Deferred compensation plans with respect to
service for State and local governments.”

1 (c) EFFECTIVE DATE.—

2 (1) IN GENERAL.—The amendments made by this
3 section shall apply to taxable years beginning after
4 December 31, 1978.

5 (2) TRANSITIONAL RULES.—

6 (A) IN GENERAL.—In the case of any taxable
7 year beginning after December 31, 1978, and be-
8 fore January 1, 1982—

9 (i) any amount of compensation deferred
10 under a plan of a State providing for a deferral
11 of compensation (other than a plan described in
12 section 457 (e) (2) of the Internal Revenue
13 Code of 1954), and any income attributable to
14 the amounts so deferred, shall be includible in
15 gross income only for the taxable year in which
16 such compensation or other income is paid or
17 otherwise made available to the participant or
18 other beneficiary, but

19 (ii) the maximum amount of the compensa-
20 tion of any one individual which may be ex-
21 cluded from gross income by reason of clause
22 (i) and by reason of section 457 (a) of such
23 Code for any such taxable year shall not exceed
24 the lesser of—

25 (I) \$7,500, or

1 (II) 88 $\frac{1}{2}$ percent of the participant's
2 includible compensation.

3 (B) APPLICATION OF CATCH-UP PROVISIONS
4 IN CERTAIN CASES.—If, in the case of any partici-
5 pant for any taxable year, all of the plans are eligi-
6 ble State deferred compensation plans, then clause
7 (ii) of subparagraph (A) of this paragraph shall
8 be applied with the modification provided by para-
9 graph (3) of section 457 (b) of such Code.

10 (C) APPLICATION OF CERTAIN COORDINA-
11 TION PROVISIONS.—In applying clause (ii) of sub-
12 paragraph (A) of this paragraph and section 403
13 (b) (2) (A) (ii) of such Code, rules similar to the
14 rules of section 457 (c) (2) of such Code shall
15 apply.

16 (D) MEANING OF TERMS.—Except as other-
17 wise provided in this paragraph, terms used in this
18 paragraph shall have the same meaning as when
19 used in section 457 of such Code.

20 **SEC. 123. CERTAIN PRIVATE DEFERRED COMPENSATION**
21 **PLANS.**

22 (a) GENERAL RULE.—The taxable year of inclusion
23 in gross income of any amount covered by a private deferred
24 compensation plan shall be determined in accordance with

1 the principles set forth in regulations, rulings, and judicial
 2 decisions relating to deferred compensation which were in
 3 effect on February 1, 1978.

4 (b) PRIVATE DEFERRED COMPENSATION PLAN DE-
 5 FINED.—

6 (1) IN GENERAL.—For purposes of this section, the
 7 term "private deferred compensation plan" means a
 8 plan, agreement, or arrangement—

9 (A) where the person for whom the service
 10 is performed is not a State (within the meaning of
 11 paragraph (1) of section 457(d) of the Internal
 12 Revenue Code of 1954) and not an organization
 13 which is exempt from tax under section 501 of
 14 such Code, and

15 (B) under which the payment or otherwise
 16 making available of compensation is deferred.

17 (2) CERTAIN PLANS EXCLUDED.—Paragraph (1)
 18 shall not apply to—

19 (A) a plan described in section 401(a) of the
 20 Internal Revenue Code of 1954 which includes a
 21 trust exempt from tax under section 501(a) of
 22 such Code, and

23 (B) an annuity plan or contract described in
 24 section 403 of such Code.

35:

1 (O) a qualified bond purchase plan described
 2 in section 405 (a) of such Code, which is
 3 a portion of any plan which consists
 4 of a transfer of property described in section 83
 5 (d) (determined without regard to subsection (e)
 6 of such Code) of such Code; and
 7 (E) that portion of any plan which consists
 8 of a trust to which section 402 (b) of such Code
 9 applies. (c) EFFECTIVE DATE.—This section shall apply to tax-
 10 able years ending on or after February 1, 1978.
 11
 12 SEC. 126. CLARIFICATION OF DEDUCTIBILITY OF PAY-
 13 MENTS OR DEFERRED COMPENSATION, ETC.,
 14 TO INDEPENDENT CONTRACTORS.
 15 (a) IN GENERAL.—Section 404 (relating to deduction
 16 for contributions of an employer to an employee's trust or
 17 annuity plan and compensation under a deferred-payment
 18 plan) is amended by inserting after subsection (c) the
 19 following new subsection: (d) DEDUCTIBILITY OF PAYMENTS OF DEFERRED
 20 COMPENSATION, ETC., TO INDEPENDENT CONTRACTORS.—
 21 If a plan would be described in so much of subsection (a)
 22 as precedes paragraph (1) thereof (as modified by sub-
 23 section (b)), but for the fact that there is no employer-
 24 employee relationship, the contributions or compensation—

1 “(1) shall not be deductible by the payor thereof
2 under section 162 or 212, but

3 “(2) shall (if they would be deductible under
4 section 162 or 212 but for paragraph (1)) be deductible
5 under this subsection for the taxable year in which an
6 amount attributable to the contribution or compensation
7 is includible in the gross income of the persons partici-
8 pating in the plan, but, in the case of a plan in which
9 more than 1 person participates, only if separate accounts
10 are maintained for each such person.”

11 **(b) CLARIFICATION OF SECTION 404 (b).**—Subsection
12 (b) of section 404 (relating to method of contributions,
13 etc., having the effect of a plan) is amended by striking
14 out “similar plan” and inserting in lieu thereof “other plan”.

15 **(c) EFFECTIVE DATE.**—The amendments made by this
16 section shall apply to deductions for taxable years beginning
17 after December 31, 1978.

18 **SEC. 124. TAX TREATMENT OF CAFETERIA PLANS.**

19 **(a) IN GENERAL.**—Part III of subchapter B of chapter
20 1 (relating to items specifically excluded from gross income)
21 is amended by redesignating section 124 as section 125 and
22 by inserting after section 123 the following new section:

23 **“SEC. 124. CAFETERIA PLANS.**

24 **“(a) IN GENERAL.**—Except as provided in subsection
25 (b), no amount shall be included in the gross income of a

1 participant in a cafeteria plan solely by reason of the fact
 2 that, under the plan, the participant may choose among the
 3 benefits of the plan.

4 “(b) EXCEPTION FOR HIGHLY COMPENSATED PAR-
 5 TICIPANTS WHERE PLAN IS DISCRIMINATORY.—

6 “(1) IN GENERAL.—In the case of a highly com-
 7 pensated participant, subsection (a) shall not apply to
 8 any benefit attributable to a plan year for which the
 9 plan discriminates in favor of—

10 “(A) highly compensated individuals as to
 11 eligibility to participate, or

12 “(B) highly compensated participants as to
 13 contributions or benefits.

14 “(2) YEAR OF INCLUSION.—For purposes of de-
 15 termining the taxable year of inclusion, any benefit de-
 16 scribed in paragraph (1) shall be treated as received
 17 or accrued in the participant's taxable year in which
 18 the plan year ends.

19 “(c) DISCRIMINATION AS TO BENEFITS OR CON-
 20 TRIBUTIONS.—For purposes of subparagraph (B) of sub-
 21 section (b) (1), a cafeteria plan does not discriminate where
 22 nontaxable benefits and total benefits (or employer contribu-
 23 tions allocable to nontaxable benefits and employer contribu-
 24 tions for total benefits) do not discriminate in favor of highly
 25 compensated participants.

1 “(d) **CAFETERIA PLAN DEFINED.**—For purposes of
2 this section—

3 “(1) **IN GENERAL.**—The term ‘cafeteria plan’
4 means a plan under which—

5 “(A) all participants are employees; and

6 “(B) the participants may choose among 2 or
7 more benefits.

8 The benefits which may be chosen may be nontaxable
9 benefits or cash, property, or other taxable benefits.

10 “(2) **DEFERRED COMPENSATION PLANS EX-**
11 **CLUDED.**—The term ‘cafeteria plan’ does not include any
12 plan which provides for deferred compensation.

13 “(e) **HIGHLY COMPENSATED PARTICIPANT AND IN-**
14 **DIVIDUAL DEFINED.**—For purposes of this section—

15 “(1) **HIGHLY COMPENSATED PARTICIPANT.**—The
16 term ‘highly compensated participant’ means a partici-
17 pant who is—

18 “(A) an officer,

19 “(B) a shareholder,

20 “(C) highly compensated, or

21 “(D) a spouse or dependent (within the mean-
22 ing of section 152) of an individual described in
23 subparagraph (A), (B), or (C).

24 “(2) **HIGHLY COMPENSATED INDIVIDUAL.**—The
25 term ‘highly compensated individual’ means an individ-

1 person who is described in subparagraph (A), (B), (C),
 2 and (D) of paragraph (1).

3 **“(f) NONTAXABLE BENEFIT DEFINED.**—For pur-
 4 poses of this section, the term ‘nontaxable benefit’ means any
 5 benefit which, with the application of subsection (a), is not
 6 includible in the gross income of the employee.

7 **“(g) SPECIAL RULES.**—

8 **“(1) COLLECTIVELY BARGAINED PLAN NOT CON-**

9 **“(A) DISCRIMINATORY.**—For purposes of this sec-

10 tion, a plan shall not be treated as discriminatory if the

11 plan is maintained under an agreement which the Secre-

12 tary finds to be a collective bargaining agreement be-

13 tween employee representatives and one or more

14 employers.

15 **“(2) HEALTH BENEFITS.**—For purposes of sub-

16 paragraph (B) of subsection (b) (1), a cafeteria plan

17 which provides health benefits shall not be treated as

18 discriminatory if—

19 **“(A) contributions on behalf of each partici-**

20 **“(i) participant include an amount which—**

21 **“(i) equals 100 percent of the cost of the**

22 **“(i) health benefit coverage under the plan of the**

23 **“(i) majority of the highly compensated participants**

24 **“(i) similarly situated, or**

25 **“(ii) equals or exceeds 75 percent of the**

1 cost of the health benefit coverage of the partici-
2 pant (similarly situated) having the highest
3 health benefit coverage under the plan, and

4 “(B) contributions or benefits in excess of
5 those described in subparagraph (A) bear a uniform
6 relationship to compensation.

7 “(3) CERTAIN PARTICIPATION ELIGIBILITY
8 RULES NOT TREATED AS DISCRIMINATORY.—For pur-
9 poses of subparagraph (A) of subsection (b) (1), a
10 classification shall not be treated as discriminatory if the
11 plan—

12 “(A) benefits a group of employees described
13 in subparagraph (B) of section 410(b) (1), and

14 “(B) meets the requirements of clauses (i) and
15 (ii) :

16 “(i) No employee is required to complete
17 more than 3 years of employment with the em-
18 ployer or employers maintaining the plan as a
19 condition of participation in the plan, and the
20 service requirement for each employee is the
21 same.

22 “(ii) Any employee who has satisfied the
23 employment requirement of clause (i) and who
24 is otherwise entitled to participate in the plan
25 commences participation no later than the first

1 day of the first plan year beginning after the
 2 date the service requirement was satisfied unless
 3 the employee was separated from service be-
 4 fore the first day of that plan year.

5 “(4) CERTAIN CONTROLLED GROUPS.—All em-
 6 ployees who are treated as employed by a single
 7 employer under subsection (b) or (c) of section 414
 8 shall be treated as employed by a single employer for
 9 purposes of this section.

10 “(h) REGULATIONS.—The Secretary shall prescribe
 11 such regulations as may be necessary to carry out the provi-
 12 sions of this section.”

13 (b) CLERICAL AMENDMENT.—The table of sections for
 14 part III of subchapter B of chapter 1 is amended by strik-
 15 ing out the item relating to section 124 and inserting in lieu
 16 thereof the following:

“Sec. 124. Cafeteria plans.

“Sec. 125. Cross references to other Acts.”

17 (c) EFFECTIVE DATE.—The amendments made by this
 18 section shall apply to taxable years beginning after Decem-
 19 ber 31, 1978.

20 **SEC. 125. ADMINISTRATION OF 1954 CODE IN THE CASE**
 21 **OF CERTAIN CASH OR DEFERRED ARRANGE-**
 22 **MENTS.**

23 (a) GENERAL RULE.—In the case of any qualified
 24 cash or deferred arrangement under a profit-sharing plan,

1 the Internal Revenue Code of 1954 shall be administered
2 in a manner consistent with—

3 (1) Revenue Ruling 56-497 (1956-2 C.B. 284),

4 (2) Revenue Ruling 63-180 (1963-2 C.B. 189),

5 and

6 (3) Revenue Ruling 68-89 (1968-1 C.B. 402).

7 (b) **QUALIFIED CASH OR DEFERRED ARRANGEMENT**
8 **DEFINED.**—For purposes of this section—

9 (1) **IN GENERAL.**—The term “qualified cash or de-
10 ferred arrangement” means any arrangement under
11 which a contribution is made by an employer to a trust
12 on behalf of an employee only if the employee elects not
13 to receive such contribution from the employer in cash.

14 (2) **EXCEPTION.**—The term “qualified cash or de-
15 ferred arrangement” does not include an arrangement un-
16 der which the contribution by the employer to the trust is
17 made in return for a reduction in the basic or regular
18 compensation of the employee or in lieu of an increase
19 in such compensation.

20 (c) **PROFIT-SHARING PLAN DEFINED.**—For purposes
21 of this section, the term “profit-sharing plan” includes a stock
22 bonus plan.

23 (d) **EFFECTIVE DATE.**—This section shall apply to
24 taxable years beginning after December 31, 1977.

1 **TITLE II—TAX SHELTER PROVI-**
2 **SIONS**

3 **Subtitle A—Provisions Related To At**
4 **Risk Rules**

5 **SEC. 201. EXTENSION OF SECTION 465 AT RISK RULES TO**
6 **ALL ACTIVITIES OTHER THAN REAL ESTATE.**

7 (a) **EXTENSION.**—Subsection (c) of section 465 (re-
8 lating to activities to which section applies) is amended by
9 adding at the end thereof the following new paragraph:

10 “(3) **EXTENSION TO OTHER ACTIVITIES.**—

11 “(A) **IN GENERAL.**—In the case of taxable
12 years beginning after December 31, 1978, this sec-
13 tion also applies to each activity—

14 “(i) engaged in by the taxpayer in carry-
15 ing on a trade or business or for the production
16 of income, and

17 “(ii) which is not described in paragraph
18 (1).

19 “(B) **AGGREGATION OF ACTIVITIES WHERE**
20 **TAXPAYER ACTIVELY PARTICIPATES IN MANAGE-**
21 **MENT OF TRADE OR BUSINESS.**—Except as provided
22 in subparagraph (C), for purposes of this section,
23 activities described in subparagraph (A) which
24 constitute a trade or business shall be treated as 1
25 activity if—

1 “(i) the taxpayer actively participates in
2 the management of such trade or business, or

3 “(ii) such trade or business is carried on
4 by a partnership or electing small business cor-
5 poration (as defined in section 1371(b)) and
6 65 percent or more of the losses for the taxable
7 year is allocable to persons who actively par-
8 ticipate in the management of the trade or
9 business.

10 “(C) AGGREGATION OR SEPARATION OF AC-
11 TIVITIES UNDER REGULATIONS.—The Secretary
12 shall prescribe regulations under which activities
13 described in subparagraph (A) shall be aggregated
14 or treated as separate activities.

15 “(D) EXCLUSION FOR REAL PROPERTY.—In
16 the case of activities described in subparagraph (A),
17 the holding of real property (other than mineral
18 property) shall be treated as a separate activity, and
19 subsection (a) shall not apply to losses from such
20 activity. For purposes of the preceding sentence,
21 personal property and services which are incidental
22 to making real property available as living accommo-
23 dations shall be treated as part of the activity of
24 holding such real property.

1 “(E) APPLICATION OF SUBSECTION (b)
2 (8).—In the case of an activity described in sub-
3 paragraph (A), subsection (b) (3) shall apply
4 only to the extent provided in regulations prescribed
5 by the Secretary.”

6 (b) REPEAL OF SECTION 704 (d) AT RISK RULES.—

7 (1) IN GENERAL.—Subsection (d) of section 704
8 is amended by striking out the last 2 sentences.

9 (2) TRANSITIONAL RULE.—In the case of a loss
10 which was not allowed for any taxable year by reason of
11 the last 2 sentences of section 704 (d) of the Internal
12 Revenue Code of 1954 (as in effect before the date of
13 the enactment of this Act), such loss shall be treated as
14 a deduction (subject to section 465 (a) of such Code)
15 for the first taxable year beginning after December 31,
16 1978.

17 (c) CLERICAL AMENDMENTS.—

18 (1) The heading of section 465 is amended to read
19 as follows:

20 “SEC. 465. DEDUCTIONS LIMITED TO AMOUNT AT RISK.”

21 (2) The table of sections for subpart C of part II of
22 subchapter E of chapter 1 is amended by striking out
23 “in case of certain activities” in the item relating to
24 section 465.

1 SEC. 202. EXTENSION OF AT RISK PROVISIONS TO
2 CLOSELY HELD CORPORATIONS.

3 Subsection (a) of section 465 (relating to deductions
4 limited to amount at risk) is amended to read as follows:

5 “(a) LIMITATION TO AMOUNT AT RISK.—

6 “(1) IN GENERAL.—In the case of—

7 “(A) an individual,

8 “(B) an electing small business corporation
9 (as defined in section 1371 (b)), and

10 “(C) a corporation with respect to which the
11 stock ownership requirement of paragraph (2) of
12 section 542 (a) is met,

13 engaged in an activity to which this section applies, any
14 loss from such activity for the taxable year shall be
15 allowed only to the extent of the aggregate amount with
16 respect to which the taxpayer is at risk (within the
17 meaning of subsection (b)) for such activity at the
18 close of the taxable year.

19 “(2) DEDUCTION IN SUCCEEDING YEAR.—Any
20 loss from an activity to which this section applies not
21 allowed under this section for the taxable year shall
22 be treated as a deduction allocable to such activity in the
23 first succeeding taxable year.”

1 **SEC. 203. RECAPTURE OF LOSSES WHERE AMOUNT AT**
 2 **RISK IS LESS THAN ZERO.**

3 Section 465 (relating to deductions limited to amount at
 4 risk) is amended by adding at the end thereof the following
 5 new subsection:

6 **“(e) RECAPTURE OF LOSSES WHERE AMOUNT AT**
 7 **RISK IS LESS THAN ZERO.—**

8 **“(1) IN GENERAL.—**If zero exceeds the amount
 9 which the taxpayer is at risk in any activity at the
 10 close of any taxable year—

11 **“(A)** the taxpayer shall include in his gross
 12 income for such taxable year (as income from such
 13 activity) an amount equal to such excess, and

14 **“(B)** an amount equal to the amount so in-
 15 cluded in gross income shall be treated as a deduc-
 16 tion allocable to such activity for the first succeed-
 17 ing taxable year.

18 **“(2) LIMITATION.—**The excess referred to in para-
 19 graph (1) shall not exceed—

20 **“(A)** the aggregate amount of the reductions
 21 required by subsection (b) (5) with respect to the
 22 activity for all prior taxable years, reduced by

23 **“(B)** the amounts previously included in gross

1 income with respect to such activity under this sub-
2 section."

3 **SEC. 204. EFFECTIVE DATES.**

4 (a) **IN GENERAL.**—The amendments made by this sub-
5 title shall apply to taxable years beginning after Decem-
6 ber 31, 1978.

7 (b) **TRANSITIONAL RULE FOR RECAPTURE PROVI-**
8 **SIONS.**—If the amount which the taxpayer is at risk in any
9 activity as of the close of the taxpayer's last taxable year
10 beginning before January 1, 1979, is less than zero, section
11 465(e) (1) of the Internal Revenue Code of 1954 (as
12 added by section 203 of this Act) shall be applied with
13 respect to such activity of the taxpayer by substituting such
14 negative amount for zero.

15 **Subtitle B—Partnership Provisions**

16 **SEC. 211. PENALTY FOR FAILURE TO FILE PARTNERSHIP**
17 **RETURN.**

18 (a) **GENERAL RULE.**—Subchapter B of chapter 68
19 (relating to assessable penalties) is amended by adding at
20 the end thereof the following new section:

21 **"SEC. 6093. FAILURE TO FILE PARTNERSHIP RETURN.**

22 " (a) **GENERAL RULE.**—In addition to the penalty im-
23 posed by section 7203 (relating to willful failure to file
24 return, supply information, or pay tax), if any partnership

1 required to file a return under section 6031 for any taxable
2 year—

3 “(1) fails to file such return at the time prescribed
4 therefor (determined with regard to any extension of
5 time for filing), or

6 “(2) files a return which fails to show the in-
7 formation required under section 6031,
8 such partnership shall be liable for a penalty determined
9 under subsection (b) for each month (or fraction thereof)
10 during which such failure continues (but not to exceed 5
11 months), unless it is shown that such failure is due to rea-
12 sonable cause.

13 “(b) AMOUNT PER MONTH.—For purposes of subsec-
14 tion (a), the amount determined under this subsection for
15 any month is the product of—

16 “(1) \$50, multiplied by

17 “(2) the number of persons who were partners in
18 the partnership during any part of the taxable year.

19 “(c) ASSESSMENT OF PENALTY.—The penalty imposed
20 by subsection (a) shall be assessed against the partnership.

21 “(d) DEFICIENCY PROCEDURES NOT TO APPLY.—
22 Subchapter B of chapter 63 (relating to deficiency proce-
23 dures for income, estate, gift, and certain excise taxes)
24 shall not apply in respect of the assessment or collection of
25 any penalty imposed by subsection (a).”

1 (b) **CLERICAL AMENDMENT.**—The table of sections for
2 subchapter B of chapter 68 is amended by adding at the
3 end thereof the following new item:

 “Sec. 6698. Failure to file partnership return.”

4 (c) **EFFECTIVE DATE.**—The amendments made by this
5 section shall apply with respect to returns for taxable years
6 beginning after December 31, 1978.

7 **SEC. 212. EXTENSION OF STATUTE OF LIMITATIONS IN**
8 **THE CASE OF PARTNERSHIP ITEMS.**

9 (a) **ASSESSMENT OF DEFICIENCIES.**—Section 6501
10 (relating to limitations on assessment and collection) is
11 amended by adding at the end thereof the following new
12 subsection:

13 “(q) **SPECIAL RULES FOR PARTNERSHIP ITEMS OF**
14 **FEDERALLY REGISTERED PARTNERSHIPS.**—

15 “(1) **IN GENERAL.**—In the case of any tax imposed
16 by subtitle A with respect to any person, the period for
17 assessing a deficiency attributable to any partnership
18 item of a federally registered partnership shall not expire
19 before the later of—

20 “(A) the date which is 4 years after the date
21 on which the partnership return for the partnership
22 taxable year in which the item arose was filed (or, if
23 later, the date prescribed for filing the return), or

24 “(B) if the name or address of such person

1 does not appear on the partnership return, the date
2 which is 1 year after the date on which such in-
3 formation is furnished to the Secretary in such man-
4 ner and at such place as he may prescribe by regu-
5 lations.

6 “(2) PARTNERSHIP ITEM DEFINED.—For purposes
7 of this subsection, the term ‘partnership item’ means—

8 “(A) any item required to be taken into ac-
9 count for the partnership taxable year under any
10 provision of subchapter K of chapter 1 to the extent
11 that regulations prescribed by the Secretary provide
12 that for purposes of this subtitle such item is more
13 appropriately determined at the partnership level
14 than at the partner level, and

15 “(B) any other item to the extent affected by
16 an item described in subparagraph (A).

17 “(3) EXTENSION BY AGREEMENT.—The exten-
18 sions referred to in subsection (c) (4), insofar as they
19 relate to partnership items, may, with respect to any
20 person, be consented to—

21 “(A) except to the extent the Secretary is
22 otherwise notified by the partnership, by a general
23 partner of the partnership, or

24 “(B) by any person authorized to do so by the
25 partnership in writing.

1 “(4) **FEDERALLY REGISTERED PARTNERSHIP.—**

2 For purposes of this subsection, the term ‘federally reg-
3 istered partnership’ means, with respect to any partner-
4 ship taxable year, any partnership—

5 “(A) interests in which have been offered for
6 sale at any time during such taxable year or a
7 prior taxable year in any offering required to be
8 registered with the Securities and Exchange Com-
9 mission, or

10 “(B) which, at any time during such taxable
11 year or a prior taxable year, was subject to the
12 annual reporting requirements of the Securities and
13 Exchange Commission.”

14 (b) **CREDITS AND REFUNDS.—**

15 (1) **IN GENERAL.—**Section 6511 (relating to lim-
16 itations on credit or refund) is amended by redesignating
17 subsection (g) as subsection (h) and by inserting after
18 subsection (f) the following new subsection:

19 “(g) **SPECIAL RULE FOR PARTNERSHIP ITEMS OF**
20 **FEDERALLY REGISTERED PARTNERSHIPS.—**

21 “(1) **IN GENERAL.—**In the case of any tax im-
22 posed by subtitle A with respect to any person, the
23 period for filing a claim for credit or refund of any over-
24 payment attributable to any partnership item of a feder-

1 ally registered partnership shall not expire before the
2 later of—

3 “(A) the date which is 4 years after the date
4 prescribed by law (including extensions thereof) for
5 filing the partnership return for the partnership tax-
6 able year in which the item arose, or

7 “(B) if an agreement under the provisions of
8 section 6501 (c) (4) extending the period for the
9 assessment of any deficiency attributable to such
10 partnership item is made before the date specified in
11 subparagraph (A), the date 6 months after the
12 expiration of such extension.

13 In any case to which the preceding sentence applies,
14 the amount of the credit or refund may exceed the por-
15 tion of the tax paid within the period provided in sub-
16 section (b) (2) or (c), whichever is applicable.

17 “(2) DEFINITIONS.—For purposes of this subsec-
18 tion, the terms ‘partnership item’ and ‘federally regis-
19 tered partnership’ have the same meanings as such terms
20 have when used in section 6501 (q).”

21 (2) TECHNICAL AMENDMENT.—Paragraph (2) of
22 section 6512 (b) (relating to overpayment determined
23 by Tax Court) is amended by striking out “(c), or
24 (d)” each place it appears and inserting in lieu thereof
25 “(c), (d), or (g)”.

1 (c) **EFFECTIVE DATE.**—The amendments made by this
 2 section shall apply to partnership items arising in partner-
 3 ship taxable years beginning after December 31, 1978.

4 **TITLE III—PROVISIONS PRIMARILY**
 5 **AFFECTING BUSINESS INCOME**
 6 **TAX**

7 **Subtitle A—Corporate Rate Reductions**

8 **SEC. 301. CORPORATE RATE REDUCTIONS.**

9 (a) **IN GENERAL.**—Section 11 (relating to the tax
 10 imposed on corporations) is amended to read as follows:

11 **“SEC. 11. TAX IMPOSED.**

12 **“(a) CORPORATIONS IN GENERAL.**—A tax is hereby
 13 imposed for each taxable year on the taxable income of every
 14 corporation.

15 **“(b) AMOUNT OF TAX.**—The amount of the tax im-
 16 posed by subsection (a) shall be the sum of—

17 **“(1) 17 percent of so much of the taxable income**
 18 **as does not exceed \$25,000;**

19 **“(2) 20 percent of so much of the taxable income**
 20 **as exceeds \$25,000 but does not exceed \$50,000;**

21 **“(3) 30 percent of so much of the taxable income**
 22 **as exceeds \$50,000 but does not exceed \$75,000;**

23 **“(4) 40 percent of so much of the taxable income**
 24 **as exceeds \$75,000 but does not exceed \$100,000; plus**

25 **“(5) 46 percent of so much of the taxable income**
 26 **as exceeds \$100,000.**

1 “(c) EXCEPTIONS.—Subsection (a) shall not apply to
2 a corporation subject to a tax imposed by—

3 “(1) section 594 (relating to mutual savings banks
4 conducting life insurance business),

5 “(2) subchapter L (sec. 801 and following, relating
6 to insurance companies), or

7 “(3) subchapter M (sec. 851 and following, relat-
8 ing to regulated investment companies and real estate
9 investment trusts).

10 “(d) FOREIGN CORPORATIONS.—In the case of a
11 foreign corporation, the tax imposed by subsection (a) shall
12 apply only as provided by section 882.”

13 (b) CONFORMING AMENDMENTS.—

14 (1) CROSS REFERENCES RELATING TO CORPORA-
15 TIONS.—Paragraph (7) of section 12 (relating to cross
16 references relating to tax on corporations) is amended
17 to read as follows:

 “(7) For limitation on benefits of graduated rate
 schedule provided in section 11(b), see section 1551.”

18 (2) DIVIDENDS RECEIVED ON CERTAIN PREFERRED
19 STOCK.—Subparagraph (B) of section 244 (a) (2) (re-
20 lating to dividends received on certain preferred stock)
21 is amended by striking out “the sum of the normal tax
22 rate and the surtax rate for the taxable year prescribed
23 by section 11” and inserting in lieu thereof “the high-
24 est rate of tax specified in section 11 (b)”.

1 (3) DIVIDENDS PAID ON CERTAIN PREFERRED
 2 STOCK OF PUBLIC UTILITIES.—Subparagraph (B) of
 3 section 247 (a) (2) (relating to dividends paid on cer-
 4 tain preferred stock of public utilities) is amended by
 5 striking out “the sum of the normal tax rate and the
 6 surtax rate for the taxable year specified in section 11”
 7 and inserting in lieu thereof “the highest rate of tax
 8 specified in section 11 (b)”.

9 (4) TAX ON UNRELATED BUSINESS INCOME OF
 10 CHARITABLE, ETC., ORGANIZATIONS.—

11 (A) IMPOSITION OF TAX.—Paragraph (1) of
 12 section 511 (a) (relating to charitable, etc., organi-
 13 zations taxable at corporation rates) is amended by
 14 striking out “a normal tax and a surtax” and insert-
 15 ing in lieu thereof “a tax”.

16 (B) ORGANIZATIONS SUBJECT TO TAX.—
 17 Paragraph (2) of section 511 (a) is amended by
 18 striking out “taxes” each place it appears and in-
 19 serting in lieu thereof “tax”.

20 (5) POLITICAL ORGANIZATIONS.—Paragraph (1)
 21 of section 527 (b) (relating to tax imposed) is amended
 22 to read as follows:

23 “(1) IN GENERAL.—A tax is hereby imposed for
 24 each taxable year on the political organization taxable
 25 income of every political organization. Such tax shall be

1 computed by multiplying the political organization tax-
2 able income by the highest rate of tax specified in sec-
3 tion 11 (b)."

4 (6) **HOMESOWNERS ASSOCIATIONS.**—Paragraph (1)
5 of section 528 (b) (relating to tax imposed) is amended
6 to read as follows:

7 " (1) **IN GENERAL.**—A tax is hereby imposed for
8 each taxable year on the homeowners association tax-
9 able income of every homeowners association. Such tax
10 shall be computed by multiplying the homeowners as-
11 sociation taxable income by the highest rate of tax
12 specified in section 11 (b)."

13 (7) **LIFE INSURANCE COMPANIES.**—Paragraph
14 (1) of section 802 (a) (relating to tax imposed) is
15 amended by striking out "a normal tax and surtax" and
16 inserting in lieu thereof "a tax".

17 (8) **MUTUAL INSURANCE COMPANIES.**—

18 (A) **IN GENERAL.**—Subsection (a) of section
19 821 (relating to tax on mutual insurance companies
20 to which part II applies) is amended to read as
21 follows:

22 "(a) **IMPOSITION OF TAX.**—

23 " (1) **IN GENERAL.**—A tax is hereby imposed for
24 each taxable year on the mutual insurance company
25 taxable income of every mutual insurance company

1 (other than a life insurance company and other than a
2 fire, flood, or marine insurance company subject to the
3 tax imposed by section 891). Such tax shall be com-
4 puted by multiplying the mutual insurance company
5 taxable income by the rates provided in section 11 (b).

6 “(2) CAP ON TAX WHERE INCOME IS LESS THAN
7 \$12,000.—The tax imposed by paragraph (1) shall not
8 exceed 34 percent of the amount by which the mutual
9 insurance company taxable income exceeds \$6,000.”

10 (B) SMALL COMPANIES.—Paragraph (1) of
11 section 821 (c) (relating to alternative tax for
12 certain small companies) is amended to read as
13 follows:

14 “(1) IMPOSITION OF TAX.—

15 “(A) IN GENERAL.—There is hereby imposed
16 for each taxable year on the income of every mutual
17 insurance company to which this subsection applies
18 a tax (which shall be in lieu of the tax imposed by
19 subsection (a)). Such tax shall be computed by
20 multiplying the taxable investment income by the
21 rates provided in section 11 (b).

22 “(B) CAP WHERE INCOME IS LESS THAN
23 \$6,000.—The tax imposed by subparagraph (A)
24 shall not exceed 34 percent of the amount by which
25 the taxable investment income exceeds \$3,000.”

1 (9) **ELECTION BY MUTUAL INSURANCE COM-**
 2 **PANY WHICH IS A RECIPROCAL.**—Paragraph (1) of
 3 section 826 (c) (relating to exception) is amended to
 4 read as follows:

5 “(1) is subject to the tax imposed by section 11;”.

6 (10) **REGULATED INVESTMENT COMPANIES.**—
 7 Paragraph (1) of section 852 (b) (relating to method
 8 of taxation of companies and shareholders) is amended
 9 to read as follows:

10 “(1) **IMPOSITION OF TAX ON REGULATED INVEST-**
 11 **MENT COMPANIES.**—There is hereby imposed for each
 12 taxable year upon the investment company taxable in-
 13 come of every regulated investment company a tax com-
 14 puted as provided in section 11, as though the investment
 15 company taxable income were the taxable income
 16 referred to in section 11.”

17 (11) **REAL ESTATE INVESTMENT TRUSTS.**—Para-
 18 graph (1) of section 857 (b) (relating to imposition of
 19 normal tax and surtax on real estate investment trusts)
 20 is amended to read as follows:

21 “(1) **IMPOSITION OF TAX ON REAL ESTATE IN-**
 22 **VESTMENT TRUSTS.**—There is hereby imposed for each
 23 taxable year on the real estate investment trust taxable
 24 income of every real estate investment trust a tax com-
 25 puted as provided in section 11, as though the real

1 estate investment trust taxable income were the taxable
2 income referred to in section 11."

3 (12) TAX ON INCOME OF FOREIGN CORPORATIONS
4 CONNECTED WITH UNITED STATES BUSINESS.—The
5 heading of subsection (a) of section 882 (relating to
6 tax on income of foreign corporations connected with
7 United States business) and the heading of paragraph
8 (1) of such subsection are amended to read as follows:

9 "(a) IMPOSITION OF TAX.—

10 "(1) IN GENERAL.—"

11 (13) FOREIGN TAX CREDIT.—Paragraph (2) of
12 section 907 (a) (relating to reduction in amount al-
13 lowed as foreign tax under section 901) is amended to
14 read as follows:

15 "(2) the percentage which is equal to the highest
16 rate of tax specified in section 11 (b)."

17 (14) SPECIAL DEDUCTION FOR WESTERN HEMI-
18 SPHERE TRADE CORPORATION.—Subparagraph (B) of
19 section 922 (a) (2) (relating to general rule) is
20 amended by striking out "the sum of the normal tax
21 rate and the surtax rate for the taxable year prescribed
22 by section 11" and inserting in lieu thereof "the highest
23 rate of tax specified in section 11 (b)."

24 (15) ELECTION BY INDIVIDUALS TO BE SUB-
25 JECT TO TAX AT CORPORATE RATES.—Subsection (c)

1 of section 962 (relating to surtax exemption with respect
2 to individuals subject to tax at corporate rates) is
3 amended to read as follows:

4 “(c) PRO RATION OF EACH SECTION 11 BRACKET
5 AMOUNT.—For purposes of applying subsection (a) (1),
6 the amount in each taxable income bracket in the tax table
7 in section 11 (b) shall not exceed an amount which bears
8 the same ratio to such bracket amount as the amount in-
9 cluded in the gross income of the United States shareholder
10 under section 951 (a) for the taxable year bears to such
11 shareholder’s pro rata share of the earnings and profits for
12 the taxable year of all controlled foreign corporations with
13 respect to which such shareholder includes any amount in
14 gross income under section 951 (a).”

15 (16) TREATMENT OF RECOVERIES OF FOREIGN EX-
16 PROPRIATION LOSSES.—Paragraph (4) of section 1351
17 (d) (relating to adjustment for prior tax benefits) is
18 amended to read as follows:

19 “(4) SUBSTITUTION OF CURRENT TAX RATE.—
20 For purposes of this subsection, the rates of tax specified
21 in section 11 (b) for the taxable year of the recovery
22 shall be treated as having been in effect for all prior tax-
23 able years.”

24 (17) AMENDMENTS OF SECTION 1551.—

25 (A) Subsection (a) of section 1551 (relating

1 to disallowance of surtax exemption and accumu-
2 lated earnings credit) is amended—

3 (i) by striking out “disallow the surtax
4 exemption (as defined in section 11 (d))” and
5 inserting in lieu thereof “disallow the benefits
6 of the rates contained in section 11 (b) which
7 are lower than the highest rate specified in such
8 section”, and

9 (ii) by striking out “such exemption or”
10 and inserting in lieu thereof “such benefits or”.

11 (B) The section heading of section 1551 is
12 amended to read as follows:

13 **“SEC. 1551. DISALLOWANCE OF THE BENEFITS OF THE**
14 **GRADUATED CORPORATE RATES AND AC-**
15 **CUMULATED EARNINGS CREDIT.”**

16 (C) The table of sections for part I of sub-
17 chapter B of chapter 6 is amended by striking out
18 the item relating to section 1551 and inserting in
19 lieu thereof the following new item:

“Sec. 1551. Disallowance of the benefits of the graduated
corporate rates and accumulated earnings
credit.”

20 (18) **LIMITATIONS ON CERTAIN MULTIPLE TAX**
21 **BENEFITS IN THE CASE OF CERTAIN CONTROLLED**
22 **CORPORATIONS.—**

23 (A) **IN GENERAL.—**Subsection (a) of section

1 1561 (relating to limitations on certain multiple
2 tax benefits in the case of certain controlled corpo-
3 rations) is amended—

4 (i) by striking out paragraph (1) and in-
5 serting in lieu thereof the following:

6 “(1) amounts in each taxable income bracket in
7 the tax table in section 11 (b) which do not aggregate
8 more than the maximum amount in such bracket to
9 which a corporation which is not a component member
10 of a controlled group is entitled,”

11 (ii) by striking out “amount” each place
12 it appears in the second sentence and inserting
13 in lieu thereof “amounts”, and

14 (iii) by striking out the last sentence.

15 (B) CERTAIN SHORT TAXABLE YEARS.—Para-
16 graph (1) of section 1561 (b) (relating to certain
17 short taxable years) is amended to read as follows:

18 “(1) the amount in each taxable income bracket in
19 the tax table in section 11 (b),”.

20 (19) REPEAL OF CERTAIN OBSOLETE PROVI-
21 SIONS.—

22 (A) Subsection (c) of section 6154 (defining
23 estimated tax) is amended to read as follows:

24 “(c) ESTIMATED TAX DEFINED.—For purposes of this

1 title, in the case of a corporation the term 'estimated tax'
2 means the excess of—

3 “(1) the amount which the corporation estimates
4 as the amount of the income tax imposed by section 11
5 or 1201 (a), or subchapter L of chapter 1, whichever
6 is applicable, over

7 “(2) the amount which the corporation estimates as
8 the sum of the credits against tax provided by part IV
9 of subchapter A of chapter 1.”

10 (B) Subsection (e) of section 6655 (defining
11 tax) is amended to read as follows:

12 “(e) DEFINITION OF TAX.—For purposes of subsec-
13 tion: (b) and (d), the term 'tax' means the excess of—

14 “(1) the tax imposed by section 11 or 1201 (a), or
15 subchapter L of chapter 1, whichever is applicable, over

16 “(2) the credits against tax provided by part IV
17 of subchapter A of chapter 1.”

18 (c) EFFECTIVE DATE.—The amendments made by this
19 section shall apply to taxable years beginning after Decem-
20 ber 31, 1978.

21 Subtitle B—Credits

22 SEC. 311. 10-PERCENT INVESTMENT TAX CREDIT AND
23 \$100,000 LIMITATION ON USED PROPERTY
24 MADE PERMANENT.

25 (a) 10-PERCENT INVESTMENT TAX CREDIT.—Para-

1 graph (2) of section 46 (a) (relating to amount of credit
2 for current taxable year) is amended—

3 (1) by striking out “, and before January 1, 1981”
4 in clauses (i) and (iii) of subparagraph (D),

5 (2) by striking out “, and before January 1, 1981,
6 and placed in service by the taxpayer before January 1,
7 1981” in clause (ii) of subparagraph (D), and

8 (3) by adding at the end thereof the following new
9 subparagraph:

10 “(E) SPECIAL RULE FOR SUBPARAGRAPH
11 (B).—For purposes of applying subparagraph (B),
12 subparagraph (D) shall be applied—

13 “(i) by inserting ‘and before January 1,
14 1981,’ after ‘1975,’ the second place it appears
15 in clause (i) and where it appears in clause
16 (iii), and

17 “(ii) by inserting ‘and before January 1,
18 1981, and placed in service by the taxpayer
19 before January 1, 1981,’ after ‘1975,’ in clause
20 (ii).”

21 (b) \$100,000 LIMITATION ON USED PROPERTY.—
22 Paragraph (2) of section 301 (c) of the Tax Reduction Act
23 of 1975 (relating to effective date for increase of dollar
24 limitation on used property) is amended by striking out “,
25 and before January 1, 1981”.

1 **SEC. 312. INCREASE IN LIMITATION ON INVESTMENT**
 2 **CREDIT TO 90 PERCENT OF TAX LIABILITY.**

3 **(a) INCREASE IN GENERAL LIMITATION.—**Paragraph
 4 **(3)** of section 46 **(a)** (relating to amount of credit) is
 5 amended to read as follows:

6 **“(3) LIMITATION BASED ON AMOUNT OF TAX.—**
 7 Notwithstanding paragraph **(1)**, the credit allowed by
 8 section 38 for the taxable year shall not exceed—

9 **“(A)** so much of the liability for tax for the
 10 taxable year as does not exceed \$25,000, plus

11 **“(B)** the following percentage of so much
 12 of the liability for tax for the taxable year as
 13 exceeds \$25,000:

*If the taxable year ends in:	The percentage is:
1979	60
1980	70
1981	80
1982 or thereafter.....	90.”

14 **(b) SPECIAL RULES FOR CERTAIN UTILITIES, RAIL-**
 15 **ROADS, AND AIRLINES.—**

16 **(1) UTILITIES.—**Paragraph **(7)** of section 46 **(a)**
 17 (relating to alternative limitation in the case of cer-
 18 tain utilities) is amended to read as follows:

19 **“(7) ALTERNATIVE LIMITATION IN THE CASE**
 20 **OF CERTAIN UTILITIES.—**

21 **“(A) IN GENERAL.—**If, for the taxable year
 22 ending in 1979—

1 “(i) the amount of the qualified invest-
2 ment of the taxpayer which is attributable to
3 public utility property is 25 percent or more
4 of his aggregate qualified investment, and

5 “(ii) the application of this paragraph re-
6 sults in a percentage higher than 60 percent,
7 then subparagraph (B) of paragraph (3) of this
8 subsection shall be applied by substituting for ‘60
9 percent’ the taxpayer’s applicable percentage for
10 such year.

11 “(B) APPLICABLE PERCENTAGE.—The appli-
12 cable percentage for any taxpayer for any taxable
13 year ending in 1979 is—

14 “(i) 50 percent, plus

15 “(ii) that portion of 20 percent which the
16 taxpayer’s amount of qualified investment
17 which is public utility property bears to his ag-
18 gregate qualified investment.

19 If the proportion referred to in clause (ii) is 75
20 percent or more, the applicable percentage of the
21 taxpayer for the year shall be 70 percent.

22 “(C) PUBLIC UTILITY PROPERTY DEFINED.—
23 For purposes of this paragraph, the term ‘public
24 utility property’ has the meaning given to such term
25 by the first sentence of subsection (c) (3) (B).”

1 (2) ALTERNATIVE LIMITATION IN THE CASE OF
2 CERTAIN RAILROADS AND AIRLINES.—Subsection (a)
3 of section 46 is amended by striking out paragraphs (8)
4 and (9) and by inserting in lieu thereof the following
5 new paragraph:

6 “(8) ALTERNATIVE LIMITATION IN THE CASE OF
7 CERTAIN RAILROADS AND AIRLINES.—

8 “(A) IN GENERAL.—If, for a taxable year
9 ending in 1979 or 1980—

10 “(i) the amount of the qualified investment
11 of the taxpayer which is attributable to railroad
12 property or to airline property, as the case may
13 be, is 25 percent or more of his aggregate quali-
14 fied investment, and

15 “(ii) the application of this paragraph re-
16 sults in a percentage higher than 60 percent
17 (70 percent in the case of a taxable year end-
18 ing in 1980),

19 then subparagraph (B) of paragraph (3) of this
20 subsection shall be applied by substituting for ‘60
21 percent’ (‘70 percent’ in the case of a taxable year
22 ending in 1980) the taxpayer’s applicable percent-
23 age for such year.

24 “(B) APPLICABLE PERCENTAGE.—The appli-

1 cable percentage of any taxpayer for any taxable
2 year under this paragraph is—

3 “(i) 50 percent, plus
4 “(ii) that portion of the tentative per-
5 centage for the taxable year which the taxpay-
6 er’s amount of qualified investment which is
7 railroad property or airline property (as the
8 case may be) bears to his aggregate qualified
9 investment.

10 If the proportion referred to in clause (ii) is 75
11 percent or more, the applicable percentage of the
12 taxpayer for the taxable year shall be 90 percent
13 (80 percent in the case of a taxable year ending
14 in 1980).

15 “(C) TENTATIVE PERCENTAGE.—For pur-
16 poses of subparagraph (B), the tentative percent-
17 age shall be determined under the following table:

“If the taxable year ends in:	The tentative percentage is:
1979 -----	40
1980 -----	30

18 “(D) RAILROAD PROPERTY DEFINED.—For
19 purposes of this paragraph, the term ‘railroad
20 property’ means section 38 property used by the
21 taxpayer directly in connection with the trade or
22 business carried on by the taxpayer of operating a

1 railroad (including a railroad switching or terminal
2 company).

3 “(E) AIRLINE PROPERTY DEFINED.—For purposes
4 of this paragraph, the term ‘airline property’
5 means section 38 property used by the taxpayer
6 directly in connection with the trade or business
7 carried on by the taxpayer of the furnishing or
8 sale of transportation as a common carrier by air
9 subject to the jurisdiction of the Civil Aeronautics
10 Board or the Federal Aviation Administration.”

11 (c) REPEAL OF CERTAIN OBSOLETE PROVISIONS.—

12 (1) Subsections (h), (i), and (j) of section 48
13 and sections 49 and 50 are hereby repealed.

14 (2) Paragraphs (1) and (2) of section 46(f)
15 and subparagraph (B) of section 48(a)(7) are each
16 amended by striking out “described in section 50”.

17 (3) Subparagraph (A) of section 48(a)(7) is
18 amended by striking out “(other than pre-termination
19 property)”.

20 (4) Subsection (i) of section 167 is hereby re-
21 pealed.

22 (5) The table of sections for subpart B of part IV
23 of subchapter A of chapter 1 is amended by striking
24 out the items relating to sections 49 and 50.

25 (d) EFFECTIVE DATE.—The amendments made by

1 this section shall apply to taxable years ending after De-
2 cember 31, 1978.

3 **SEC. 31A. INVESTMENT CREDIT FOR POLLUTION CONTROL**
4 **FACILITIES.**

5 (a) **IN GENERAL.**—Paragraph (5) of section 46(c)
6 (relating to applicable percentage in the case of certain pol-
7 lution control facilities) is amended to read as follows:

8 “(5) **APPLICABLE PERCENTAGE IN THE CASE OF**
9 **CERTAIN POLLUTION CONTROL FACILITIES.**—

10 “(A) **IN GENERAL.**—Notwithstanding para-
11 graph (2), in the case of property—

12 “(i) with respect to which an election
13 under section 169 applies, and

14 “(ii) the useful life of which (determined
15 without regard to section 169) is not less than
16 5 years,

17 100 percent shall be the applicable percentage for
18 purposes of applying paragraph (1) with respect
19 to so much of the adjusted basis of the property as
20 (after the application of section 169(f)) constitutes
21 the amortizable basis for purposes of section 169.

22 “(B) **SPECIAL RULE WHERE PROPERTY IS**
23 **FINANCED BY INDUSTRIAL DEVELOPMENT BONDS.**—

24 To the extent that any property is financed by the
25 proceeds of an industrial development bond (within

1 the meaning of section 103 (b) (2)) the interest
2 on which is exempt from tax under section 103,
3 subparagraph (A) shall be applied by substituting
4 '50 percent' for '100 percent'."

5 (b) **EFFECTIVE DATE.**—The amendment made by
6 subsection (a) shall apply to—

7 (1) property acquired by the taxpayer after De-
8 cember 31, 1978, and

9 (2) property the construction, reconstruction, or
10 erection of which was completed by the taxpayer after
11 December 31, 1978 (but only to the extent of the basis
12 thereof attributable to construction, reconstruction, or
13 erection after such date).

14 **SEC. 314. INVESTMENT CREDIT ALLOWED FOR CERTAIN**
15 **REHABILITATED BUILDINGS.**

16 (a) **IN GENERAL.**—Paragraph (1) of section 48 (a)
17 (defining section 38 property) is amended by striking out
18 the period at the end of subparagraph (C) and by inserting
19 in lieu thereof “; or” and the following new subparagraph:

20 “(D) in the case of a qualified rehabilitated
21 building, that portion of the basis which is attribut-
22 able to qualified rehabilitation expenditures (within
23 the meaning of subsection (g)).”

24 (b) **QUALIFIED REHABILITATED BUILDINGS DE-**

1 FINED.—Section 48 is amended by inserting after subsection
2 (f) the following new subsection:

3 “(g) SPECIAL RULES FOR QUALIFIED REHABILI-
4 TATED BUILDINGS.—For purposes of this subpart—

5 “(1) QUALIFIED REHABILITATED BUILDING DE-
6 FINED.—

7 “(A) IN GENERAL.—The term ‘qualified re-
8 habilitated building’ means any building (and its
9 structural components) —

10 “(i) which has been rehabilitated,

11 “(ii) which was placed in service before
12 the beginning of the rehabilitation, and

13 “(iii) 75 percent or more of the existing
14 external walls of which are retained in place as
15 external walls in the rehabilitation process.

16 “(B) 5 YEARS MUST HAVE ELAPSED SINCE
17 CONSTRUCTION OR PRIOR REHABILITATION.—A
18 building shall not be a qualified rehabilitated build-
19 ing unless there is a period of at least 5 years
20 between—

21 “(i) the date the physical work on this re-
22 habilitation of the building began, and

23 “(ii) the later of—

24 “(I) the date such building was first
25 placed in service, or

1 “(II) the date such building was
2 placed in service in connection with a prior
3 rehabilitation with respect to which a credit
4 was allowed by reason of subsection (a)
5 (1) (D).

6 “(C) MAJOR PORTION TREATED AS SEPA-
7 RATE BUILDING IN CERTAIN CASES.—Where there
8 is a separate rehabilitation of a major portion of a
9 building, such major portion shall be treated as a
10 separate building.

11 “(D) REHABILITATION INCLUDES RECON-
12 STRUCTION.—Rehabilitation includes reconstruc-
13 tion.

14 “(2) QUALIFIED REHABILITATION EXPENDITURE
15 DEFINED.—

16 “(A) IN GENERAL.—The term ‘qualified reha-
17 bilitation expenditure’ means any amount properly
18 chargeable to capital account which is incurred after
19 July 26, 1978—

20 “(i) for property (or additions or im-
21 provements to property) with a useful life of
22 5 years or more, and

23 “(ii) in connection with the rehabilitation
24 of a qualified rehabilitated building.

25 “(B) CERTAIN EXPENDITURES NOT IN-

1 **CLUDED.—**The term ‘qualified rehabilitation expend-
 2 **iture’** does not include—

3 “(i) **PROPERTY OTHERWISE SECTION 38**
 4 **PROPERTY.—**Any expenditure for property
 5 which constitutes section 38 property (deter-
 6 mined without regard to subsection (a) (1)
 7 (D)).

8 “(ii) **COST OF ACQUISITION.—**The cost of
 9 acquiring any building or any interest therein.

10 “(iii) **ENLARGEMENTS.—**Any expenditure
 11 attributable to the enlargement of the existing
 12 building.

13 “(3) **PROPERTY TREATED AS NEW SECTION 38**
 14 **PROPERTY.—**Property which is treated as section 38
 15 property by reason of subsection (a) (1) (D) shall be
 16 treated as new section 38 property.”

17 (c) **TECHNICAL AMENDMENT.—**Paragraph (8) of
 18 section 48 (a) (relating to amortized property) is amended
 19 by striking out “or 188” and inserting in lieu thereof “188,
 20 or 191”.

21 (d) **EFFECTIVE DATE.—**The amendments made by this
 22 section shall apply to taxable years ending after July 26,
 23 1978; except that the amendment made by subsection (c)
 24 shall only apply with respect to property placed in service
 25 after such date.

1 **SEC. 315. TARGETED JOBS CREDIT.**

2 (a) **IN GENERAL.**—Section 51 (relating to amount
3 of credit) is amended to read as follows:

4 **“SEC. 51. AMOUNT OF CREDIT.**

5 “(a) **DETERMINATION OF AMOUNT.**—The amount of
6 the credit allowable by section 44B for the taxable year
7 shall be the sum of—

8 “(1) 50 percent of the qualified first-year wages
9 for such year, and

10 “(2) 16 $\frac{1}{2}$ percent of the qualified second-year wages
11 for such year.

12 “(b) **QUALIFIED WAGES DEFINED.**—For purposes of
13 this subpart—

14 “(1) **IN GENERAL.**—The term ‘qualified wages’
15 means the wages paid or incurred by the employer
16 during the taxable year to individuals who are mem-
17 bers of a targeted group.

18 “(2) **QUALIFIED FIRST-YEAR WAGES.**—The term
19 ‘qualified first-year wages’ means, with respect to any
20 individual, qualified wages attributable to service ren-
21 dered during the 1-year period beginning with the day
22 the individual begins work for the employer (or, in the
23 case of a vocational rehabilitation referral, the day the
24 individual begins work for the employer on or after the
25 beginning of such individual’s rehabilitation plan).

1 “(3) QUALIFIED SECOND-YEAR WAGES.—The
2 term ‘qualified second-year wages’ means, with respect
3 to any individual, the qualified wages attributable to
4 service rendered during the 1-year period beginning on
5 the day after the last day of the 1-year period with re-
6 spect to such individual determined under paragraph
7 (2).

8 “(4) ONLY FIRST \$6,000 OF WAGES PER YEAR
9 TAKEN INTO ACCOUNT.—The amount of the qualified
10 first-year wages, and the amount of the qualified second-
11 year wages, which may be taken into account with re-
12 spect to any individual shall not exceed \$6,000 per year.

13 “(5) WAGES DEFINED.—Except as provided in
14 subsection (g) (2), the term ‘wages’ has the meaning
15 given to such term by subsection (b) of section 3306
16 (determined without regard to any dollar limitation
17 contained in such section).

18 “(c) MEMBERS OF TARGETED GROUPS.—For pur-
19 poses of this subpart—

20 “(1) IN GENERAL.—An individual is a member of
21 a targeted group if such individual is—

22 “(A) a WIN registrant,

23 “(B) a vocational rehabilitation referral,

24 “(C) a food stamp youth,

1 “(D) a Vietnam veteran who is a member of
2 a household receiving food stamps,

3 “(E) an SSI recipient,

4 “(F) a general assistance recipient, or

5 “(G) a youth participating in a qualified co-
6 operative education program.

7 “(2) WIN REGISTRANT.—The term ‘WIN regis-
8 trant’ means any individual who is certified by the
9 Secretary of Labor as having been placed in employ-
10 ment under a work incentive program established under
11 section 432 (b) (1) of the Social Security Act.

12 “(3) VOCATIONAL REHABILITATION REFERRAL.—
13 The term ‘vocational rehabilitation referral’ means any
14 individual who is certified by the Secretary of Labor
15 or by the appropriate vocational rehabilitation agency
16 as—

17 “(A) having a physical or mental disability
18 which, for such individual, constitutes or results in
19 a substantial handicap to employment, and

20 “(B) having been referred to the employer
21 upon completion of (or while receiving) rehabilita-
22 tive services pursuant to—

23 “(i) an individualized written rehabilita-
24 tion plan under a State plan for vocational

1 rehabilitation services approved under the Re-
2 habilitation Act of 1973, or

3 “(ii) a program of vocational rehabilita-
4 tion carried out under chapter 31 of title 38,
5 United States Code.

6 “(4) **FOOD STAMP YOUTH.**—

7 “(A) **IN GENERAL.**—The term ‘food stamp
8 youth’ means any individual who is certified by the
9 Secretary of Labor as meeting—

10 “(i) the age requirements of subparagraph
11 (B), and

12 “(ii) the food stamp requirements of para-
13 graph (9).

14 “(B) **AGE REQUIREMENTS.**—An individual
15 meets the age requirements of this subparagraph if
16 such individual has attained age 18 but not age 25
17 on the hiring date. For purposes of the preceding
18 sentence, an individual who, on the hiring date, has
19 attained age 16 and has graduated from high school
20 or a vocational school shall be treated as having at-
21 tained age 18.

22 “(5) **VIETNAM VETERAN WHO IS MEMBER OF**
23 **HOUSEHOLD RECEIVING FOOD STAMPS.**—The term ‘Viet-
24 nam veteran who is a member of a household receiv-

1 ing food stamps' means any individual who is certified
2 by the Secretary of Labor as—

3 “(A) (i) having served on active duty (other
4 than active duty for training) in the Armed Forces
5 of the United States for a period of more than 180
6 days, any part of which occurred after August 4,
7 1964, and before May 8, 1975, or

8 “(ii) having been discharged or released from
9 active duty in the Armed Forces of the United States
10 for a service-connected disability if any part of such
11 active duty was performed after August 4, 1964,
12 and before May 8, 1975,

13 “(B) not having any day during the pre-
14 employment period which was a day of extended ac-
15 tive duty in the Armed Forces of the United States,
16 and

17 “(C) meeting the food stamp requirements of
18 paragraph (9).

19 For purposes of subparagraph (B), the term ‘extended
20 active duty’ means a period of more than 90 days during
21 which the individual was on active duty (other than
22 active duty for training).

23 “(6) SSI RECIPIENTS.—The term ‘SSI recipient’
24 means any individual who is certified by the Secretary
25 of Labor as receiving supplemental security income bene-

1 fits under title XVI of the Social Security Act (includ-
 2 ing supplemental security income benefits of the type
 3 described in section 1616 of such Act or section 212 of
 4 Public Law 93-66) for any month ending in the pre-
 5 employment period.

6 “(7) GENERAL ASSISTANCE RECIPIENTS.—

7 “(A) IN GENERAL.—The term ‘general assist-
 8 ance recipient’ means any individual who is certified
 9 by the Secretary of Labor as receiving assistance
 10 under a qualified general assistance program for any
 11 period of not less than 30 days ending within the
 12 pre-employment period.

13 “(B) QUALIFIED GENERAL ASSISTANCE
 14 PROGRAM.—The term ‘qualified general assistance
 15 program’ means any program of a State or a politi-
 16 cal subdivision of a State—

17 “(i) which provides general assistance or
 18 similar assistance which—

19 “(I) is based on need, and

20 “(II) consists of money payments, and

21 “(ii) which is designated by the Secretary
 22 (after consultation with the Secretary of Health,
 23 Education, and Welfare) as meeting the re-
 24 quirements of clause (i).

1 “(8) YOUTH PARTICIPATING IN A QUALIFIED
2 COOPERATIVE EDUCATION PROGRAM.—

3 “(A) IN GENERAL.—The term ‘youth partici-
4 pating in a qualified cooperative education program’
5 means any individual who is certified by the school
6 participating in the program as—

7 “(i) having attained age 16 and not having
8 attained age 19,

9 “(ii) not having graduated from a high
10 school or vocational school, and

11 “(iii) being enrolled in and actively pur-
12 suing a qualified cooperative education program. ---

13 “(B) QUALIFIED COOPERATIVE EDUCATION
14 PROGRAM DEFINED.—The term ‘qualified coopera-
15 tive education program’ means a program of voca-
16 tional education for individuals who (through writ-
17 ten cooperative arrangements between a qualified
18 school and 1 or more employers) receive instruc-
19 tion (including required academic instruction) by
20 alternation of study and school with a job in any
21 occupational field (but only if these 2 experiences
22 are planned by the school and employer so that each
23 contributes to the student’s education and em-
24 ployability).

1 “(C) QUALIFIED SCHOOL DEFINED.—The
2 term ‘qualified school’ means—

3 “(i) a specialized high school used exclu-
4 sively or principally for the provision of voca-
5 tional education to individuals who are available
6 for study in preparation for entering the labor
7 market,

8 “(ii) the department of a high school ex-
9 clusively or principally used for providing vo-
10 cational education to persons who are available
11 for study in preparation for entering the labor
12 market, or

13 “(iii) a technical or vocational school used
14 exclusively or principally for the provision of
15 vocational education to persons who have com-
16 pleted or left high school and who are available
17 for study in preparation for entering the labor
18 market.

19 A school which is not a public school shall be treated
20 as a qualified school only if it is exempt from tax
21 under section 501 (a).

22 “(D) INDIVIDUAL MUST BE CURRENTLY PUB-
23 LISHING PROGRAM.—Wages shall be taken into ac-
24 count with respect to a qualified cooperative educa-
25 tion program only if the wages are attributable to

1 services performed while the individual meets the
2 requirements of subparagraph (A).

3 “(9) **FOOD STAMP REQUIREMENTS.**—An individ-
4 ual meets the food stamp requirements of this paragraph
5 if the appropriate food stamp agency determines that,
6 during the pre-employment period, such individual was
7 a member of a household which, at any time during such
8 period, was receiving food stamps under the Food Stamp
9 Act of 1977.

10 “(10) **PRE-EMPLOYMENT PERIOD.**—The term ‘pre-
11 employment period’ means the 60-day period ending on
12 the hiring date.

13 “(11) **HIRING DATE.**—The term ‘hiring date’
14 means the day the individual is hired by the employer.

15 “(d) **QUALIFIED FIRST-YEAR WAGES CANNOT EX-**
16 **CEED 30 PERCENT OF FUTA WAGES FOR ALL EMPLOY-**
17 **RES.**—The amount of the qualified first-year wages which
18 may be taken into account under subsection (a) (1) for
19 any taxable year shall not exceed 30 percent of the aggregate
20 unemployment insurance wages paid by the employer during
21 the calendar year ending in such taxable year. For purposes
22 of the preceding sentence, the term ‘unemployment insurance
23 wages’ has the meaning given to the term ‘wages’ by section
24 3306 (b).

1 “(e) REMUNERATION MUST BE FOR TRADE OR BUSI-
2 NESS EMPLOYMENT.—

3 “(1) IN GENERAL.—For purposes of this subpart,
4 remuneration paid by an employer to an employee dur-
5 ing any year shall be taken into account only if more than
6 one-half of the remuneration so paid is for services per-
7 formed in a trade or business of the employer.

8 “(2) SPECIAL RULE FOR CERTAIN DETERMINA-
9 TION.—Any determination as to whether paragraph (1),
10 or subparagraph (A) or (B) of subsection (g) (1),
11 applies with respect to any employee for any year shall
12 be made without regard to subsections (a) and (b) of
13 section 52.

14 “(3) YEAR DEFINED.—For purposes of this sub-
15 section and subsection (g), the term ‘year’ means the
16 taxable year; except that, for purposes of applying so
17 much of such subsections as relates to subsection (d),
18 such term means the calendar year.

19 “(f) SECRETARY OF LABOR TO NOTIFY EMPLOYERS
20 OF AVAILABILITY OF CREDIT.—The Secretary of Labor,
21 in consultation with the Internal Revenue Service, shall take
22 such steps as may be necessary or appropriate to keep em-
23 ployers apprised of the availability of the credit provided by
24 section 44B.

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1 “(g) SPECIAL RULES FOR AGRICULTURAL LABOR
2 AND RAILWAY LABOR.—For purposes of this subpart—

3 “(1) UNEMPLOYMENT INSURANCE WAGES.—

4 “(A) AGRICULTURAL LABOR.—If the services
5 performed by any employee for an employer during
6 more than one-half of any pay period (within the
7 meaning of section 3306 (d)) taken into account
8 with respect to any year constitute agricultural labor
9 (within the meaning of section 3306 (k)), the term
10 ‘unemployment insurance wages’ means, with re-
11 spect to the remuneration paid by the employer to
12 such employee for such year, an amount equal to so
13 much of such remuneration as constitutes ‘wages’
14 within the meaning of section 3121 (a) , except that
15 the contribution and benefit base for each calendar
16 year shall be deemed to be \$6,000.

17 “(B) RAILWAY LABOR.—If more than one-
18 half of remuneration paid by an employer to an
19 employee during any year is remuneration for serv-
20 ice described in section 3306 (c) (9) , the term ‘un-
21 employment insurance wages’ means, with respect
22 to such employee for such year, an amount equal to
23 so much of the remuneration paid to such employee
24 during such year which would be subject to contri-
25 butions under section 8 (a) of the Railroad Unem-

1 employment Insurance Act (45 U.S.C. 358 (a)) if
2 the maximum amount subject to such contributions
3 were \$500 per month.

4 “(2) WAGES.—In any case to which subparagraph
5 (A) or (B) of paragraph (1) applies, the term ‘wages’
6 means unemployment insurance wages (determined
7 without regard to any dollar limitation).”

8 (b) TERMINATION OF WIN CREDIT.—Subsection (a)
9 of section 50B (relating to definitions; special rules for WIN
10 credit) is amended by adding at the end thereof the following
11 new paragraph:

12 “(4) TERMINATION.—For purposes of this subpart,
13 the term ‘work incentive program expenses’ shall not
14 include any amount paid or incurred by the taxpayer in
15 a taxable year beginning after December 31, 1978.”

16 (c) TECHNICAL AND CONFORMING AMENDMENTS.—

17 (1) AMENDMENTS OF SECTION 52.—

18 (A) Section 52 (relating to special rules for
19 computing credit for employment of certain new
20 employees) is amended—

21 (i) by striking out subsections (c), (e),
22 (i), and (j), and

23 (ii) by redesignating subsections (d), (f),
24 (g), and (h) as subsections (c), (d), (e),
25 and (f), respectively.

1 (B) Subsections (a) and (b) of section 52 are
2 each amended by striking out "proportionate con-
3 tribution to the increase in unemployment insurance
4 wages" and inserting in lieu thereof "proportionate
5 share of the wages".

6 (C) Subsection (e) of section 52 (as re-
7 designated by subparagraph (A)) is amended—

- 8 (i) by adding "and" at the end of para-
9 graph (1);
10 (ii) by striking out ", and" at the end of
11 paragraph (2) and inserting a period; and
12 (iii) by striking out paragraph (3).

13 (2) AMENDMENT OF SECTION 53.—Section 53
14 (relating to limitation based on amount of tax) is
15 amended by striking out subsection (b) and by re-
16 designating subsection (c) as subsection (b).

17 (d) EFFECTIVE DATE.—

18 (1) IN GENERAL.—Except as otherwise provided
19 in this subsection, the amendments made by this section
20 shall apply to amounts paid or incurred after Decem-
21 ber 31, 1978, in taxable years ending after such date.

22 (2) SPECIAL RULES FOR NEWLY TARGETED
23 GROUPS.—

24 (A) INDIVIDUAL MUST BE HIRED AFTER

1 JULY 26, 1978.—In the case of a member of a
2 newly targeted group—

3 (i) such individual shall be taken into ac-
4 count for purposes of the credit allowable by
5 section 44B of the Internal Revenue Code of
6 1954 only if such individual is first hired by the
7 employer after July 26, 1978, and

8 (ii) such individual shall be treated for
9 purposes of such credit as having first begun
10 work for the employer not earlier than Janu-
11 ary 1, 1979.

12 (B) MEMBER OF NEWLY TARGETED GROUP
13 DEFINED.—For purposes of subparagraph (A),
14 an individual is a member of a newly targeted group
15 if—

16 (i) such individual meets the requirements
17 of subparagraph (C), (D), (E), (F), or (G)
18 of section 51 (c) (1) of such Code, and

19 (ii) such individual does not meet the re-
20 quirements of subparagraph (A) or (B) of
21 such section 51 (c) (1).

22 (3) TRANSITIONAL RULE.—In the case of a taxable
23 year which begins in 1978 and ends after December 31,
24 1978, the amount of the credit allowable by section 44B

1 of the Internal Revenue Code of 1954 (determined with-
 2 out regard to section 53 of such Code) shall be the
 3 sum of—

4 (A) the amount of the credit which would be so
 5 allowable without regard to the amendments made
 6 by this section, plus

7 (B) the amount which would be so allowable by
 8 reason of the amendments made by this section.

9 (4) SUBSECTION (c) (2).—The amendments made
 10 by subsection (c) (2) shall apply to taxable years begin-
 11 ning after December 31, 1978.

12 (e) REPORT ON EFFECTIVENESS OF JOBS CREDIT.—

13 (1) REPORT ON TARGETED JOBS CREDIT.—Not
 14 later than June 30, 1981, the Secretary of the Treasury
 15 and the Secretary of Labor shall jointly submit to the
 16 Committee on Ways and Means of the House of Repre-
 17 sentatives and the Committee on Finance of the Senate
 18 a report on—

19 (A) the effectiveness of the targeted jobs
 20 credit provided by the amendments made by this
 21 section in improving the employment situation of
 22 the targeted groups, and

23 (B) the types of employers claiming such credit.

24 (2) GENERAL JOBS CREDIT.—The report required

1 under paragraph (1) shall also include an evaluation
2 of—

3 (A) the effectiveness of the general jobs credit
4 provided by section 44B of the Internal Revenue
5 Code of 1954 for 1977 and 1978 in stimulating em-
6 ployment and enhancing economic growth, and

7 (B) the types of employers claiming such
8 credit.

9 **Subtitle C—Miscellaneous Provisions**

10 **SEC. 321. INCREASE IN LIMIT ON SMALL ISSUES OF IDB'S** 11 **TO \$10,000,000.**

12 (a) **GENERAL RULE.**—Subparagraph (D) of section
13 103 (b) (6) (relating to \$5,000,000 limit in certain cases)
14 is amended by striking out “\$5,000,000” in the heading and
15 in the text and inserting in lieu thereof “\$10,000,000”.

16 (b) **EFFECTIVE DATE.**—The amendment made by sub-
17 section (a) shall apply to obligations issued after December
18 31, 1978, in taxable years ending after such date.

19 **SEC. 322. THREE-YEAR EXTENSION OF PROVISION FOR 60-** 20 **MONTH DEPRECIATION OF EXPENDITURES TO** 21 **REHABILITATE LOW-INCOME RENTAL HOUS-** 22 **ING.**

23 Subsection (k) of section 167 (relating to depreciation
24 of expenditures to rehabilitate low-income rental housing)

1 is amended by striking out "January 1, 1979" each place
 2 it appears and inserting in lieu thereof "January 1, 1982".

3 **Subtitle D—Small Business Provisions**

4 **PART I—PROVISIONS RELATING TO**

5 **SUBCHAPTER S**

6 **SEC. 331. SUBCHAPTER S CORPORATIONS ALLOWED 15** 7 **SHAREHOLDERS.**

8 (a) **GENERAL RULE.**—Paragraph (1) of section 1371

9 (a) (defining small business corporation) is amended to
 10 read as follows:

11 " (1) have more than 15 shareholders;".

12 (b) **TECHNICAL AMENDMENTS.**—

13 (1) Section 1371 is amended by striking out sub-
 14 section (e) and by redesignating subsection (f) as
 15 subsection (e).

16 (2) Paragraph (2) of section 1371 (a) is amended
 17 by striking out "subsection (f)" and inserting in lieu
 18 thereof "subsection (e)".

19 **SEC. 332. PERMITTED SHAREHOLDERS OF SUBCHAPTER S** 20 **CORPORATIONS.**

21 (a) **HUSBAND AND WIFE TREATED AS ONE INDIVID-**
 22 **UAL.**—Subsection (c) of section 1371 (relating to stock
 23 owned by husband and wife) is amended to read as follows:

24 "(c) **STOCK OWNED BY HUSBAND AND WIFE.**—For

1 purposes of subsection (a) (1), a husband and wife (and
2 their estates) shall be treated as one shareholder.”

3 (b) GRANTOR OF GRANTOR TRUST TREATED AS THE
4 SHAREHOLDER.—Subsection (e) of section 1371 (as re-
5 designated by section 331 (b) (1) of this Act) is amended
6 by inserting after the first sentence the following new sen-
7 tence: “In the case of a trust described in paragraph (1),
8 the grantor shall be treated as the shareholder.”

9 **SEC. 333. EXTENSION OF PERIOD FOR MAKING SUBCHAP-**
10 **TER S ELECTIONS.**

11 (a) GENERAL RULE.—Subsection (c) of section 1372
12 (relating to when and how subchapter S election may be
13 made) is amended to read as follows:

14 “(c) WHEN AND HOW MADE.—

15 “(1) IN GENERAL.—An election under subsection
16 (a) may be made by a small business corporation for
17 any taxable year—

18 “(A) at any time during the preceding taxable
19 year, or

20 “(B) at any time during the first 75 days of
21 the taxable year.

22 “(2) TREATMENT OF CERTAIN LATE ELECTIONS.—

23 If—

24 “(A) a small business corporation makes an

1 election under subsection (a) for any taxable year,
2 and

3 “(B) such election is made after the first 75
4 days of the taxable year and on or before the last
5 day of such taxable year,

6 then such election shall be treated as made for the
7 following taxable year.

8 “(3) MANNER OF MAKING ELECTION.—An elec-
9 tion under subsection (a) shall be made in such manner
10 as the Secretary shall prescribe by regulations.”

11 (b) TECHNICAL AMENDMENTS.—

12 (1) The second sentence of section 1372(a) is
13 amended to read as follows: “Such election shall be valid
14 only if all persons who are shareholders in such corpo-
15 ration on the day on which such election is made consent
16 to such election.”

17 (2) Subparagraph (A) of section 1372(e) (1) is
18 amended to read as follows: -----

19 “(A) An election under subsection (a) made
20 by a small business corporation shall terminate if
21 any person who was not a shareholder in such
22 corporation on the day on which the election is
23 made becomes a shareholder in such corporation and
24 affirmatively refuses (in such manner as the Secre-
25 tary may by regulations prescribe) to consent to

1 such election on or before the 60th day after the
2 day on which he acquires the stock.”

3 (3) Subparagraph (C) of section 1372 (e) (1) is
4 amended by inserting “(or, if later, the first taxable
5 year for which such election would otherwise have been
6 effective)” after “in the corporation”.

7 **SEC. 334. EFFECTIVE DATE.**

8 The amendments made by this part shall apply to tax-
9 able years beginning after December 31, 1978.

10 **PART II—OTHER PROVISIONS**

11 **SEC. 335. SMALL BUSINESS CORPORATION STOCK.**

12 (a) INCREASE TO \$1,000,000 AMOUNT OF STOCK
13 POTENTIALLY SUBJECT TO ORDINARY LOSS TREATMENT;
14 REMOVAL OF EQUITY CAPITAL TEST.—Subsection (c) of
15 section 1244 (relating to losses on small business stock)
16 is amended by striking out paragraph (2) and inserting in
17 lieu thereof the following:

18 “(3) SMALL BUSINESS CORPORATION DEFINED.—

19 “(A) IN GENERAL.—For purposes of this sec-
20 tion, a corporation shall be treated as a small busi-
21 ness corporation if the aggregate amount of money
22 and other property received by the corporation
23 for stock, as a contribution to capital, and as
24 paid-in surplus, does not exceed \$1,000,000. The
25 determination under the preceding sentence shall

1 be made as of the time of the issuance of the
 2 stock in question but shall include amounts received
 3 for such stock and for all stock theretofore issued.

4 “(B) AMOUNT TAKEN INTO ACCOUNT WITH
 5 RESPECT TO PROPERTY.—For purposes of subpara-
 6 graph (A), the amount taken into account with
 7 respect to any property other than money shall be
 8 the amount equal to the adjusted basis to the cor-
 9 poration of such property for determining gain, re-
 10 duced by any liability to which the property was
 11 subject or which was assumed by the corporation.
 12 The determination under the preceding sentence
 13 shall be made as of the time the property was re-
 14 ceived by the corporation.”

15 (b) INCREASE IN MAXIMUM AMOUNT TREATED AS
 16 ORDINARY LOSS FOR ANY TAXABLE YEAR.—Subsection
 17 (b) of section 1244 is amended—

18 (1) by striking out “\$25,000” in paragraph (1)
 19 and inserting in lieu thereof “\$50,000”, and

20 (2) by striking out “\$50,000” in paragraph (2)
 21 and inserting in lieu thereof “\$100,000”.

22 (c) REMOVAL OF REQUIREMENT THAT STOCK IS-
 23 SUANCE BE PURSUANT TO PLAN.—Subsection (c) of sec-
 24 tion 1244 (defining section 1244 stock) is amended by

1 striking out paragraph (1) and inserting in lieu thereof the
2 following new paragraphs:

3 “(1) IN GENERAL.—For purposes of this section,
4 the term ‘section 1244 stock’ means common stock in
5 a domestic corporation if—

6 “(A) at the time such stock is issued, such
7 corporation was a small business corporation,

8 “(B) such stock was issued by such corpora-
9 tion for money or other property (other than stock
10 and securities), and

11 “(C) such corporation, during the period of
12 its 5 most recent taxable years ending before the
13 date the loss on such stock was sustained, derived
14 more than 50 percent of its aggregate gross receipts
15 from sources other than royalties, rents, dividends,
16 interests, annuities, and sales or exchanges of stocks
17 or securities.

18 “(2) RULES FOR APPLICATION OF PARAGRAPH

19 (1)(C).—

20 “(A) PERIOD TAKEN INTO ACCOUNT WITH
21 RESPECT TO NEW CORPORATIONS.—For purposes of
22 paragraph (1) (C), if the corporation has not been
23 in existence for 5 taxable years ending before the
24 date the loss on the stock was sustained, there shall
25 be substituted for such 5-year period.

1 “(i) the period of the corporation’s taxable
2 years ending before such date, or

3 “(ii) if the corporation has not been in
4 existence for 1 taxable year ending before such
5 date, the period such corporation has been in
6 existence before such date.

7 “(B) GROSS RECEIPTS FROM SALES OF SE-
8 CURITIES.—For purposes of paragraph (1) (C),
9 gross receipts from the sales or exchanges of stock
10 or securities shall be taken into account only to the
11 extent of gains therefrom.

12 “(C) NONAPPLICATION WHERE DEDUCTIONS
13 EXCEED GROSS INCOME.—Paragraph (1) (C) shall
14 not apply with respect to any corporation if, for the
15 period taken into account for purposes of paragraph
16 (1) (C), the amount of the deductions allowed by
17 this chapter (other than by sections 172, 243, 244,
18 and 245) exceeds the amount of gross income.”

19 (d) TECHNICAL AMENDMENTS.—Paragraph (2) of
20 section 1244 (d) (relating to special rules) is amended—

21 (1) by striking out “subparagraph (E)” and
22 inserting in lieu thereof “subparagraph (C)”, and

23 (2) by striking out “paragraphs (1) (E) and
24 (2) (A)” and inserting in lieu thereof “paragraphs
25 (1) (C) and (3) (A)”.

1 (e) **EFFECTIVE DATE.**—The amendments made by
2 this section shall apply to stock issued after the date of the
3 enactment of this Act.

4 **SEC. 336. SPECIAL DEPRECIATION RULES FOR SMALL**
5 **BUSINESS.**

6 (a) **SECTION 179 PERCENTAGE INCREASED TO 25**
7 **PERCENT.**—Subsection (a) of section 179 (relating to addi-
8 tional first-year depreciation allowance for small business)
9 is amended by striking out “20 percent” and inserting in lieu
10 thereof “25 percent”.

11 (b) **INCREASE IN DOLLAR LIMITATION.**—

12 (1) The first sentence of section 179 (b) is amended
13 by striking out “\$10,000” each place it appears and
14 inserting in lieu thereof “\$20,000”.

15 (2) The second sentence of section 179 (b) is
16 amended by striking out “\$20,000 in lieu of \$10,000”
17 and inserting in lieu thereof “\$40,000 in lieu of
18 \$20,000”.

19 (c) **BENEFITS LIMITED TO SMALL BUSINESS.**—

20 (1) **IN GENERAL.**—Section 179 is amended by
21 redesignating subsections (c), (d), and (e) as sub-
22 sections (d), (e), and (f), respectively, and by insert-
23 ing after subsection (b) the following new subsection:

24 “(c) **BENEFITS LIMITED TO SMALL BUSINESS.**—

25 “(1) **IN GENERAL.**—This section shall not apply

1 for the taxable year if (as of the first day of such year)
 2 the aggregate adjusted basis of the depreciable property
 3 of the taxpayer is \$1,000,000 or more.

4 "(2) DEPRECIABLE PROPERTY DEFINED.—For
 5 purposes of this subsection, the term 'depreciable
 6 property' means property which is of a character sub-
 7 ject to the allowance for depreciation provided by
 8 section 167."

9 (2) CONTROLLED GROUPS.—Paragraph (6) of
 10 subsection (e) (as redesignated by paragraph (1) of
 11 this subsection) of section 179 is amended—

12 (A) by striking out the heading and insert-
 13 ing in lieu thereof "(6) APPLICATION OF SUB-
 14 SECTIONS (b) AND (c) IN THE CASE OF CON-
 15 TROLLED GROUP.—"; and

16 (B) by striking out "For purposes of sub-
 17 section (b)" and inserting in lieu thereof "For
 18 purposes of subsections (b) and (c)".

19 (3) CONFORMING AMENDMENT.—Subparagraph
 20 (A) of section 48(c)(3) is amended by striking out
 21 "section 179(d)(2)" and inserting in lieu thereof
 22 "section 179(e)(2)".

23 (d) EFFECTIVE DATE.—The amendments made by
 24 this section shall apply to taxable years beginning after
 25 December 31, 1978.

1 **Subtitle E—Accounting Provisions**

2 **SEC. 341. TREATMENT OF CERTAIN CLOSELY HELD FARM**
3 **CORPORATIONS FOR PURPOSES OF RULE RE-**
4 **QUIRING ACCRUAL ACCOUNTING.**

5 **(a) GENERAL RULE.**—Section 447 (relating to method
6 of accounting for corporations engaged in farming) is
7 amended by adding at the end thereof the following new
8 subsection:

9 **“(h) EXCEPTION FOR CERTAIN CLOSELY HELD COR-**
10 **PORATIONS.—**

11 **“(1) IN GENERAL.**—This section shall not apply
12 to any corporation if, on October 4, 1976, and at all
13 times thereafter—

14 **“(A) members of 2 families (within the**
15 **meaning of subsection (d) (1)) have owned (di-**
16 **rectly or through the application of subsection (d))**
17 **at least 65 percent of the total combined voting**
18 **power of all classes of stock of such corporation en-**
19 **titled to vote, and at least 65 percent of the total**
20 **number of shares of all other classes of stock of such**
21 **corporation; or**

22 **“(B) (i) members of 3 families (within the**
23 **meaning of subsection (d) (1)) have owned (di-**
24 **rectly or through the application of subsection (d))**
25 **at least 50 percent of the total combined voting**

1 power of all classes of stock of such corporation
 2 entitled to vote, and at least 50 percent of the total
 3 number of shares of all other classes of stock of such
 4 corporation; and

5 “(ii) substantially all of the stock of such cor-
 6 poration which is not so owned (directly or through
 7 the application of subsection (d)) by members of
 8 such 3 families is owned directly—

9 “(I) by employees of the corporation or
 10 members of their families (within the meaning
 11 of section 267 (c) (4)), or

12 “(II) by a trust for the benefit of the em-
 13 ployees of such corporation which is described
 14 in section 401 (a) and which is exempt from
 15 taxation under section 501 (a) .

16 “(2) STOCK HELD BY EMPLOYEES, ETC.—For pur-
 17 poses of this subsection, stock which—

18 “(A) is owned directly by employees of the
 19 corporation or members of their families (within
 20 the meaning of section 267 (c) (4)) or by a trust
 21 described in paragraph (1) (B) (ii) (II) , and

22 “(B) was acquired on or after October 4, 1976,
 23 from the corporation or from a member of a family
 24 which, on October 4, 1976, was described in sub-
 25 paragraph (A) or (B) (i) of paragraph (1) ,

1 shall be treated as owned by a member of a family which,
 2 on October 4, 1976, was described in subparagraph (A)
 3 or (B) (i) of paragraph (1).

4 “(3) CORPORATION MUST BE ENGAGED IN FARM-
 5 ING.—This subsection shall apply only in the case of a
 6 corporation which was, on October 4, 1976, and at all
 7 times thereafter, engaged in the trade or business of
 8 farming.”

9 (b) EFFECTIVE DATE.—The amendment made by
 10 subsection (a) shall apply to taxable years beginning after
 11 December 31, 1977.

12 **SEC. 342. ACCOUNTING FOR GROWING CROPS.**

13 (a) APPLICATION OF SECTION.—This section shall
 14 apply to a taxpayer who—

- 15 (1) is a farmer, nurseryman, or florist,
 16 (2) is on an accrual method of accounting, and
 17 (3) is not required by section 447 of the Internal
 18 Revenue Code of 1954 to capitalize preproductive period
 19 expenses.

20 (b) TAXPAYER MAY NOT BE REQUIRED TO INVEN-
 21 TORY GROWING CROPS.—A taxpayer to whom this section
 22 applies may not be required to inventory growing crops
 23 for any taxable year beginning after December 31, 1977.

24 (c) TAXPAYER MAY ELECT TO CHANGE TO CASH
 25 METHOD.—A taxpayer to whom this section applies may,

1 for any taxable year beginning after December 31, 1977,
 2 and before January 1, 1981, change to the cash receipts
 3 and disbursements method of accounting with respect to any
 4 trade or business in which the principal activity is growing
 5 crops.

6 (d) SECTION 481 OF CODE TO APPLY.—Any change
 7 in the way in which a taxpayer accounts for the costs of
 8 growing crops resulting from the application of subsection
 9 (b) or (c)—

10 (1) shall not require the consent of the Secretary
 11 of the Treasury or his delegate, and

12 (2) shall be treated, for purposes of section 481
 13 of the Internal Revenue Code of 1954, as a change in
 14 the method of accounting initiated by the taxpayer.

15 (e) GROWING CROPS.—For purposes of this section,
 16 the term “growing crops” does not include trees grown for
 17 lumber, pulp, or other nonlife purposes.

18 TITLE IV—CAPITAL GAINS

19 SEC. 401. REPEAL OF ALTERNATIVE TAX ON CAPITAL 20 GAINS OF INDIVIDUALS.

21 (a) GENERAL RULE.—Section 1201 (relating to alter-
 22 native tax) is amended—

23 (1) by striking out subsections (b) and (c),

24 (2) by redesignating subsection (d) as subsection
 25 (b), and

1 (3) by amending the section heading to read as
2 follows:

3 "SEC. 1201. ALTERNATIVE TAX FOR CORPORATIONS."

4 (b) CONFORMING AMENDMENTS.—

5 (1) Paragraph (1) of section 3 (b) is amended by
6 striking out subparagraph (B) and by redesignating
7 subparagraphs (C) and (D) as subparagraphs (B) and
8 (C), respectively.

9 (2) Subsection (a) of section 5 is amended by
10 striking out paragraph (3) and by redesignating para-
11 graphs (4) and (5) as paragraphs (3) and (4),
12 respectively.

13 (3) Paragraph (1) of section 871 (b) is amended
14 by striking out "section 1, 402 (e) (1), or 1201 (b)"
15 and inserting in lieu thereof "section 1 or 402 (e) (1)".

16 (4) Subsection (b) of section 877 is amended by
17 striking out "section 1, 402 (e) (1), or 1201 (b)" and
18 inserting in lieu thereof "section 1 or 402 (e) (1)".

19 (5) Paragraph (1) of section 911 (d) is amended—

20 (A) by striking out "section 1 or section 1201"
21 each place it appears and inserting in lieu thereof
22 "section 1", and

23 (B) by striking out "(whichever is applica-
24 ble)" each place it appears.

1 (6) Subsection (b) of section 1304 is amended—

2 (A) by adding “and” at the end of para-
3 graph (2),

4 (B) by striking out paragraph (3), and

5 (C) by redesignating paragraph (4) as para-
6 graph (3).

7 (7) The table of sections for part 1 of subchapter P
8 of chapter 1 is amended by striking out the item relat-
9 ing to section 1201 and inserting in lieu thereof the
10 following:

“Sec. 1201. Alternative tax for corporations.”

11 (c) EFFECTIVE DATE.—The amendments made by
12 this section shall apply to taxable years beginning after
13 December 31, 1978.

14 **SEC. 402. REMOVAL OF CAPITAL GAINS FROM ITEMS OF**
15 **TAX PREFERENCE FOR PURPOSES OF MINI-**
16 **MUM AND MAXIMUM TAX.**

17 (a) GENERAL RULE.—Subsection (a) of section 57
18 (defining items of preference) is amended by striking out
19 paragraph (9).

20 (b) CONFORMING AMENDMENTS.—

21 (1) Section 56 (relating to imposition of minimum
22 tax) is amended by striking out subsections (d) and

23 (e).

1 (2) Section 57 (defining items of tax preference)
2 is amended by striking out subsection (e).

3 (3) Subsection (d) of section 58 (relating to elect-
4 ing small business corporations and their shareholders)
5 is amended to read as follows:

6 “(d) **ELECTING SMALL BUSINESS CORPORATIONS AND**
7 **THEIR SHAREHOLDERS.**—The items of tax preference of an
8 electing small business corporation (as defined in section
9 1371 (b)) for each taxable year of the corporation shall be
10 treated as items of tax preference of the shareholders of such
11 corporation, and shall not be treated as items of tax prefer-
12 ence of such corporation. The sum of the items so treated
13 shall be apportioned pro rata among such shareholders in a
14 manner consistent with section 1374 (c) (1). For purposes
15 of this subsection, this part shall be treated as applying to
16 such corporation.”

17 (4) Subsection (f) of section 58 (relating to reg-
18 ulated investment companies, etc.) is amended to read
19 as follows:

20 “(f) **REGULATED INVESTMENT COMPANIES, ETC.**—
21 In the case of a regulated investment company to which part
22 I of subchapter M applies or a real estate investment trust to
23 which part II of subchapter M applies, the items of tax
24 preference of such company or such trust for each taxable

1 year (other than, in the case of a real estate investment
2 trust, the item of tax preference set forth in section 57 (a)
3 (2)) shall be treated as items of tax preference of the share-
4 holders of such company, or the shareholders or holders of
5 beneficial interests of such trust (and not as items of tax
6 preference of such company or such trust), in the same pro-
7 portion that the dividends (other than capital gains divi-
8 dends) paid to each such shareholder, or holder of beneficial
9 interest, bears to the taxable income of such company or such
10 trust determined without regard to the deduction for divi-
11 dends paid."

12 (5) Subsection (g) of section 58 (relating to tax
13 preferences attributable to foreign sources) is amended—

14 (A) by striking out "paragraphs (6) and
15 (9)" in paragraph (1) and inserting in lieu thereof
16 "paragraph (6)",

17 (B) by amending the first sentence of para-
18 graph (2) to read as follows: "For purposes of sec-
19 tion 56, any item of tax preference set forth in para-
20 graph (6) of section 57 (a) which is attributable to
21 sources within any foreign country or possession of
22 the United States shall not be taken into account if,
23 under the tax laws of such country or possession,

1 preferential treatment is not accorded transfers of
2 shares of stock pursuant to stock options described
3 in such paragraph (6).”, and

4 (C) by amending the heading of paragraph
5 (2) to read as follows:

6 “(2) STOCK OPTIONS.—”.

7 (6) Subsection (i) of section 58 (defining cor-
8 poration) is amended by striking out “Except as pro-
9 vided in subsection (d) (2), for” and inserting in lieu
10 thereof “For”.

11 (7) Paragraph (1) of section 1372(b) (relating
12 to the effect of election by small business corporation)
13 is amended by striking out “by section 58 (d) (2) and”.

14 (8) Sections 1373 (c) and 1375 (a) (3) are each
15 amended by striking out “taxes imposed by sections 56
16 and 1378 (a)” and inserting in lieu thereof “tax imposed
17 by section 1378 (a)”.

18 (c) EFFECTIVE DATE.—The amendments made by
19 this section shall apply to taxable years beginning after
20 December 31, 1978.

21 **SEC. 403. SEPARATE MINIMUM TAX ON CAPITAL GAINS.**

22 (a) IN GENERAL.—Subchapter A of chapter 1 (relat-
23 ing to determination of tax liability) is amended by adding at
24 the end thereof the following new part:

1 **"PART VII—SEPARATE MINIMUM TAX ON**
2 **CAPITAL GAINS**

 "Sec. 59. Imposition of tax.

3 **"SEC. 59. IMPOSITION OF TAX.**

4 " (a) **GENERAL RULE.**—In the case of a taxpayer other
5 than a corporation, if—

6 " (1) 10 percent of an amount equal to (A) $\frac{1}{2}$ of
7 the net capital gain for the taxable year, reduced by
8 (B) \$10,000, exceeds

9 " (2) the regular tax for the taxable year,
10 then there is hereby imposed (in addition to all other taxes
11 imposed by this title) a tax equal to the amount of such
12 excess.

13 " (b) **MARRIED INDIVIDUALS FILING SEPARATE RE-**
14 **URNS.**—In the case of a married individual who files a
15 separate return for the taxable year, paragraph (1) (B) of
16 subsection (a) shall be applied by substituting '\$5,000' for
17 '\$10,000'.

18 " (c) **GAIN FROM SALE OF PRINCIPAL RESIDENCE**
19 **NOT TAKEN INTO ACCOUNT.**—In determining net capital
20 gain for purposes of subsection (a) (1) (A), there shall not
21 be taken into account gain on the sale or exchange of any
22 principal residence which satisfies the holding and use
23 requirements of section 121 (a) (relating to one-time ex-
24 clusion of gain from sale of principal residence).

1 adjustment in exclusion for computing minimum tax for
2 tax preferences) is amended to read as follows:

3 “(d) ADJUSTMENT IN EXCLUSION FOR COMPUTING
4 MINIMUM TAXES.—If a return is made for a short period
5 by reason of subsection (a), then—

6 “(1) the \$10,000 amount specified in section 56,
7 modified as provided by section 58, and

8 “(2) the \$10,000 amount specified in section 59
9 (a), modified as provided by section 59 (b),
10 shall be reduced to the amount which bears the same ratio to
11 such specified amount as the number of days in the short
12 period bears to 365.”

13 (4) Subsection (d) of section 511 (relating to tax
14 preferences) is amended by adding at the end thereof the
15 following new sentence: “The tax imposed by section 59
16 shall apply to an organization subject to tax under sub-
17 section (b) with respect to items which enter into the
18 computation of unrelated business taxable income.”

19 (5) Subsection (a) of section 901 (relating to
20 allowance of foreign tax credit) is amended by inserting
21 “or by section 59 (relating to separate minimum tax on
22 capital gains)” after “for tax preferences”).

23 (6) Paragraph (1) of section 6015 (c) (defining
24 estimated tax) is amended by striking out “section 56”
25 and inserting in lieu thereof “section 56 or 59”.

1 exchanged in a taxable transaction, for purposes of deter-
 2 mining gain or loss on the transaction (but for no other pur-
 3 pose) the indexed basis of the asset shall be substituted for its
 4 adjusted basis.

5 “(b) INDEXED ASSET.—

6 “(1) IN GENERAL.—For purposes of this section,
 7 the term ‘indexed asset’ means—

8 “(A) stock which is common stock or possesses
 9 most of the attributes of common stock,

10 “(B) tangible personal property, and

11 “(C) real property,

12 which has been held for more than 1 year and which is
 13 a capital asset or property used in the trade or business
 14 (as defined in section 1231 (b)).

15 “(2) CERTAIN PROPERTY EXCLUDED.—

16 “(A) IN GENERAL.—The term ‘indexed asset’
 17 does not include stock in—

18 “(i) an electing small business corporation
 19 (within the meaning of section 1371 (b)),

20 “(ii) a regulated investment company
 21 (within the meaning of section 851 (a)),

22 “(iii) a real estate investment trust (within
 23 the meaning of section 856 (a)),

24 “(iv) a foreign corporation, and

1 “(v) a personal holding company (as de-
2 fined in section 542).

3 “(B) COLLAPSIBLE CORPORATION.—In the
4 case of a sale, exchange, or distribution to which
5 section 341 (a) (relating to collapsible corporations)
6 applies, such transaction shall not be treated as a sale
7 or exchange of an indexed asset to which subsection
8 (a) applies.

9 “(c) INDEXED BASIS.—For purposes of this section—

10 “(1) INDEXED BASIS.—The indexed basis for any
11 asset is—

12 “(A) the adjusted basis of the asset, multiplied
13 by

14 “(B) the applicable inflation ratio.

15 “(2) APPLICABLE INFLATION RATIO.—The ap-
16 plicable inflation ratio for any asset is the percentage
17 arrived at by dividing—

18 “(A) the CPI for the calendar month in which
19 the sale or exchange takes place, by

20 “(B) the CPI for the calendar month in which
21 the holding period of the asset began (or, if later,
22 December 1979).

23 The applicable inflation ratio shall not be taken into
24 account unless it is greater than 1. The applicable infla-

1 tion ratio for any asset shall be rounded to the nearest
2 $\frac{1}{10}$ of 1 percent.

3 "(3) CPI FOR CALENDAR MONTH.—The CPI for
4 any calendar month is the Consumer Price Index for
5 All Urban Consumers for such month.

6 "(d) TAXABLE TRANSACTION.—For purposes of this
7 section, the term 'taxable transaction' means a sale or ex-
8 change in which gain or loss is recognized in whole or in
9 part to the person disposing of the asset.

10 "(e) SPECIAL RULES.—For purposes of this section—

11 "(1) TREATMENT AS SEPARATE ASSET.—In the
12 case of any asset, the following shall be treated as a
13 separate asset:

14 "(A) a substantial improvement to property,

15 "(B) in the case of a corporation, a substantial
16 contribution to capital or a substantial reduction
17 in capital,

18 "(C) in the case of a transaction in which gain
19 or loss is recognized only in part, that portion of the
20 asset to which the recognized gain or loss is properly
21 attributable, and

22 "(D) any other portion of an asset to the ex-
23 tent that separate treatment of such portion is ap-
24 propriate to carry out the purposes of this section.

1 “(2) ASSETS WHICH ARE NOT INDEXED ASSETS
2 THROUGHOUT HOLDING PERIOD.—

3 “(A) IN GENERAL.—The applicable inflation
4 ratio shall be appropriately reduced for calendar
5 months at any time during which the asset (or the
6 predecessor asset) was not an indexed asset.

7 “(B) CERTAIN SHORT SALES.—For purposes
8 of applying subparagraph (A), an asset shall
9 be treated as not an indexed asset for any short sale
10 period during which the taxpayer or the taxpayer’s
11 spouse sells short property substantially identical to
12 the asset. For purposes of the preceding sentence,
13 the short sale period begins on the day after the sub-
14 stantially identical property is sold and ends on
15 the closing date for the sale.

16 “(3) SECTION CANNOT INCREASE ORDINARY LOSS
17 UNDER SECTION 1231.—To the extent that (but for this
18 paragraph) this section would create or increase the net
19 ordinary loss to which the second sentence of section
20 1231 (a) applies, such second sentence shall not apply.
21 The taxpayer shall be treated as having a long-term
22 capital loss in an amount equal to the amount of the
23 net ordinary loss to which the preceding sentence applies.

24 “(f) SALES BETWEEN RELATED PERSONS.—

1 “(1) **IN GENERAL.**—This section shall not apply
2 to any sale or exchange between related persons.

3 “(2) **RELATED PERSONS DEFINED.**—For purposes
4 of this section, the term ‘related persons’ means—

5 “(A) persons bearing a relationship set forth
6 in section 267 (b), and

7 “(B) persons treated as single employer under
8 subsection (b) or (c) of section 414.

9 “(g) **REGULATIONS.**—The Secretary shall prescribe
10 such regulations as may be necessary or appropriate to carry
11 out the purposes of this section.”

12 (b) **CLERICAL AMENDMENT.**—The table of sections for
13 part II of subchapter O of chapter 1 is amended by striking
14 out the item relating to section 1024 and inserting in lieu
15 thereof the following:

 “Sec. 1024. Indexing of certain assets for purposes of deter-
 mining gain or loss.

 “Sec. 1025. Cross references.”

16 (c) **EFFECTIVE DATE.**—The amendments made by this
17 section shall apply to dispositions after December 31, 1979,
18 in taxable years ending after such date.

19 **SEC. 405. ONE-TIME EXCLUSION OF GAIN FROM SALE OF**
20 **PRINCIPAL RESIDENCE.**

21 (a) **GENERAL RULE.**—The section heading and sub-
22 sections (a) and (b) of section 121 (relating to gain from

1 sale or exchange of residence of individual who has attained
2 age 65) are amended to read as follows:

3 **"SEC. 121. ONE-TIME EXCLUSION OF GAIN FROM SALE OF**
4 **PRINCIPAL RESIDENCE.**

5 "(a) **GENERAL RULE.**—At the election of the taxpayer,
6 gross income does not include gain from the sale or exchange
7 of property if, during the 3-year period ending on the date
8 of such sale or exchange, such property has been owned and
9 used by the taxpayer as his principal residence for periods
10 aggregating 2 years or more.

11 "(b) **LIMITATIONS.**—

12 "(1) **DOLLAR LIMITATION.**—The amount of the
13 gain excluded from gross income under subsection (a)
14 shall not exceed \$100,000 (\$50,000 in the case of a
15 separate return by a married individual).

16 "(2) **APPLICATION TO ONLY 1 SALE OR EX-**
17 **CHANGE.**—Subsection (a) shall not apply to any sale
18 or exchange by the taxpayer if an election by the tax-
19 payer or his spouse under subsection (a) with respect to
20 any other sale or exchange is in effect.

21 "(3) **ADDITIONAL ELECTION IF PRIOR SALE WAS**
22 **MADE ON OR BEFORE JULY 26, 1978.**—In the case of
23 any sale or exchange after July 26, 1978, this section
24 shall be applied by not taking into account any election

1 made with respect to a sale or exchange on or before
2 such date."

3 (b) TECHNICAL AND CONFORMING AMENDMENTS.—

4 (1) Paragraph (1) of section 121 (d) is amended
5 by striking out "age, holding, and use" each place it ap-
6 pears and inserting in lieu thereof "holding and use".

7 (2) Paragraph (2) of section 121 (d) is amended—

8 (A) by striking out "8-year period" and in-
9 serting in lieu thereof "3-year period", and

10 (B) by striking out "subsection (a) (2)" each
11 place it appears and inserting in lieu thereof "sub-
12 section (a)".

13 (3) Paragraph (3) of section 121 (d) is amended
14 by striking out "subsection (a) (2)" each place it ap-
15 pears and inserting in lieu thereof "subsection (a)".

16 (4) Paragraph (5) of section 121 (d) is
17 amended—

18 (A) by striking out "8-year period" and insert-
19 ing in lieu thereof "3-year period", and

20 (B) by striking out "5 years" and inserting in
21 lieu thereof "2 years".

22 (5) Paragraph (7) of section 121 (d) is amended
23 to read as follows:

24 "(7) SECTIONS 1033 AND 1034 NOT TO APPLY
25 TO SALES TO WHICH THIS SECTION APPLIES.—Sections

1 1033 (relating to involuntary conversions) and 1034
 2 (relating to rollover of gain on sale of principal resi-
 3 dence) shall not apply to any sale or exchange of a resi-
 4 dence with respect to which an election under this
 5 section applies.”

6 (6) The table of sections for part III of subchapter
 7 B of chapter 1 is amended by striking out the item
 8 relating to section 121 and inserting in lieu thereof the
 9 following:

“Sec. 121. One-time exclusion of gain from sale of principal
 residence.”

10 (7) Paragraph (3) of section 1033 (g) (relating to
 11 cross references) is amended to read as follows:

“(3) For one-time exclusion from gross income of
 gain from involuntary conversion of principal residence,
 see section 121.”

12 (8) Subsection (k) of section 1034 (relating to
 13 cross references) is amended to read as follows:

14 “(k) CROSS REFERENCE.—

“For one-time exclusion from gross income of gain
 from sale of principal residence, see section 121.”

15 (9) Section 1038 (e) (1) (A) is amended by striking
 16 out “relating to gain from sale or exchange of residence
 17 of an individual who has attained age 65” and inserting
 18 in lieu thereof “relating to one-time exclusion of gain
 19 from sale of principal residence”.

20 (10) Section 1250 (d) (7) (B) is amended by strik-

1 ing out "relating to gains from sale or exchange of
 2 residence of individual who has attained the age of 65"
 3 and inserting in lieu thereof "relating to one-time exclu-
 4 sion of gain from sale of principal residence".

5 (11) Section 6012 (c) is amended by striking and
 6 "relating to sale of residence by individual who has
 7 attained age 65" and inserting in lieu thereof "relating
 8 to one-time exclusion of gain from sale of principal
 9 residence".

10 (c) EFFECTIVE DATE.—The amendments made by this
 11 section shall apply to sales or exchanges after July 26, 1978,
 12 in taxable years ending after such date.

13 **SEC. 406. WAIVER OF CERTAIN 18-MONTH RULES OF SEC-**
 14 **TION 1034 WHEN SALE OF RESIDENCE IS CON-**
 15 **NNECTED WITH COMMENCING WORK AT NEW**
 16 **PLACE.**

17 (a) IN GENERAL.—Subsection (d) of section 1034
 18 (relating to sale or exchange of residence) is amended to
 19 read as follows:

20 "(d) LIMITATION.—
 21 "(1) IN GENERAL.—Subsection (a) shall not apply
 22 with respect to the sale of the taxpayer's residence if
 23 within 18 months before the date of such sale the tax-
 24 payer sold at a gain other property used by him as his

1 principal residence, and any part of such gain was not
 2 —recognized by reason of subsection (a).

3 “(2) **SUBSEQUENT SALE CONNECTED WITH COM-**
 4 **MENCING WORK AT NEW PLACE.**—Paragraph (1) shall
 5 not apply with respect to the sale of the taxpayer’s resi-
 6 dence if—

7 “(A) such sale was in connection with the com-
 8 mencement of work by the taxpayer as an employee
 9 or as a self-employed individual at a new principal
 10 place of work, and

11 “(B) if the residence so sold is treated as the
 12 former residence for purposes of section 217 (relat-
 13 ing to moving expenses), the taxpayer would satisfy
 14 the conditions of subsection (c) of section 217 (as
 15 modified by the other subsections of such section).”

16 (b) **RELATED TECHNICAL AMENDMENT.**—Paragraph
 17 (4) of section 1034 (c) is amended by adding at the end
 18 thereof the following new sentence: “If a principal residence
 19 is sold in a sale to which subsection (d) (2) applies within
 20 18 months after the sale of the old residence, for purposes of
 21 applying the preceding sentence with respect to the old resi-
 22 dence, the principal residence so sold shall be treated as the
 23 last residence used during such 18-month period.”

24 (c) **CLERICAL AMENDMENTS.**—

1 (1) The section heading of section 1034 is amended
2 to read as follows:

3 “SEC. 1034. ROLLOVER OF GAIN ON SALE OF PRINCIPAL
4 RESIDENCE.”

5 (2) The table of sections for part III of subchapter
6 O of chapter 1 is amended by striking out the item relat-
7 ing to section 1034 and inserting in lieu thereof the fol-
8 lowing new item:

 “Sec. 1034. Rollover of gain on sale of principal residence.”

9 (3) Subparagraph (B) of section 1038(e) (1)
10 (relating to certain acquisitions of real property) is
11 amended by striking out “(relating to sale or exchange
12 of residence)” and inserting in lieu thereof “(relating to
13 rollover of gain on sale of principal residence)”.

14 (4) Subparagraph (A) of section 1250(d) (7)
15 (relating to gain from dispositions of certain depreciable
16 realty) is amended by striking out “relating to sale or
17 exchange of residence” and inserting in lieu thereof
18 “relating to rollover of gain on sale of principal
19 residence”.

20 (5) Subparagraph (C) of section 6212(c) (2)
21 (relating to cross references) is amended by striking out
22 “personal residence” and inserting in lieu thereof “prin-
23 cipal residence”.

24 (6) Paragraph (4) of section 6504 (relating to

1 cross references) is amended by striking out "residence"
2 and inserting in lieu thereof "principal residence".

3 (d) EFFECTIVE DATE.—The amendments made by this
4 section shall apply to sales and exchanges of residences after
5 July 26, 1978, in taxable years ending after such date.

6 **SEC. 407. STUDY OF EFFECTS OF CHANGES IN THE TAX**
7 **TREATMENT OF CAPITAL GAINS ON STIMULAT-**
8 **ING INVESTMENT AND ECONOMIC GROWTH.**

9 Not later than September 30, 1981, the Secretary of the
10 Treasury shall submit to the Committee on Ways and Means
11 of the House of Representatives and to the Committee on
12 Finance of the Senate a report on the effectiveness of the
13 changes made by this title in the tax treatment of capital gains
14 of individuals and corporations in stimulating investment
15 and increasing the rate of economic growth. The report shall
16 also include an analysis of the effects these changes had on
17 employment growth and on income tax revenues.

Passed the House of Representatives August 10, 1978.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

The CHAIRMAN. I will submit a very brief opening statement for record and I would urge everybody else to do the same if they would, please, so we could get on with the Secretary's statement.

Senator HANSEN. Mr. Chairman, on behalf of Senator Curtis who cannot be here, I submit his opening statement to submit for the record, also.

[The material referred to follows:]

OPENING STATEMENT OF SENATOR LONG

This morning the Committee on Finance begins hearings on H.R. 13511, the Revenue Act of 1978. This bill provides significant tax reductions for individuals and corporations, contains important provisions to stimulate investment and employment, and reduces effective capital gains tax rates.

We look forward to hearing the many suggestions of witnesses on ways we can improve on what the House has done. Our first witness will be Hon. W. Michael Blumenthal, Secretary of the Treasury.

STATEMENT OF SENATOR CARL T. CURTIS

Mr. Chairman, it gives me great pleasure to participate in the opening of hearings on H.R. 13511. This is a historic occasion. This bill represents a move toward true tax reform as contrasted with income distribution schemes which have been offered in the past in the name of tax reform.

While the bill provides some needed tax reduction to individuals and corporate taxpayers I am confident that under the leadership of Chairman Long we can improve upon a good beginning.

The provisions relating to capital gains are one of the most important pieces of legislation to be considered by Congress in several years. From a policy standpoint it is a welcome relief to see the Congress finally make the distinction between capital and income and between economic gain and inflation.

Finally, it is refreshing to see that the economic community, to a large extent, have now come to realize that taxes have an impact on economic decisions and a tax reduction often will provide a net gain in Federal revenues.

This bill before us represents a departure from past tax bills and is a step toward economic growth, a trend that should be welcomed and encouraged.

STATEMENT BY SENATOR FLOYD K. HASKELL

On July 14 of this year I sat in this room and talked about the most serious domestic problem our country faces: inflation.

Our Nation's economic outlook has changed dramatically in the past several months.

In 1975 unemployment was 8.5 percent. Industrial plant capacity in 1975 fell below 70 percent. We took steps to stimulate economic recovery. Our most important goal was to reduce unemployment and stimulate economic growth. These were sound economic steps at that time.

Today conditions are different. Now unemployment is 6.2 percent. Industrial plant utilization is over 84.1 percent. Yet today we are considering the same policy we advocated in 1975—tax cuts and deficit spending. It's time to recognize that the economic remedies necessary in 1975 are not the economic remedies necessary in 1978.

Reducing deficit spending and moving toward a balanced budget is one weapon in our hands to reduce inflation. Cutting taxes does not stop inflation. But reducing inflation will stop the increase in taxes.

The American public is tired of inflation. A whole generation of Americans is beginning to feel that it may never achieve financial security. Prices of the basic necessities of life—food, energy, housing, medical care—are rising faster than anything else.

I believe we are missing the mark. What is needed now is a new economic focus. There are several steps Congress could take that would be a major step toward bringing inflation under control.

First, we should delay the scheduled Social Security tax increases, as recommended by Senator Nelson. I voted against these increases last year and putting

them into effect now would only add to inflation. Anticipated increases in social security taxes will merely cause prices to rise as the cost of labor rises. If we can impose a three year moratorium on the social security increases, we can give ourselves a chance to study the problems of this complex system and come up with a better solution—rather than directly increasing labor costs in an inflationary period.

Secondly, we should cut federal spending by three to five percent. Such a move would not scar important federal programs but would cut the fat from the budget the bureaucrats build in each year. Such a cut would reduce the federal deficit by at least \$15-billion.

Thirdly, we should reject the tax cuts being proposed today, and maintain the 1975 tax reduction. By enacting a tax cut such as adopted by the House, we are promising the American public a short-term reduction in their taxes, without telling them that the result will be a further loss of buying power in the long run. Commonsense tells us that in today's economy, increasing purchasing power—which a tax cut does—only fuels inflation.

An income tax cut of the magnitude suggested by the House or the Administration will require more deficit spending and will take us further and further away from balancing the budget. Further deficit spending in an inflationary period will have the effect of forcing the Federal Reserve to deflate the economy through monetary policy. The expansion we desperately need in our economy will be deterred by higher interest rates, thus defeating any stimulative effect a tax cut might have.

The maxim is simple: unless Congress controls inflation through restrained fiscal policy, the Federal Reserve will "deflate" the economy through restrictive monetary policy. Restrictive monetary policy has induced two recessions this decade. The fact that mortgage interest rates have now reached an all-time high should warn us that we must send a signal to the Federal Reserve that Congress is willing to moderate fiscal policy.

If we want a vote of confidence from business, we must create confidence again in the dollar and the economy. What better message can we send the business community than a first step at balancing the budget. Now that is a green light for expansion.

A reduction in federal spending, and a rejection of the tax cut together with a rollback of the Social Security taxes would demonstrate to the American people that Congress is serious about cutting inflation. These moves would demonstrate to a world that has lost confidence in the American dollar that we intend to change that reality.

I believe the American people are willing to sacrifice a tax cut if it will help our battle against inflation, and if Congress can cut federal spending.

And, if the American people are willing to sacrifice a tax cut if it will help our battle against inflation, and if Congress can cut federal spending.

And, if the American people know we are committed to fighting inflation and balancing the federal budget, they will join that fight wholeheartedly.

Senator ROTH. Mr. Chairman, I have a very brief statement, if I could take the liberty of reading it.

The CHAIRMAN. How about summarizing it, Senator.

Senator ROTH. It is only one page.

Mr. Chairman, as we begin the hearings on the House-passed tax bill, I believe it is essential to emphasize that the House tax bill is not a tax cut bill at all. If this bill is enacted, virtually every working American will pay higher taxes next year.

Neither the House tax bill nor the administration's tax bill would offset the massive new social security tax increases and the automatic tax increases caused by inflation.

According to the Joint Committee on Taxation, social security and inflation tax increases will amount to at least \$20 billion next year. Within 5 years, these tax increases will soar to more than \$100 million per year.

Now, the House bill seeks to take care of business and it seeks to take care of investors. But the House bill shortchanges the individual taxpayers of this country.

I believe we need a real tax cut to offset the massive tax increases and to reduce the tax burden on the working men and women of this country.

The Roth-Kemp bill is just such a tax cut, one that can restore incentive to our stagnant economy, creating real economic growth and meaningful jobs. The basic thrust of this administration's economic policy is to fight inflation by slowing economic growth and permitting taxes to increase.

Roth-Kemp signals a new economics based upon lower taxes and real economic growth without inflation.

Thank you, Mr. Chairman.

The CHAIRMAN. I have a chart here that I was going to ask the Secretary about during the course of his testimony. The chart indicates that even after you allow for the social security tax increase and after you allow for inflation, there is a net tax cut over and above those two elements for a family of 4 with income from \$12,500 up to \$17,500, but not for families in higher brackets, that is, in the middle income brackets. If we have enough budget authority, we should make this a tax cut for everybody, I would hope that we can change the bill so it will be a tax cut for everybody.

Now, I know we have enough room within the budget to cover the social security tax increase, and my hope is that we have enough slack within the budget resolution to take care of inflation as well for all taxpayers. That is something we will have to ask the Secretary about as the matter goes along.

Mr. Secretary, we are pleased to have you with us, and we will certainly welcome your statement.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Secretary BLUMENTHAL. Thank you, Mr. Chairman and distinguished members of the committee. We have submitted a rather detailed, formal document with my testimony on this important matter. It is of great significance to the economy and to all taxpayers. I will not suggest that I read all of it, Mr. Chairman.

I do want to read some portions of it, somewhat more than I normally do, because of its importance, but I will be summarizing others with your permission, so that we can get on with the questioning.

The committee begins consideration today of H.R. 13511, the Revenue Act of 1978. This bill recently adopted by the House of Representatives would reduce tax liabilities by \$16.3 billion in calendar year 1979. Of this amount, \$10.4 billion is attributable to personal tax relief, \$4 billion to business tax reductions, and \$1.4 billion to a cut in capital gains tax.

My testimony will assess the House-passed bill in light of the objectives outlined in the President's tax message last January. One goal emphasized by the President is to provide substantial tax relief for individuals, particularly those in the low and middle income categories.

Another objective is to furnish sufficient investment incentives that encourage business to modernize productive facilities and to create permanent, meaningful jobs. We also believe that the income tax

structure should be improved through forms that make the system more equitable and simpler for the average taxpayer.

H.R. 13511 takes some steps toward these goals, but there is substantial room for improvement. The size of the net tax reduction, about \$16 billion, is within a reasonable range of tax cuts that will maintain growth without increasing inflationary pressure. Moreover, the bill's split between personal and business relief is acceptable.

But we do not like the distribution of the cuts among taxpayers. In my statement, I will describe ways in which we believe the relief can be distributed more equitably.

I will also suggest, Mr. Chairman, additional structural tax changes for the committee's consideration.

We are pleased that the House adopted some of the reform proposals recommended by the President. The bill includes new tax shelter restrictions, simplification of the itemized deductions schedule, elimination of the tax exclusion for unemployment benefits at high income levels, and repeal of the special alternative tax ceiling on the capital gains interest in the top rate bracket.

We urge the committee to build upon these reforms now contained in H.R. 13511.

I think, Mr. Chairman, in this regard, the results of a recent Roper survey are illuminating, for they indicate that the American public considers tax reform the third most pressing national problem ranking behind only controlling inflation and lowering the crime rate.

And, significantly, tax reform to the Roper respondents is equated much more frequently with tax fairness and with tax reductions. I think this expression of public sentiment is a matter which would provide a useful guide for your consideration.

I do want to spend a minute, Mr. Chairman, on the economic situation and the need for prudent tax reduction, including the size of the tax reduction.

Evaluation of the present situation clearly is required in the general economy. In many ways, our economy has performed remarkably well over the past year and a half. The unemployment rate has dropped from 7.8 percent at the end of 1976 to 6.2 percent in July of this year. Almost 6 million more people are employed now than were employed at the beginning of this administration, and a larger percentage of the working age population now holds jobs than ever before.

So in the fourth year of our recovery from recession, we are still expanding at a real growth rate of about 4 percent.

To maintain this recovery, tax policy must take account of several factors. In 1979, social security tax liabilities will be increased over 1977 levels by \$4 billion due to previously scheduled rate increases, and by an additional \$7 billion due to changes enacted in 1977. Other tax increases will result as a higher cost of living pushes individuals into higher rate brackets without increasing real income.

An income tax cut in 1979 will help to compensate for these factors and thereby maintain adequate purchasing power to continue our economic growth.

Perhaps the most significant risk in the economic outlook is inflation, and I would say, Mr. Chairman, I would strike the word "perhaps." It is the most significant risk in our economic output.

Over the first half of 1978, the consumer price index has risen at an annual rate exceeding 10.4 percent. We believe that the inflation rate for the second half of this year will be substantially lower, I would estimate by about one-third, to between 6 and 6.5 percent, and that the annual rate will be more moderate in 1979 for the year as a whole than it is for 1978 as a whole.

Nevertheless, inflation will continue to be a troublesome problem. It is, therefore, our No. 1 concern.

In recognition of the need to restrain inflationary pressures, the administration has called for a reduction in the size of the 1979 tax cut from the \$25 billion originally recommended in January to \$20 billion.

Moreover, we have urged Congress to trim an additional \$5 billion from Federal budget outlays for fiscal 1979 in order to reduce the deficit for that year to \$43.5 billion. That kind of budgetary restraint, in our view, is essential under these circumstances.

Tax and budget policy must address another threat to continued economic recovery and that is sluggish business investment. Investment and new plant and equipment now accounts for only one-tenth of our Nation's real gross national product, a much smaller share than is needed to provide the tools of production for a full employment economy in the 1980's.

Manufacturing capacity has increased at an annual rate of only 3 percent over the past 4 years, as opposed to a 4½-percent capacity growth rate during the postwar period through 1973.

Incentives in the form of business tax cuts are needed to improve this disappointing record of business fixed investment and to avoid inflationary capacity bottlenecks in the years ahead.

We believe that the tax reduction contained in the House bill for 1979 represents generally an appropriate fiscal response to these economic concerns. The magnitude of the cut is about \$1.2 billion less than that recommended by the administration.

Tax relief of this size would help maintain the recovery without bloating the deficit and exacerbating inflation.

We recommend that the Finance Committee adopt a tax cut of approximately the same magnitude.

A tax cut substantially larger than that in the House bill would create serious risks for our economic recovery, in particular for inflation. Whatever temporary benefits might be obtained through a lower tax burden would be quickly negated by the resulting rise in prices and interest rates.

Increased after-tax incomes for individuals would be illusory and the tax incentives for business investment and job creation would be undermined. These economic risks should not be taken. We ask this committee not to adopt a significant increase in the tax reduction over that now contained in H.R. 13511.

Let me then, briefly, turn to the tax relief for individuals as the first specific item, Mr. Chairman.

I would hope that the Committee would bear in mind, in dealing with individual tax cuts, that, above all, what we must do is to maintain the fundamental principle of tax equity that individuals are taxed in accordance with the ability to pay. That is a principle which is deeply embedded in our tax system, and has been for a good many years, and it should be maintained.

In our view, that means that tax reduction should be focused primarily on people in the middle and in the lower income brackets, although not exclusively so.

The tax bill that has been adopted by the House does not adequately respond to this principle of tax equity, in our view. The changes that have been made in the House may, in the abstract, appear to have merit but if you examine them, you see the obvious inequities.

According to that bill, a typical four-person family with wages of \$10,000 would receive an income tax reduction of only \$62. That is a cut that is one-fifteenth the size of the reduction provided to a family with a salary 10 times as large. Relief for the typical four-person family of \$20,000 income level is less than one-sixth the tax cut enjoyed by a \$100,000 income family.

It is also important to recognize, Mr. Chairman, that these figures relating to the personal income tax relief that I have cited do not include the impact of the reduction in capital gains taxes that is included in the House bill. It is natural that capital gains tax reductions tend to benefit primarily higher income groups. That means that if that is factored in, the regressive nature of the tax cut as the House has presented it is intensified.

As you know, we supported in the House the Fisher-Corman substitute that would have emphasized greater tax cuts for people up to \$50,000, and clearly those are not only the lower, but also the middle level of taxpayers. We would strongly urge that the committee, in reviewing the individual tax cuts, take a close look at what is happening to people up to \$50,000 of income and distribute the individual tax cuts in such a way as to provide an equitable distribution of the available resources in that regard.

In considering how to do this, Mr. Chairman, you are obviously aware that there are two ways of doing this. One is by rate changes and the other is by deciding on the size of the exemption or credit for dependents. Neither of these factors can be viewed in isolation. You have to take the two factors together, either the exemption or the credit, together with the kind of rate cut that you have in order to get to a final result on the distribution, and to get the proper degree of progressivity.

In that regard, we suggest, Mr. Chairman, that a \$240 credit for each dependent be combined with generous rate cuts in the middle income bracket to achieve the recommended distribution.

The new credit, \$240, would replace the current \$750 exemption for each dependent and the general tax credit, which is equal to the greater of \$35 per dependent or 2 percent on the first \$9,000 of taxable income.

By eliminating this complicated scheme, you would also do a great deal to contribute to the simplification in the tax schedules and help individuals in filling out their forms.

Let me now turn quickly to changes in the itemized deductions. The House has responded favorably to a number of the personal tax changes that were recommended by the President. Amongst those were a number of proposals for changes in simplification and itemized deductions, and we ask this committee, Mr. Chairman, to accept these provisions in order to continue the tax simplification efforts which began last year.

In the Tax Reduction and Simplification Act of 1977, Congress worked with the administration to enact changes that incorporated the standard deduction in the tax table, lessen the number of computations made by taxpayers, and simplify the total reporting and recordkeeping burden.

As a result of these changes, approximately 40 percent of all individual taxpayers were able to file a short form 1040A for tax year 1977, and the number of lines on that form was reduced from 25 to 15. The error rate of taxpayers has decreased dramatically from 9.1 percent to 6.5 percent for the long form and from 12 percent to 5.1 percent for the short form.

We have received encouraging indications from taxpayers that they like this simplification. I hope this committee can help in continuing that trend.

State and local taxes which would be eliminated according to 13511 of the House bill refer primarily to the deduction of State and local gasoline taxes, and we hope that you will accept that particular proposal. We also recommend, Mr. Chairman, that this committee decides to eliminate the special deduction for general sales taxes as well as personal property tax and miscellaneous tax, while retaining the State and local income and real property taxes, the deductions for those.

By extending H.R. 13511 to remove deductions for these other forms of State and local taxes, the committee could achieve further simplification, and tax increases could be avoided by using the revenue raised from these changes to provide larger tax reductions in the schedule.

We are gratified that the House has approved and adopted the Administration's proposal to simplify the confusing scheme for deductions and credits for political contributions, and I hope that that will be retained by this committee also.

Similarly, we feel that the current provision for medical deductions is unnecessarily complicated. There are 12 lines on schedule A of form 1040 which we are devoted to computation for deductions for dental and medical expenses alone. Currently, one-half of the first \$300 of health insurance premium is deductible outright for those who itemize. Other medical expenses are deductible to the extent that they exceed 3 percent, and so forth.

The House has accepted the President's proposal to treat medical insurance premiums, drugs and medicines, in one manner, in the same manner. All of these expenditures would be subject to one floor in the House bill—3 percent of adjusted gross income. We think that this change would simplify the return preparation. However, for those who now itemize their medicines and drugs, the House bill would have the effect of reducing the overall floor from 4 to 3 percent, and this change would increase, would offset it, and increase the number of itemizers.

We therefore think that the committee may wish to consider additional simplification measures in this area and take a look at the kind of floor that should be adopted. Possibly, a 5-percent floor would be more appropriate to the situation that can be judged to be normal on the one hand and abnormal on the other.

The House also adopted the administration's recommendation with regard to taxing unemployment compensation for those persons who have incomes, that in the case of individuals are above \$20,000 and for a married couple are above \$25,000. Under the bill, 50 cents of unem-

ployment compensation would be taxed for every dollar of taxable income above the ceiling, and we recommend that that be retained in your version of the bill as well.

As to the earned income credit action that was taken by the House, we similarly recommend that that be retained. We agree with the House version on this.

On deferred compensation arrangements as contained in the House bill, we agree with what has been done. We would like to work with the committee on further technical changes that we think would be desirable.

Let me then turn to the next important area, Mr. Chairman; namely, that relating to tax shelters. It is an important area because it has been recognized by the Congress and by this committee over a good many years. It is tax shelters—the ability for some individuals to shelter much or all of their income from taxation—that has caused the greatest concern among the average taxpayers and the kind of feeling, even to some extent unjustified feeling, that there are a large number of people who pay no taxes. That number has been decreasing.

We have a report that has recently been put out on that, a subject which I believe you have seen, but certainly there are still many individuals who pay virtually no tax, or very little tax, and who are in high brackets.

And therefore, the continued tightening in the tax shelter area is an important consideration, and I hope you will look at it carefully.

These are devices used by taxpayers to generate artificial paper losses to offset income from other sources. There are at least two undesirable byproducts of this kind of activity. First, this kind of avoidance by high income persons is demoralizing to the average taxpayer who bears a substantial tax burden on all other income. Secondly, many shelter activities drain investment funds from productive enterprises into schemes designed primarily to generate tax loss. I think all of us have had the experience of being approached with all kinds of schemes that have no other purpose than to figure out how you might avoid paying taxes to the Federal Government.

I have had occasion to look at many of these. I have known many persons who have invested in these kinds of things. The irony of it is, while they avoid paying taxes, they generally lose their money some other way by investing in some of these harebrained schemes.

I think we would do much better, Mr. Chairman, if we just eliminated and tightened up on the possibility of doing this in the first place.

In an effort to combat these various new shelter devices, Mr. Chairman, the House adopted an extension of the current at-risk rules recommended by the President. The at-risk limitation denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability.

The 1976 act extended coverage only to partnerships and to a few specialized activities of individuals. Under the House bill, the at-risk rule would be broadened to cover all activities except real estate carried on individually, through partnership, or by corporation controlled by five or fewer persons. This important provision in H.R. 13511 should be retained.

The President has also recommended that the Internal Revenue Service be authorized to implement tax audits of partnerships and to resolve tax issues at the partnership level rather than being forced to proceed against each partner individually.

H.R. 13511 now contains only minor portions of the President's proposal. He would like to work with you to adopt additional portions of the administration's partnership audit proposal.

Let me now turn to entertainment expenses. I will not go into the justification that motivated the administration to recommend in the original legislation that the allowance for the deductibility for various kinds of entertainment expenses be substantially tightened. None of these provisions are contained in H.R. 13511. We continue to believe that these proposals are in accord with sound principles of tax policy and, more importantly, that they address the overwhelming sentiment of the American public.

I referred earlier to the Roper poll. The Roper poll clearly indicates that most people feel that way.

If this committee, in considering this, does not wish to go all the way along the line of what the administration has proposed, we do urge that you take account of the attitude of taxpayers and at least deny a deduction for the expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and the fees paid to social athletic or sporting clubs.

Let me now turn to corporate rate reductions. The present law taxes the first \$25,000 of corporate income at a 20-percent rate and the second \$25,000 of income at 22 percent with income over \$50,000 being taxed at a 48-percent rate.

The House bill provides a corporate rate schedule that is much more steeply graduated than the current rate structure and, in fact, taxes corporate income at the full rate, now reduced to 46 percent, only at \$100,000.

We certainly would prefer to provide relief to small business, genuine small business, in other ways. We think that this graduation at the bottom is really what has been referred to in the literature as the ultimate tax haven, tax shelter, for a high income individual. We have done a number of studies to indicate in what tax brackets shareholders and small corporations are. We find that shareholders and small corporations frequently, or generally, are in higher tax brackets than those, for example, receiving dividends from corporations as a whole. We do not believe that graduation of this kind at the bottom above \$50,000 really helps small business. We do have some proposals, some of which have been adopted by the House, that we feel are of better help to small business. We certainly feel that this committee should not go beyond the graduation up to \$100,000 as it has been proposed in the House bill.

There are a number of other items which I have commented on in my prepared testimony but which I will skip, Mr. Chairman. They relate to the investment tax credit on which the House took some action that we agree with. They relate to industrial development bonds and small issue exemptions for economically distressed areas. I think the documents that I have prepared speak for themselves.

I would like to briefly mention that we do support generally the targeted job tax credit provision that is in the House bill. That is in

line with our own proposals. We think that this targeting of the existing job tax credit will be of help to small business, will be of help in providing additional employment for people and therefore, we hope that you will also accept it.

Turning now to the small business proposal, as I said a moment ago, Mr. Chairman, that there are a number of ways in which small business each be genuine helpful.

Therefore, we urge the committee to retain in H.R. 13511 two provisions recommend by the President to provide specific relief to small corporations. The first of these is the subchapter S rule that treats certain corporations as partnerships and that would be simplified and liberalized under the House bill.

The second relating to risk taking would be encouraged by doubling, from \$500,000 to \$1 million, the amount of a small corporation's stock that could qualify for special ordinary loss treatment, and by doubling from \$25,000 to \$50,000 the amount of losses that can be claimed by any taxpayer with respect to such stock and by eliminating several other technical requirements that needlessly restrict the ability of small businesses to use this provision.

We do not support a provision in the House bill that increases the first year depreciation allowance for certain businesses. Under the House bill, the maximum allowance of first year bonus depreciation that could be taken would be increased from \$2,000 to \$5,000 and this special provision would be limited for the first time to taxpayers with less than \$1 million of depreciable property.

This new depreciation provision would add further complications to a system that is already quite confusing to many small businesses. Far more valuable assistance can be provided to businesses by simplifying the depreciation calculation that must now be made.

We repeat here our recommendation outlined in H.R. 12078 for a new simple table for equipment depreciation tantamount to a streamlined ADR system for small business.

I will not comment on the farm accounting provisions. I think they are clear as to my testimony.

Let me then turn to the domestic international sales corporations. Mr. Chairman, we had recommended, in the original proposal by the administration, that this particular provision for the DISC be eliminated primarily because we have found that it is quite expensive. There is a lot of revenue loss to the Treasury involved in this, and it has not resulted, in our judgment, in increases in exports in any way commensurate to this very large loss of revenue.

We do need to stimulate exports. The current DISC provision is the wrong approach.

If a DISC program is going to be maintained, Mr. Chairman, we would like to work with you to focus it more effectively. Many DISC benefits now go to exporters with large profit margins, companies that would obviously be exporting in the absence of any special incentive. The committee therefore may consider the elimination of the 50-50 rule that commits one-half of those large profits to be allocated to DISC.

Another possible restriction might place a dollar limitation on DISC benefits, in order to target the relief to small companies that may experience difficulties entering the export market. What we want

is to encourage middle and smaller business, help them get into the export market for the first time.

The large corporations of this country know all about exports, are intimately involved in it, and DISC is really very little more than a windfall for many of them.

I now return to the much-discussed subject of capital gains, Mr. Chairman. H.R. 13511 contains significant changes in the tax treatment of capital gains. Following a recommendation of the President, the House bill would have repealed the special 25-percent alternative tax that now applies to the first \$50,000 of capital gains of high-income individuals.

A one-time exclusion will be permitted for up to \$100,000 of gain on the sale of a principal residence. The bill would also eliminate capital gains as an item of tax preference for purposes of the individual and corporate minimum tax, and as a preference offset to the amount of personal service income eligible for the 50-percent maximum tax ceiling.

Capital gains in excess of \$20,000 would be subject to a new alternative minimum tax of 5 percent, if that tax exceeded regular tax liability.

Finally, in determining capital gains or losses, an inflation adjustment would be provided after 1979 for common stock, for real estate and tangible personal property only. Taken together, these changes would reduce capital gains tax liabilities by \$1.9 billion in 1979 with that figure expanding to nearly \$7 billion in 1980.

Mr. Chairman, as we have indicated in the past, we had recommended other forms of providing tax relief for the income from capital gains. If capital gains relief is to be chosen, we recommend that consideration of several modifications in the House-passed version of H.R. 13511 be considered and enacted by this bill.

First, to limit tax avoidance by wealthy individuals, a reasonable alternative minimum tax on large capital gains should be adopted in place of the token, what we have called "micro-mini tax" in the House bill.

Second, the existing minimum tax on the capital gains of corporations should be retained.

Third, the exclusion for residences might be altered to reduce the revenue loss.

Fourth, the special inflation adjustment for certain capital gains and certain capital assets should be eliminated.

I think it is important, Mr. Chairman, that I comment briefly on the reasons for each of these four recommended changes in the House bill that we are making to you.

As to the adoption of a true alternative tax on capital gains, in attempting to provide relief for persons with significant capital gains tax liabilities, the House created an undesirable byproduct. Their bill would exacerbate the problem of tax avoidance by wealthy individuals making extensive use of tax shelters. Eliminating the current minimum tax provisions would reduce the top rate on capital gains to 35 percent. That result appears to be the objective sought by the House.

But the replacement of the current minimum tax with the new micro-mini tax also has the effect of reducing from 7.5 percent to 5

percent the maximum capital gains tax rate paid by individuals who have completely sheltered millions of dollars of capital gains taxes from regular tax liability. The present minimum tax with a modest income on sheltered capital gains would be diluted, by reducing it from 7.5 percent to 5 percent.

An example derived from actual tax files may help to illustrate the increased sheltering opportunities that would be available under the House bill. Let me emphasize that it is available only for the very highest income brackets.

An individual with \$2,184,982 of capital gains uses \$1,095,057 of shelter losses to eliminate all regular tax liability. The regular tax that would normally be paid on one-half of capital gains—\$1,092,491—is offset completely by the tax loss.

Under current law, he would pay at least a minimum tax of \$160,984 on that over \$2 million gain, so that he would have an effective tax rate on all of his capital gains of 7.4 percent. If the micro-mini tax in the House bill were adopted in place of the current minimum tax, this person's minimum tax liability would fall to \$108,249, a tax rate of less than 5 percent on capital gains exceeding \$2 million.

Viewed in the context of the other capital gains changes in H.R. 13511, there is no justification for an alternative minimum tax that is so insignificant. The current minimum tax rate was kept low because it affects unsheltered taxpayers. It can add several percentage points to an effective tax rate that is already substantial.

If the current add-on minimum tax of capital gains is eliminated in favor of an alternative tax approach, a graduated alternative minimum tax can be adopted so that persons with very large capital gains would have to pay more than a token 5- or 7.5-percent tax.

Such a graduated true alternative tax is reflected in the amendment we supported on the House floor—the Corman-Fisher approach—and it is an approach that we commend to this committee.

This amendment would affect only persons with ordinary losses exceeding ordinary income. For those individuals, the true alternative tax would simply require that ordinary losses be offset against capital gains before the special capital gains tax deductions—that is, half of the total gain is applied.

This new limitation would never reduce the amount of the special gains tax deduction below \$5,000, nor would it apply in a manner to reduce the benefit of charitable deductions.

This true alternative tax approach would provide a much more reasonable minimum tax liability for the individual described earlier who has sheltered over \$2 million of capital gains from all regular tax liability. He would be required to pay tax on about one-fourth of his total capital gains.

Rather than paying a micro-mini tax of \$108,249 as imposed under the House bill, this taxpayer's liability would be \$345,628 under the true alternative tax.

The effective tax rate on \$2 million of capital gains would be nearly 16 percent under this amendment. Hardly an extraordinary amount of tax, Mr. Chairman, if we consider that we pay up to 50 percent of earned income at much lower levels than \$2 million and that on unearned income, we pay a marginal rate of 70 percent. I do not

shudder at the thought of a 16-percent tax rate for someone declaring a \$2 million gain.

Mr. Chairman, you and other members of this committee have played an instrumental role in developing the minimum tax concept, an effort to minimize the extent to which high income taxpayers can use various preferences to eliminate all or most tax liability.

The Treasury Department will release today its high income report for the tax year 1976. This report will show that provisions in the tax reform act of 1976 have succeeded in reducing dramatically the number of high-income nontaxable returns.

In 1976, the number of nontaxable returns for individuals with expanded incomes of over \$200,000 fell by 75 percent, from 210 in 1975 to 53 in 1976. The number of nontaxable individuals with adjusted gross income over \$200,000 fell from 260 to 22, a decrease of over 90 percent.

The results of this report should not lead to complacency, however, for there are still nontaxable returns with high economic incomes that, for various reasons, do not fit into the categories of expanded income, or adjusted gross income. Moreover, for every nontaxable high-income return, there are still 10 or more nearly nontaxable returns, where income has been reduced by more than 80 percent by use of preferences, deductions and tax credits.

We believe that the true alternative tax on capital gains represents a significant effort to continue the important work already performed by this committee in reducing large-scale tax avoidance. It begins to focus on the problem of the nearly nontaxable return.

You may wish to expand the alternative tax concept to include preferences other than capital gains. Whatever course of action is selected, we believe it is critical to amend H.R. 13511 to avoid a serious setback to the important minimum tax reform effort that you have already successfully conducted through your work here.

Next, as to the retention of the minimum tax on capital gains for corporations, a corporation can now elect to have its capital gains taxed at a 30-percent alternative rate as opposed to a top rate of 48 percent under the regular corporate schedule.

The corporate alternative tax on capital gains is considered a preference item for minimum tax purposes, but unlike the individual minimum tax, the corporate minimum tax adds a very insignificant amount to the effective capital gains rate, a maximum increase of only 1.125 percentage points, even if all the corporations income is eligible for the capital gains preference.

Other provisions in the House bill would cause a corporate minimum income tax to be even less burdensome than it is now. If the corporate rate schedule in H.R. 13511 is enacted, the impact of a corporate minimum tax would be reduced still further to a maximum 0.717 percentage point addition to the capital gains rate.

Moreover, by providing a 30-percent corporate rate on ordinary income between \$50,000 and \$75,000, the House bill would reduce the number of corporations that would elect the alternative capital gains tax and subject themselves to an additional minimum tax liability.

We see no reason for eliminating the corporate minimum tax on capital gains as it has been proposed in H.R. 13511. Even with the individual capital gains relief in the House bill, a maximum corporate

rate on capital gains tax would still be more than four percentage points below the maximum individual rate.

In our view, the elimination of the corporate minimum tax can be justified only if the alternative capital gains rate for corporations is raised to the maximum individual level—that is, 35 percent.

On the question of the reduction and the revenue cost for the exclusion of residences. As you know, that has an exclusion up to \$100,000 in H.R. 13511. It is quite costly. It would cost the Treasury \$700 million.

We certainly believe—indeed, have proposed—liberalization in this area for the average homeowner. We wonder, Mr. Chairman, whether you might not wish to consider reducing that \$100,000 amount, if you reduced it to the first \$50,000 of the sales price on residences for persons 55 years or older, for example, you would be able to reduce this loss from \$700 million to \$300 million and possibly use the revenue in some other way that might, in your judgment, be more acceptable.

I would now like to come to a conclusion by spending just a very few minutes on the inflation adjustment which is contained in the House bill, the so-called Archer amendment. We believe that this amendment, which would provide inflation adjustment for certain capital assets, reflects a serious mistake by the House. This provision is unfair, complicating and very costly.

It should be eliminated from the bill.

The Archer amendment is inequitable because it selects for inflation adjustment only one aspect of the tax law—the income of persons who already enjoy the benefits of the capital gains preference. It is difficult to justify an inflation adjustment for owners of capital assets while ignoring the effects of inflation on the savings account depositor, for example.

Nor is it fair to permit the holder of debt-financed property to adjust the assets base for inflation while making no allowance for the fact that the debt is being repaid with cheaper dollars. You cannot have it both ways, and that is really what is happening if you are using debt in order to finance the holding of a particular asset.

These inequities are illustrated graphically by considering three hypothetical taxpayers: Taxpayer A, who has a \$100,000 certificate of deposit which bears interest at a rate of 5 percent; taxpayer B, who purchases a capital asset for \$100,000, sells it for \$105,000 after it appreciates 5 percent in 1 year; and taxpayer C who purchases a capital asset for \$200,000 financing the purchase with \$100,000 of debt bearing 5 percent interest. This asset is then sold for \$210,000, after it had also appreciated 5 percent in 1 year.

At the end of 1 year, each of these taxpayers has an additional \$5,000 in cash and is in the same economic position before taxes. However, the Archer amendment would result in disparate tax treatment.

Assume an inflation rate of 5 percent. Taxpayer A has an additional \$5,000 of taxable income and receives no relief under Archer. Taxpayer B has no additional taxable income because the inflation adjustment equals his appreciation. Taxpayer C is in a better position than either A or B. Although he has \$5,000 more cash upon the sale of his capital assets, he will show a loss for tax purposes equal to the \$5,000 of interest paid.

Such disparities make no tax sense at all and they will distort investments and borrowing decisions.

The economic distortions and tax shelter possibilities of the Archer amendment are only beginning to be analyzed by tax specialists. For example, the special inflation adjustment granted to owners of corporate stock would undoubtedly lead to the subterfuge of incorporating assets not eligible for the adjustment. Indexing the basis for depreciable assets only for tax purposes of measuring gain would encourage businesses to engage in unproductive asset exchanges, using an inflation adjustment to avoid reporting gain on the exchange while taking a stepped-up basis to increase depreciation allowances for the newly acquired equipment.

The amendment would introduce staggering new complexities into the tax problem. Taxpayers and the Internal Revenue Service would have to make determinations such as: one, whether a particular asset qualifies for indexation either in whole or in part; two, if an asset qualifies only in part, the portion of the asset basis that is adjustable; three, whether a particular transaction is one in which indexation is allowed; and four, the holding period for measuring adjustment where, for example, the basis of an asset is the sum of the cost of numerous property improvements made through the years.

The answer to each of these questions might differ from that applied for other tax purposes. Recordkeeping and return preparations burden for other taxpayers would be increased substantially and disputes with the IRS would arise more frequently.

The revenue cost of the Archer amendment would exceed \$4 billion annually in 1983. This cut is twice as large as all the other forms of capital gains deductions in the bill. In combination with the other capital gains changes, the tax reduction on business and investment income, this amendment would result in a tax bill that provides 71 percent of the total relief to the owners of capital.

As H.R. 3511 now stands with the Archer amendment, it is a bill tilted far too heavily away from American wage earners. In addition to this proposal, the proposal's inequity, complexity, and excessive cost, there is a problem with Archer that is even more fundamental. Indexation is a response to high inflation rates, but the proliferation of indexation scheme tends to make those rates an accepted fact of economic life.

The economic defect becomes institutionalized; rather than accommodating to inflation, we should bend all our efforts to control and eliminate them.

Mr. Chairman, I apologize again for the length of my comments, but I think the importance of the bill that is before you justifies it. We certainly want to work closely with you and your committee in considering these many matters. We are keenly aware of the fact that it is late in the session. For this reason, we have not proposed any further structural changes that otherwise might be desirable and that ought to be considered at a later date.

I thank you and the members of the committee for your attention.

The CHAIRMAN. Thank you very much for a very useful and informative statement, Mr. Secretary. I think most of us had the opportunity to read your statement in full before you delivered this statement this

morning and we will certainly study it again to get the full benefit and full impact of it.

In order to let every Senator participate in this morning's session, it is going to be necessary to ask that on the first round of questions Senators limit themselves to five minutes. After that we will see how many we have here in the afternoon session and perhaps we can give each Senator more time to ask his questions.

We are going to go by the usual early bird rule that we use on this committee, that the Senator who arrives first will ask questions first. Senators will have their turn in this order: Senators Byrd, Roth, Haskell, Hansen, Ribicoff, Talmadge, Long, Bentsen, Nelson, Packwood, Laxalt, Dansforth, and Dole.

Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, President Carter yesterday expressed great concern, and I think justifiably so, at the recent sharp drop in the value of the U.S. dollar. If one looks at this over a period of a relatively few years, we find that the dollar now has shown a reduction in value of roughly 50 percent compared to the German mark, 55 to 65 percent compared to the Swiss franc, 35 to 40 percent compared to the Japanese yen. We have held our own in regard to the Italian lira, or nearly so.

During the past 10 days, I have talked to a number of economists and others who have a wide knowledge of the European and foreign money markets and the consensus seems to be that the problem is not that the dollar is overvalued, but rather the problem is that there is a lack of confidence in the way the United States has been handling its own financial matters.

Would you comment on that?

Secretary BLUMENTHAL. Mr. Chairman, I am going to have to be very cautious in commenting on this matter. The President indicated in a statement issued yesterday that he is concerned about the disorderly conditions that have existed in the foreign exchange markets over the last few days, and that he has asked the Chairman of the Federal Reserve Board and myself, as a result of a number of consultations that we have had with him, to recommend to him what can be done to restore order in the foreign exchange markets and to counteract this situation.

We will be doing so, and doing so shortly.

It is clear that there are both short-term and long-term factors at work here. There has been a lot of speculation; there has been disorder. We are determined to do all we can in cooperation with other countries to counteract those factors, and I think you are quite right that amongst those factors the two principal long-term structural issues that worry people in other countries, indeed, that worry this administration and, I think, all thinking Americans, are first, the high rate of inflation and second, the imbalance in our trade accounts, our current accounts.

I think it is those two factors. I think what is required is an understanding that that situation will be improving through the proper policies followed by the U.S. Government.

We had an inflation rate of 10.4 percent in the first 6 months of this year. That clearly is totally unacceptable. We expect a significantly lower inflation rate in the second 6 months of this year, because the

high food prices, amongst others, are dropping. We expect that rate to be only about 6 to 6.5 percent, one-third lower.

But that double digit figure has been implanted in the minds of some people and clearly I think that that has been of some concern.

We expect 1979, for the year as a whole, to have a lower inflation rate than 1978.

So inflation measures are critical.

Second, the external account. I would have to say, through all of my contacts—and I in no way exaggerate—the fact that, for the last 15 months, a proposal on energy has been before the Congress without action is a major factor of concern to the international community. It is perceived by the international community to be an indication of some kind of lack of will by the United States in dealing with what everyone agrees is a critical problem.

Without my going into the reasons for the delay, indeed, you understand those matters probably better than I; without judging which of these various viewpoints on energy is the right one or not the right one; simply the fact that for 15 or 16 months we cannot get together and the Congress cannot pass energy legislation is very important because it means that the international community sees that there seems to be no common view on how to proceed.

I think that that is something that has to be addressed. I therefore urge, most strongly, that the Congress move forward on energy legislation. If that is done, if we can make progress on inflation as we must and deal with some of the other temporary measures, I think that we will be in better shape.

Senator BYRD. I assume that my time has expired, Mr. Chairman. Thank you.

Secretary BLUMENTHAL. I am sorry. It is not easy to give that answer in three words.

Senator BYRD. I understand.

The CHAIRMAN. Senators, that is what you are up against if you ask a question that requires an involved answer. You do not get a second shot on the first round of questioning.

Senator Roth?

Senator ROTH. Mr. Secretary, recent polls show that the American people believe, by an 80 to 16 margin, that this administration is not handling the economy well.

Very candidly, I feel that your message today demonstrates why that is the case. On page 2 of your statement, you say our economy has performed remarkably well over the past 1½ years.

Well, Mr. Secretary, I am not satisfied and I do not think the American people are satisfied with double digit inflation, with 6.2 percent unemployment, with the dollar going down, with productivity at a very low rate, and with serious problems on the trade balance. But in all candor, what concerns me the most is that you have no positive game plan, no major strategy to get the country moving again.

All you are talking about is some fine tuning, some of which may be good, some of which may be bad. But there is no proposal to do anything long-term to get this country moving upward.

You propose a \$16 billion tax cut. As I see it, your proposal means most Americans would face a tax increase next year, and I would ask you this question: Have you—assuming Congress adopts your recom-

mendations—determined by income level what this would mean to the American people in taxes, not only for this year, but for the next 5 years, and considering the fact that they are going to be paying substantially higher social security taxes, and higher inflation taxes.

Has such a chart been prepared, assuming your recommendations are accepted by this committee and the Congress? What will it do to the taxes paid by each level of income?

Secretary BLUMENTHAL. First of all, let me simply state for the record that I totally disagree with your characterization of this administration's policy of lacking a major game plan, and of being inadequate in terms of maintaining employment and the growth of the economy.

record that I notify disagree with your characterization of this ad-

But, be that as it may, we have tables that indicate the impact of this particular reduction on taxpayers by income class for next year and for the out years, and we can provide that to you.

[The following was subsequently supplied for the record:]

COMPARISON OF CHANGES IN THE COMBINED INCOME AND SOCIAL SECURITY TAXES RESULTING FROM H.R. 13511 AND THE ALTERNATIVE COMPARED WITH 1977 LAW TAXES ¹

	4-person, 1-earner families		4-person, 2-earner families ²		Single individuals	
	H.R. 13511	Alternative	H.R. 13511	Alternative	H.R. 13511	Alternative
Wage income:						
\$5,000	14	14	14	14	-7	-44
\$10,000	-34	-232	-34	-232	13	19
\$15,000	-35	-187	-35	-187	-29	-14
\$20,000	115	33	-90	-172	157	162
\$25,000	207	131	-162	-237	279	339
\$30,000	135	16	-220	-339	226	339
\$40,000	-47	-215	35	-133	112	339
\$50,000	-215	-261	223	177	3	339
\$100,000	-485	-261	-47	177	3	339

¹ Assumes deductible expenses equal to 23 percent of income.

² Assumes each spouse earns 50 percent of total family income.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Aug. 3, 1978.

Senator ROTH. Does that include the effect of inflation and social security taxes?

Secretary BLUMENTHAL. We can certainly give it to you for inflation in 1979 and for social security increases, but we cannot give it to you for the out years. You can make your own assumptions as to what kind of inflation we are going to have in 1982 and 1983.

Senator ROTH. I think the administration has already made certain estimates for inflation.

Secretary BLUMENTHAL. At the same time, we assume that there will be further tax reductions as we go along, so we have to look at what this particular bill will do to the impact of taxes next year, because—

Senator ROTH. Mr. Secretary, are you saying then that you are planning to propose additional tax cuts next year?

Secretary BLUMENTHAL. I am not saying that there will be a new tax cut next year. I am saying that it will certainly be in the out years. We are talking about a 5-year period. It could be next year or it could be the year after that. I really do not know. It depends on

the state of the economy. It depends on the rate of inflation. It depends on various other things.

But I clearly do not believe that there will be no further tax reduction in the next 5 years.

Senator ROTH. Would it not make more sense to program the tax cuts in advance rather than year by year? Would this not help to improve confidence, and some predictability and certainty to our economy?

Secretary BLUMENTHAL. I think tax policy, particular tax proposals, have to be evaluated in light of existing circumstances.

I have certainly noted that the Congress tends to change its mind rather rapidly—and perhaps quite understandably in the light of changing economic circumstances. I would not be comfortable with making tax proposals for a multiyear period without recognizing that depending on whether the economy grows by 2 percent or 4 percent or 6 percent, depending on whether the rate of inflation is at 7 percent or 5 percent or 3 percent that all of those factors have to be considered from time to time and then decisions made.

Senator ROTH. Mr. Chairman, my time is up, but I think one of the most pressing needs in the economy today, both from the standpoint of the American people and business, is to get some certainty into the tax picture. It seems to me that the most helpful thing that could be done at this stage to instill confidence in the economy is to begin planning forward on the tax picture.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Haskell?

Senator HASKELL. Mr. Chairman, I have a statement that I would like to have put in the record.¹ I would like to summarize it, Mr. Secretary, and get your comments.

About a month ago, Senator Byrd had a hearing here and I talked about inflation; that it is the most important problem. I think we both agree with that.

Three years ago when unemployment was 8.5 and industrial utilization was down below 70 percent, we were talking about stimulating the economy by a tax cut. Now we have a 6.2 unemployment rate and it is probably going down. We have 84.1% plant utilization—and we are still talking about a tax cut.

It seems to me, Mr. Secretary, that different economic times require different economic solutions. If we adopt an expansionist fiscal policy that puts more money into the economy and thereby feeds inflation when you have these economic circumstances, the Federal Reserve is going to adopt a restrictive monetary policy. As a matter of fact, they cranked it up one-eighth of a percent yesterday, I read in the paper. This is going to in turn fuel inflation, and it is going to cause a recession—at least, if history repeats itself.

Now, my suggestions would be—and I would like to get your reaction—that we do not have a tax cut. We bring forward the 1975 temporary reductions. We adopt Senator Nelson's suggestion of deferring the Social Security increases for 3 years because we know they are inflationary and we attempt to cut the budget by 3 to 5 percent which would knock about \$15 billion off. We would narrow the gap of the deficit to about \$20 billion if we did that. It seems to me that this is the kind of program that both the people in our country

¹ See p. 128.

and the people across the world are looking for in the United States—a responsiveness to a situation and a willingness to take a stand.

Now, could I have your comments on that?

Secretary BLUMENTHAL. Senator, this, I suppose, is a counterpart to what Senator Roth has in mind, who has a game plan, as I understand it, for increasing the budget deficit by \$100 billion.

Senator HASKELL. That is in his plan, not mine.

Secretary BLUMENTHAL. And by making the kinds of tax cuts, in the hope that inflation will not accelerate, but just go away.

We have looked at what is likely to happen with the economy in the absence of any type of tax cut as best we can—and heaven knows, the economists are hardly infallible.

As best we can tell, if we had no tax cuts, you would not only have particular hardships on low- and middle-income groups who have to suffer the impact of inflation, but you would have a slowing down of the economy below 2 percent, 2 to 3 percent, in such a way that unemployment would rise, and that tends to impact, obviously, those groups in the economy least able to afford it.

We have a game plan in the sense that the President has strongly indicated that he wants to move that budget towards balance. He started out with a deficit, as Senator Byrd well knows, of \$60 billion for 1979 as our target. We are now down to \$43.5, I believe, or maybe even less, depending on what action the Congress takes on the budget, so we have reduced that budget deficit by also one-third. That is a major factor.

We are cutting taxes to offset the Social Security taxes fully—even somewhat more than fully—

Senator HASKELL. May I interrupt? I think we all recognize that Social Security increases are inflationary. I think we would probably find reasonable concurrence that income tax decreases are inflationary. Why not postpone for 3 years the increases in Social Security and not have a tax decrease?

Secretary BLUMENTHAL. In the first place, we clearly need some reductions in order to help business, small business, and corporations to invest more, to expand the economy, so that we do not get bottlenecks and inflation that way. In the second place, the total impact on the cost of living of a postponement of the Social Security taxes is, I believe, two to three-tenths of a percentage point.

Now, I do not minimize the importance of this. But it is clearly not, in itself, a reason to deal with the Social Security taxes in this way, to get into the problem of using general revenues to finance Social Security taxes without having looked at the coverage questions that are involved in this, and really also making sure that the trust funds are generally maintained in sound condition.

I think the whole Social Security problem needs to be looked at, perhaps next year or the year after, as soon as possible, and that we need to look at all of those elements. I want to be sure that the integrity of those funds is maintained, that the coverage is broad, and that when we go into general revenue financing of Social Security reaching a principle which has not been previously reached, that we know what we are doing.

Senator HASKELL. I guess I, too, asked a complicated question, Mr. Chairman.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Mr. Secretary, Martin Feldstein recently completed a study funded by the Treasury and based exclusively on Treasury data showing that just the 1969 changes in the capital gains law created an enormous lockin of capital. Had the 1969 capital gains tax rate of 25 percent been in effect in 1973, corporate stock sales, according to his study, funded by the Treasury, would nearly have doubled from \$29.2 billion to \$49.5 billion.

Realized gains would have increased from \$5.4 billion to \$15.8 billion.

It does not take much to see that the investment climate is improved with lower tax. In my view, a broadbrush approach is essential to creating a good investment climate and does more for growth than targeted concepts like a special venture capital credit which conjures nightmares of regulation, or even the exclusion of the sale of a house.

I want to know how the administration proposes to create a healthy investment climate in which all Americans can participate and from which all can benefit.

Secretary BLUMENTHAL. Senator Hansen, in our judgment, the study conducted by Professor Feldstein has a number of defects and special characteristics which make its conclusions, for certain purposes, questionable.

For purposes of evaluating the impact of certain types of capital gains taxes on a permanent basis. That is my main point. He took a particular year and tried to calculate the impact in the following year. Even if he is correct and without taking up the time, or I will be accused of giving a complicated answer again, this probably deals, in our judgment, with the transitional, with the 1st year of the tax rather than with the permanent tax.

But your question was, How do we create a climate of confidence? It seems to me the climate of confidence has to be created by bringing inflation under control, by having a stable dollar, by maintaining adequate growth of the economy, and by providing incentives for capital accumulation, so that there can be adequate levels for business investment together with the confidence of business in the future of this economy.

Senator HANSEN. Earlier you spoke about inflation and the imbalance in trade accounts being two major problems that are of concern in trying to assess the woes of the dollar internationally. You mentioned that inflation was 10.4 percent the first 6 months of this year, and yet I understand that you and others were on the Hill yesterday trying to promote the passage of the natural gas bill. I just read in this morning's paper that the imports of oil into this country have not increased, but rather have dropped from slightly over 9 billion barrels per day to just under 8 billion barrels per day.

We do not start to import the amount of energy in the form of oil that Japan does. And I have read, too, what the Public Service Commissioner for the State of Wisconsin says about this gas bill. Now, he does not find anything in that bill to encourage him that the people in the State of Wisconsin would be benefited, either by controlling inflation or reducing consumer prices.

How do you rationalize the administration's approach on the natural gas bill in trying to get a handle on inflation?

Secretary BLUMENTHAL. Senator Hansen. I responded to Senator Byrd's question as to what was most in the minds of foreigners as they looked at the U.S. economy and suffered a lack of confidence. My answer was it was inflation and it was the inability of the United States to act on the energy question in the 15 months that had elapsed without Congress taking action.

I indicated that in the view of foreigners, those are the two fundamental factors that cause the uncertainty about our national wealth.

The dropoff in imports for the first 6 or 7 months of this year compared to the similar period last year is certainly encouraging. It is due to the coming onstream of oil from the North Slope. It is due to the drawing down of stocks. It clearly is not, should not, be read as an indication that we are making any dent in the \$45 billion oil import bill that we have. It is that import bill, which only amounted to about \$6 billion just a few short years ago, that is causing the foreigners to be concerned about the State of our economy.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Thank you, Mr. Chairman.

Mr. Secretary, much of the decline in the dollar, of course, has been attributed to our lack of an energy program. I would point out to you that we import about half of our energy. Japan imports, I think, virtually all of the energy. Germany imports virtually all of their energy.

According to the Department of Commerce, based on data for the second quarter of 1977, Japan had a surplus in manufactured goods for the rest of the world at an annual rate of about \$30.7 billion. Germany, on the same basis, had a 1977 surplus of about \$45.9 billion. That is manufactured goods, chemicals, machinery, transport equipment and other manufactured products except fuel and food.

During that same period, we had a modest surplus. I understand that declined to zero.

What can we do to correct that situation? I do not see any way we can stop the decline of the dollar as long as we have a negative trade surplus and Japan and Germany have these huge surpluses.

Secretary BLUMENTHAL. Senator, as you know, the composition of trade between different countries tends to be different according to the kinds of economies they have. For example, we are important food exporters, and the Japanese, on the other hand, are major food importers. So it will always be true that they have to rely much more heavily than some other countries on their earnings from manufactured goods while, in order to earn enough to import.

Now, what you point out, which is the tremendous surplus that the Japanese have clearly is a worrisome thing. That kind of imbalance also could contribute to difficulties in the international financial adjustment process.

What has also contributed to that imbalance is the fact that they have had stagnant economies, particularly the Germans, while we have had growing economies. The last time our external accounts were in balance was in the depths of the recession in this country in 1975, so the differential in growth rates between our moving up and their being flat caused some of the distortions to occur.

I should say the changes in the dollar over the last 1½ years clearly are going to have an impact, and we are beginning to see that

on our ability to export and on our reduction in imports. We are beginning to see improvements as a result of the dollar changes.

Now, that is different than having disorderly conditions in the market which we have seen in recent days. So that will improve because the dollar relationship has changed. Point No. 1.

Second, you have got to bring inflation under control, because if we do not bring inflation under control, our goods will not be competitive.

Third, those other countries have got to get their surpluses down and open up their markets for us. Some of them are too protectionist.

I think if we can do those three things and work on the energy problem, which is a part of it, I think we can bring that into balance.

Senator TALMADGE. Of course, you know we are very proud of our surplus in agricultural exports. However, there is very little labor involved in a bushel of wheat or a bushel of soybeans. There is, on the other hand, a great deal of labor in a Datsun automobile or a television set—in the things that we import.

I have met with several foreign delegations. The Japanese Diet called on me, I presume because I am the chairman of the Commission on Agriculture, and they talked a great deal about the little piddling amount of citrus fruit they are going to take from us, the piddling amount of beef that Tokyo will eat up in 24 hours, and they think that is a big deal.

Our trade representatives tell me that they are standing firm. I have told them pointedly that we could not continue to have a \$10 billion, \$12 billion, \$14 billion trade deficit with the Japanese, and I hoped that we could correct it by negotiations, but if we could not correct it by negotiation, I thought Congress would have to correct it by some other means.

Do you agree with that?

Secretary BLUMENTHAL. I certainly agree that if that is not corrected through a negotiation, that other steps are likely to be taken, and I would understand why.

Senator TALMADGE. We either have to have some plan of quotas, it seems to me, or some plan for tariffs to bring our trade balance into some real balance. Would you not agree with that?

Secretary BLUMENTHAL. I would agree that we would have to look at other means of doing that. I would not want to commit myself to coming out in favor of quotas, but I think we would have to look at other means.

I would say that, from my discussions with the Japanese officials that they know they are up against a real problem, and certainly we have to stand firm on that issue. We are just going to have to wait and see what comes out of negotiations, but it is a critical problem and it is hurting their economy just as much—that surplus is not good for them.

Senator TALMADGE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, President John Kennedy sent to us in 1963 an approach to the capital gains problem that would have raised about \$500 million a year for the Treasury by stimulating more activity in sales and in business generally in removing some of the counterproductive aspects of the tax system at that time.

Since that time, we have passed a minimum tax and then we passed amendments to that minimum tax seeking to eliminate the kinds of injustices and inequities that you have spoken to today. You testified

here that we have managed to get it down to the point that 90 percent of those who should be paying a tax but were not before are now being taxed. I have talked to Mr. Lubick; we have been looking at the figures on that, and the way he explained it to me, we have got it down now to where we are managing to tax virtually all those who should pay a tax, with the exception of about two people in the entire United States.

It would seem to me that there are ways that we can draft a better minimum tax than we have. We should more explicitly zero it in on the people who should be paying more, without it being so much of an add-on to people who are already paying a very substantial tax. If we can work that out together, should we not be able to work those two items out in such a fashion that Treasury would make a net gain in revenue rather than a loss in revenue?

Secretary BLUMENTHAL. Mr. Chairman, the Treasury is always interested in a net gain in revenue. I think the point you make is basic, and I support it fully. I believe not only that everyone who can afford to pay should pay some tax; I think that that tax should be at a reasonable minimum.

I do not think 5 percent for people who earn a lot of money is a reasonable tax to pay.

I think, therefore, that a better approach to the minimum tax, together, perhaps, as part of a package on what you are doing with capital gains, is certainly something that we would wish to explore with you.

The CHAIRMAN. It seems to me that we can draw a minimum tax that would do a far more efficient job, just knowing what we have learned. We have now had a lot of experience, and we can pull out the tax returns to the people who you are concerned about.

I think we now know what we need to know, to see not only that we catch those two or three people left in the United States who have managed to avoid the net so far, but in addition to that, that those who should be paying something will not be paying just a token tax, they will be paying a rather substantial tax.

I can figure out how to do it myself, and it seems to me that if I can do it, all of those experts you have down there in the Treasury—you have a lot bigger staff than I have—ought to be able to figure out a way to do even more of that. I would appreciate it if you would work on that.

Can your staff work with us to find better ways to move more people into using the standard deduction? It seems to me that we ought to find ways to make the standard deduction available to more taxpayers so more could have something of a break in using it. Have you explored ways that that can be done?

Secretary BLUMENTHAL. We are looking at that. I think if we could put some floors under the itemized deduction that would be one way of moving more people over. We have, of course, in our original proposal, and the House went some way in that direction, the elimination of certain deductions and building them into the rate schedule which was also designed to do that.

The CHAIRMAN. It seems to me, Mr. Secretary, that to make the law simple you need to do two things. One, you need to put more floors under some of these itemized deductions, and then, too, you need to

make some of these itemized features deductible even when you use the simplified system if they deduct on that item alone.

In other words, if a person has spent 20 percent of his income on medical expenses, I would think he ought to be able to use the standard deduction and, in so far as his medical expenses exceed, let us say, 10 percent of income, to deduct that excess on the simple form.

Secretary BLUMENTHAL. I think if we can put reasonable floors under those itemized deductions and then say that if there was a particular item on which he has an extraordinary amount of deduction nevertheless, that that should be separately deducted, that that is something we ought to investigate. We will work with you on that.

The CHAIRMAN. Thank you very much, sir.

Mr. Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

I certainly agree with you and the Secretary that we cannot have people receiving \$500,000 a year cashflow who pay no taxes. You will never explain that to the fellow who has a service station who might be making \$15,000 or \$20,000 a year. As a result, you destroy public confidence in the tax system.

I worked for a tax in the alternative in 1976, and hopefully we can get something here.

I do believe that we need a reduction in the capital gains tax, and I would like to ask unanimous consent that a newspaper column by a distinguished former member of this committee, Eugene McCarthy, be put in the record at this point.

[See p. 203 for material referred to above.]

Senator BENTSEN. I would like to speak to the question of how big a tax cut Congress should enact. We have had before the Joint Economic Committee and before this Finance Committee economists testifying that enactment of a tax cut that would range up to \$100 billion would be a serious mistake.

I frankly think it would be fiscally irresponsible at this time.

I think what we have to do is try to make people whole on what has happened to them on inflation, to the extent that we can. People have been bumped up into another tax bracket. We should try to bring them back to where they were, to the extent that we can.

But to bring about a \$100 billion tax cut would result in an increase in interest rates, a substantial increase in the budget deficit and would fan inflation.

The last thing I think we need at this time is to greatly increase consumer demand. What we ought to be trying to do is increase and modernize productive capacity in this country, to make it more effective and more efficient, and we ought to concentrate on that.

Now, I have tried to give you the complicated answer. Now, would you care to amplify that?

Secretary BLUMENTHAL. For once I can answer in two words: I agree.

Senator BENTSEN. That is fine. Then let me get to the next question.

Mr. Secretary, you and I have differed over the jobs tax credit, and I proposed it back in 1975 and 1976, as did Senator Haskell. It has met with a mixed review. We have had people who have testified that it has created 400,000 new jobs and we have had others who have testified that those jobs would have been created anyway.

I am pleased to say that I think we are in agreement on a compromise on a targeted jobs tax credit that really tries to get to some of the structurally unemployed and the youth in this country. We have got unemployment rates amongst young people, amongst young blacks, of as high as 40 percent. I think that one of the most debilitating things you can do to a young person is to tell him society has no productive role for him to fill. We pay a very large social, political and economic cost for this.

So I would like to say that I strongly support your jobs tax credit, in a targeted form.

On the environmental cost that is placed on manufacturing today, it is my understanding, Mr. Secretary, that you are proposing that we have a 5-year writeoff and a full 10-percent investment tax credit. Is that correct?

Secretary BLUMENTHAL. Yes, that is right. We would maintain the 10-percent credit and have the writeoff.

Senator BENTSEN. Now, what about OSHA. Do you extend that incentive to the increased costs resulting from OSHA?

Secretary BLUMENTHAL. I do not believe so.

Senator BENTSEN. How do you draw the distinction? Why should we not do it for such things that have to be done by Government regulation, by OSHA; if we do it on EPA?

Secretary BLUMENTHAL. I think that we would have to look and see what exactly would be involved technically. There are lots of little things that were done that came under OSHA regulations. For example, OSHA regulations say you have to have a certain kind of ladder. I do not think you should say that, but they do. You have to have a certain kind of ladder or you have to have a certain kind of provision which may be very expensive.

Perhaps we ought to look at every major investment costs as related to OSHA, but I would like to look and take a look to see if that distinction can be made and what the cost would be and to what extent it is analogous to the environmental factors.

I think you have a good point that they both involve Government regulation and they both can be a heavy burden for the individual firm.

We will look at that.

Senator BENTSEN. I appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Nelson?

Senator NELSON. Mr. Secretary, in your testimony you made reference to the question about equity and the distribution of benefits of the capital gains tax. I realize the administration posture has been negative on capital gains changes, though it passed heavily in the House and it is likely to pass in the Senate.

Now, as to that question, the answer is that there is going to be one. I would, however, like to ask this question.

The House bill, as you well know gives 90 percent of the benefit of that capital gains cut to people making over \$50,000. And it only gives benefits to 327,000 people in this country.

There is a measure that will be before us, is before us, which would deal with that capital gains question in a different way—that is,

allow an exclusion of the first \$1,500 in capital gains for an individual and an exclusion of \$3,000, of the first \$3,000 of capital gains to a couple.

That would result in 72 percent of the benefits going to people making less than \$50,000, the more equitable distribution which you addressed yourself to on the full tax question, and would benefit 4,250,000 people.

Now, given that you may not want any changes, which approach would you prefer if, in fact, one is to be adopted by the Congress?

Secretary BLUMENTHAL. Well, we have previously said that if the Congress chooses to reduce capital gains taxes, we do not oppose that as long as certain basic criteria of tax policy are followed. One of them is that the result is reasonably progressive, or at least not to regressive.

The particular proposal that you are referring to would probably be more progressive than most others, certainly those passed by the House, or even the alternate proposal that Corman-Fisher had recommended which was not adopted.

So, from that point of view, we would clearly prefer the one to which you have just referred.

There are other criteria, such as the degree to which it will stimulate investment and the degree to which the reduction in capital gains taxes will really be directed towards those activities that have some economic meaning, rather than just the rewards for speculators.

So I think it is an interesting idea. We certainly think it would be something that would go in the right direction, and if this committee would like to substitute something of this kind for what is in the present House bill, we would want to work with you on it.

I gather that there is a revenue cost involved in this proposal which is slightly less than \$1 billion—about \$860 million.

Senator NELSON. The House bill was \$950 million. This one would be about \$850.

Secretary BLUMENTHAL. \$950 million? The House bill, if I remember correctly, is a total of \$1.9 billion.

Senator NELSON. You are counting, I think, the exemption of the sale of a principal residence.

Secretary BLUMENTHAL. Yes.

Senator NELSON. I am talking only about the other capital gains provision in the House bill.

Secretary BLUMENTHAL. Everything but the residence.

Senator NELSON. That is right.

Secretary BLUMENTHAL. Then it is slightly more. Our figures indicate \$1.1 billion, and this is \$863 million, so it is somewhat less than that total amount. So if you were to make that kind of substitution, that is fine. I suspect you are going to run into—I can tell you from personal experience that you are going to run into a certain amount of opposition on this point, but we certainly would be willing to work with you.

Senator NELSON. If there were not any opposition, you and I would agree that the proposition is probably no good.

I have one more question. I think that most people in both houses of Congress and all but three or four or so on this committee have

given speeches attacking the administration for not having a game plan on inflation. Senator Roth had that to say this morning.

I think I may be only one of the three or four here who have not made a statement like that, only because I have concluded I do not know any more about it than the economists do.

But in any event, the administration has made a number of proposals, the energy proposal, the cutting back on the public works reclamation, and a very major proposal on hospital costs containment.

This committee rejected the concept by about two to one, about one-third of us supported the concept of the administration.

Speeches are being made here in this committee and on the floor about cutting budgets, stopping inflation, all kinds of windmill-tilting propositions that they know will not pass and they would be scared to death if they did.

My query is, the administration proposed a hospital cost containment bill that would save \$60 billion in 5 years, \$19 billion of which would be Federal funds and \$2.2 billion, I believe, State funds. This is at the rate of \$12 billion a year.

Do you know of any other proposal we might act on that would have a more significant effect on reducing budget costs and reducing inflation than that administration proposal?

Secretary BLUMENTHAL. I do not, Senator. I certainly regret that you did not act on hospital cost containment. I think no other cost is rising as rapidly as this one and that is certainly an area that is very, very important.

I could add many, many smaller, but equally important measures, that have been proposed or that we have tried to take by administrative action that would be anti-inflationary, that would make the Government more efficient, and that some of those who were most interested in efficiency and in fighting inflation were very strongly opposed.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Mr. Secretary, I was struck in listening to the presentation of your speech, a rather routine presentation as you went through the bulk of it, skipping around, and then the passion that crept into your voice as we got to the subject of capital gains, and the crescendo when we got to tax shelters, and it peaked at the expression "tax avoidance by wealthy individuals making extensive use of tax shelters."

So we are on the same wavelength—and I am sure that we are—what do you mean by a tax shelter?

Secretary BLUMENTHAL. By a tax shelter I mean those devices presently allowed in the code which involve the offsetting of paper losses against income such that no or little tax liability to the Federal Government has accrued.

Senator PACKWOOD. Is there any such thing as a good tax shelter?

Secretary BLUMENTHAL. A good tax shelter?

Senator PACKWOOD. From Treasury's standpoint, not from an investor's standpoint.

Secretary BLUMENTHAL. I do not think that we make that kind of value judgment, whether the tax shelter is good or bad. I make a value judgment that if individuals who have high income, and I know some of them, and I am sure you do, too—boast to me that they have not paid any tax for X years or paid only 4 or 5 percent and ridicule

me for paying 30 or 40 or 50 percent, 70 percent at the margin, I make a value judgment that that is bad for the country, and I resent it.

Senator PACKWOOD. Mr. Secretary, let me ask you again—

Secretary BLUMENTHAL. Again, the passion in my voice you are hearing correctly, Senator.

Senator PACKWOOD. And you are right. You make no value judgment, and you go right through this example of the House-passed bill reducing the minimum tax—you have a \$2,184,982 capital gains, the House bill would reduce the minimum tax from 7.4 percent to 5 percent and your two alternative tax would raise that to 16 percent.

You are right. There is no value judgment as to whether or not that income is being sheltered has any socially useful purpose. It is just that 16 percent is certainly better than 5 percent and 30 percent is probably better than 16 percent. Am I correct?

Secretary BLUMENTHAL. I would not say that. I am talking about the notion of people paying—high-income individuals paying no, or next to no, tax. Now, some people might consider, who are at the margin at the 70-percent bracket, might consider 30 percent to be next to no tax. I would not say that.

But I would certainly say that reducing taxes for people who have sheltered all of their regular income and who have multimillion dollar capital gains income, reducing that minimum tax from 7.5 percent to 5 percent, I would make the judgment that that is paying virtually no tax.

Senator PACKWOOD. Are you reasonably convinced that by virtue of sheltering their income, what they have invested in has served no worthy social purpose?

Secretary BLUMENTHAL. No; I do not say that. I would say equally that when I have saved my money and invested it and received dividends and paid 70 percent, I have invested my money in a way which has served a useful social purpose, yet I pay more than 5 percent.

Senator PACKWOOD. Well, therefore, all of the capital gains taxes on millionaires should be 70 percent.

Secretary BLUMENTHAL. No; I do not say that. We have in the tax code made various judgments about the degree to which we want to provide incentives for this or that economic activity. I do not feel that an incentive which reduces to the level of 5 percent taxes on individuals who have these large incomes is appropriate.

Senator PACKWOOD. What is magic about 16 percent?

Secretary BLUMENTHAL. There is nothing magic about 16 percent and I have never claimed it is.

Senator PACKWOOD. Why not higher?

Secretary BLUMENTHAL. It is a matter of judgment. If you wish to put it higher, we would not object.

Senator PACKWOOD. That is what I thought. You really would not object if we could get it up to 50 percent.

Secretary BLUMENTHAL. Oh, I think we would, Senator.

Senator PACKWOOD. So there is some threshold between 16 percent and 50 percent.

Secretary BLUMENTHAL. Senator, you are trying to pin me down in a way in which I am not going to allow myself to be pinned down. I have made my point.

Senator PACKWOOD. When do I get another turn?

The CHAIRMAN. I do not think you can settle that matter right now, but go ahead.

Senator PACKWOOD. Mr. Chairman, I am not going to resolve it, but he reminds me of Clement Atlee in 1947—16 percent is good, 30 percent would be better, 40 percent might be better yet. It does not matter that jobs are created. It does not matter that indeed we started re-investing our capital and worthwhile things actually happened.

We will go ahead and level the income, level the investment opportunities and then we will see what we can do afterwards to pick up the pieces in the economy.

The CHAIRMAN. I have no doubt that you will be able to make your position clear; you always do. But you may have trouble getting that witness to answer you.

Senator Danforth?

Senator DANFORTH. Mr. Secretary, early in your comments on page 3, you say that tax and budget policy must address another threat to continued economic recovery—sluggish business investment.

And this echoes a theme which you also made last March 3, 1977, very shortly after you took office. You made a speech in New York which was entitled "The Government's Role in the Capital Formation Process."

We hear all kinds of dire predictions about capital shortfalls. One, I think that was made by the New York Stock Exchange, was a prediction of \$1 trillion capital shortfall over the next 8 years. And therefore, I just want to ask you one question, with several subparts.

One, how serious is the capital formation problem and the capital formation-productivity problem?

Second, how heavily should this problem—if there is a problem—weigh with us as we are fashioning a tax bill? To what degree should we measure what we do against the capital formation problem?

Third, what tax policy options exist, whether or not they are in the President's proposal? What tax policy options exist which we should be considering or could be considering to address the problem?

Secretary BLUMENTHAL. Thank you, Senator.

As to the first question, I happen to feel, and have felt for some years, before I took this job, that the slowing down of investment and the capital formation is one of the fundamental problems that we have to face in this economy, and I think that you ought to weigh it very seriously.

If you look at the productivity figures, you will see that we used to increase productivity in the fifties and sixties by about 3 percent. By the early seventies, it had slowed to 2 percent and now we are down, last year, to less than 1 percent. I think that is in part the explanation for Senator Talmadge's concern on the export side, of the inability of the United States to compete.

If you look at R. & D. figures, you will see another element. I think it is very, very important. I think you ought to seriously address it. I think this tax bill in itself will not solve it. I think you need to come back to it next year and the year after and I certainly have been encouraging that as strongly as I can.

Second, in looking at this bill, you should equally—it follows from what I say that you should give it very serious attention. Now, having

said that, opinions begin to diverge unfortunately, but not surprisingly, but as to what is the best way to stimulate.

Certain tax policy fashions arise, sometimes fashions that fly in the face of whatever analysis is available and that is never perfect. And it happens at the moment that capital gains is up front and center as being the way to stimulate that.

Strangely enough, in January when we presented our proposal, virtually no one was talking about that.

We happen to think that an increase in cash flow through the reduction in the corporate rate across-the-board would be a very good way to stimulate it, and we still think that. There are other ways that are not proposed here, different depreciation schedules which increase tax flow, a variety of such techniques that could be used.

Clearly a reduction in capital gains taxes also will have a stimulative effect in that area and are of net benefit. They may not be the most effective.

I can present to you for the record or to you personally a variety of ways to stimulate capital investment. I have mentioned one, a different depreciation schedule, accelerated depreciation.

[The following was subsequently supplied for the record:]

STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY OF THE
TREASURY FOR TAX POLICY ON CAPITAL FORMATION, JUNE 15, 1977

Mr. Chairman and members of this subcommittee, my colleagues today are making a persuasive case for promoting a higher rate of capital formation in the U.S. economy. There is no need for my repeating it. In view of our disappointing record regarding economic growth, and gains in productivity and real income, the important question is what can public policy do about it. From my position, the question is even more specific: What can tax policy do about it?

I should first note that capital formation is not solely or perhaps even primarily a tax issue. We must look to more fundamental reasons to understand why our present rate of investment is deficient. In the aftermath of a major bout with both inflation and recession, it perhaps is not surprising that business confidence has not yet fully recovered. Uncertainty concerning opportunities for expansion of markets as well as the trust of future government policies is not easily dispelled. In this climate, general monetary and fiscal policies to reinforce the recovery of the economy in a noninflationary manner may be more important than specific structural program changes. Nonetheless, it is still possible to define a more specific role for tax policy in stimulating capital formation. This can best be appreciated by considering that investment will not be undertaken unless the after-tax rewards are commensurate with the risks of adding to productive capacity. Tax policy can affect investment decisions by changing these after-tax rewards.

In fact, as I shall discuss in more detail, there are various ways in which tax policy can improve the after-tax returns to investment and risk taking. We are now critically evaluating these alternatives as part of the process of developing tax reform proposals to submit to Congress later this year. No final decisions have been made as yet on the specific components of the tax reform program. I would like to share with you, however, some of our thinking on tax incentives for capital formation. I will also address the question of the relationship between the need for additional capital formation and the other goals of the tax reform program.

The tax reform program we are now working on has two other important goals in addition to providing adequate incentives for capital investment. The first is tax simplification to which we assign a much more important role than it has generally been assigned in the past. Simplification involves making tax returns easier for the average person to prepare, reducing the burdens of financial recordkeeping, and generally making the tax law more understandable for taxpayers. The second goal is to improve the equity of the tax system so that the laws are regarded as fair. This can be accomplished by removing op-

opportunities for tax gamesmanship with high payoffs to expert legal advice and shrewd tax planning, and by making sure that individuals with equal incomes are taxed the same while those with higher incomes are taxed at progressive rates. In providing incentives for expanding productive facilities, we must continue to keep in mind the other goals of simplification and fairness.

Designing tax proposals to stimulate capital formation equity is no simple task. I might also add that we have not yet discovered any new ways of achieving all these goals simultaneously. The problem, as always, is one of choices and tradeoffs.

ALTERNATIVE WAYS TO STIMULATE CAPITAL FORMATION

The particular instruments that may be used to increase the after-tax returns to investment and thereby stimulate additional capital formation are generally familiar to all of us. They include the investment tax credit, alternative methods of depreciation, and changes in corporate tax rates. In addition, there is a device which has not been used in this country but has been adopted by our major trading partners including Canada, England, France, Germany, and Japan. This is eliminating the double tax on corporate income, or integrating the corporate and personal income taxes.

Each of these may be discussed briefly in turn.

Investment tax credit.—The investment tax credit now stands at 10 percent for eligible property which generally includes depreciable equipment, but not buildings, used in a production process. Equipment with useful lives of less than 3 years does not receive the investment tax credit, that with lives of more than 3 years but less than 5 years receives one-third of the credit, and equipment with useful lives of greater than 5 years but less than 7 years receives two-thirds of the credit. In addition, the credit cannot exceed \$25,000 plus 50 percent of tax liability over \$25,000. However, special higher limitations are temporarily provided for public utilities, railroads, and airlines. Unused credits may be carried back 3 years and carried forward 7 years. One alternative for stimulating additional capital formation is to increase the investment credit above its current level or to relax the general 50 percent of tax liability limitation.

Depreciation allowances.—Under current law, property held for the production of income in a trade or business is allowed a reasonable deduction for exhaustion, wear and tear, and obsolescence. Depreciation deductions are calculated for tax purposes by first determining the life of the property and then applying a depreciation method allowed by law. Lives may be justified by taxpayers on the basis of either facts and circumstances or by reference to the class lives established by the asset depreciation range (ADR) system for taxpayers electing to use that system. Those electing ADR are also permitted to use 20 percent shorter lives than the published class lives. Once the asset life has been determined, the actual tax depreciation deductions are calculated by using either the straight-line method or a more accelerated method such as double declining balance.

As a mechanism for reducing taxes on capital income, it is possible to allow taxpayers larger depreciation deductions. This could be accomplished by various combinations of changes in either asset lives, more accelerated methods, or indexing depreciation for inflation.

Corporate tax rates.—Alternatively tax burdens on capital income could be reduced by direct corporate rate cuts. Currently, the first \$25,000 of corporate income is taxed at the 20 percent rate, the next \$25,000 at 22 percent, and income in excess of \$50,000 at 48 percent. Any or all of these rates could be reduced as a measure to stimulate investment.

Eliminating the double tax on corporate income.—Although the idea of eliminating the double tax on corporate income has received considerable attention in recent years, it may nonetheless be worthwhile to review the various approaches which might be used to achieve this result. There are essentially three alternatives. One is full integration of corporate and personal income taxes and the other two are alternative variants of partial integration. Full integration is equivalent to treating the corporation as a partnership. Each corporate shareholder, as does a partner under current law, would include in his own income for tax purposes his proportionate share of the corporation's income whether or not it is distributed. The corporate tax then becomes a withholding tax credited against the shareholder's final individual tax liability. In effect, the corporation pays no separate tax at all in this case but merely serves as a collection agent for the Treasury.

The two variants of partial integration eliminate the corporate tax only on distributed earnings. The corporate tax would remain on undistributed corporate income. One version of partial integration involves a deduction for dividends paid at the corporate level in the same way that interest is currently deducted by corporations. The alternative version treats corporate taxes attributed to dividends as a withholding tax. The individual shareholder grosses up his cash or "take-home" dividends the same way that take-home pay is grossed up to include taxes withheld by the employer. Then in determining final tax liability, grossed-up dividends are taken into total income but a credit against tax is allowed for the corporate tax attributable to the dividends received. Again, this is similar to our current withholding system for wages and salaries where tax liability is based on "grossed-up" or before-tax wages, and a credit is taken for taxes withheld by the employer.

The choice among alternative ways of eliminating the double tax in the event that some proposal of this kind is recommended must also be based on considerations of simplicity and equity as well as on possible differences in revenue costs.

Criteria for Choosing Among Investment Stimulus Alternatives

It is important to specify the criteria to apply in choosing among alternative ways of stimulating investment. Let me enumerate these criteria and then briefly evaluate the alternatives.

Nondiscriminatory or efficient incentives.—Where possible, incentives for capital formation should be provided in a nondiscriminatory manner. This means that market forces rather than the opportunity for specific tax advantages should determine the particular kinds of investment to be undertaken as well as the particular firms and industries which undertake it. The allocation of investment will be much more efficient when investors respond to market signals which reflect the wishes of consumers for particular goods and services.

Since the double tax on dividends in current law tends to distort the allocation of investment between corporate and noncorporate enterprise, some form of integration may make a significant contribution to economic efficiency. Other capital formation measures, to the extent that they reduce the relative taxation of corporations, have similar effects but not nearly to the same degree.

Debt Versus Equity Finance and Corporate Dividends Versus Retained Earnings

Also, tax incentives should ideally be neutral with respect to the way in which investment is financed and the extent to which corporations distribute or retain their earnings. There is considerable concern that in our present tax structure the corporation income tax biases the financing choice toward debt rather than equity financing and toward retentions rather than distributions of earnings. To the extent that debt financing is encouraged, an unbalanced financial structure can develop with too much debt piled on a limited equity base. The result could be an economic system increasingly vulnerable to cyclical fluctuations; and investors increasingly less willing to assume risk. Similarly, tax incentives to retain earnings can lead to corporate conglomerates as large firms seek outlets for their retained earnings.

Eliminating the double tax on dividends deals directly with the bias toward debt financing since returns to debt capital—that is interest—and returns to equity capital—that is dividends plus corporate retentions—would be taxed more nearly alike. The other measures for stimulating capital formation have no substantial effects in removing this bias. Similarly, by eliminating the double tax it is possible to achieve neutrality in the corporate decision to retain or distribute earnings.

Timing effects.—Alternative devices for stimulating capital formation may also have quite different effects on the timing of investment per dollar of revenue loss. These differences in timing may be important since we are concerned about investment to eliminate potential short-run bottlenecks as well as to provide an expanding productive capacity to sustain long-run growth.

The investment tax credit and changes in depreciation measures tend to have a larger short-run effect on investment per dollar of foregone revenue than either corporate rate cuts or eliminating the double tax on dividends. This occurs because in the short run the investment tax credit and accelerated depreciation have a greater effect on investment decisions. In contrast, a significant portion of the tax reduction from rate cuts and eliminating the double tax accrues to capital already in place rather than to new capital formation.

It is difficult to determine how heavily to weigh the timing differences of alternative proposals to stimulate investment. In the long run, it seems to me,

that proposals which equally increase the after-tax profitability of investment are likely to have about equal effects in increasing the capital stock. The extent to which short-run differences should be given priority depends in part on one's evaluation of the short-run constraints currently impeding capital formation. If tax considerations are exerting a significant constraint on current investment decisions, then a stronger case could be made for the investment tax credit or an acceleration of tax depreciation. On the other hand, if investment is currently constrained by a concern about whether markets will be available for the additional output produced by a larger capital stock, then structural tax policy may be less effective in the short-run and should perhaps be directed towards longer term objectives.

The overall objectives of tax reform—simplicity and equity—also enter into the evaluation of investment stimulus alternatives.

Simplicity.—Of the various investment stimulus alternatives, the simplest would be a straight cut in the corporate rate, although no significant complexities would generally be involved in increasing the investment tax credit or in allowing more accelerated depreciation methods. Also, although integration may be less familiar, it could be designed so that all the shareholder would have to do would be to copy onto the tax return information supplied by his corporation. This is particularly true for partial integration. Full intergation could involve more complexity at the shareholder level since in this case shareholders would have to increase their basis in the stock for the earnings which corporations retain on their behalf.

Equity.—Corporate and personal tax integration would be consistent with the goal of taxing all income only once and would also be more progressive than other ways of providing an investment stimulus. This result occurs because under integration, corporate income—dividend income only in the case of partial integration and all corporate income in the case of full integration—are taxed at individual marginal tax rates rather than at a flat corporate rate. Eliminating the corporate rate with respect to dividends therefore confers greater benefits per share to shareholder in lower tax brackets than to those in higher tax brackets. In other words, the effect is the same as increasing by a constant factor the dividends of all shareholders. While before-tax income goes up proportionately, after-tax income goes up more for lower income than higher income shareholders because of the progressive tax rate schedule.

The other stimulus measures—the investment tax credit, accelerated depreciation, or corporate rate cuts—also provide initial relief to owners of corporate shares, since these shareholders claim the higher after-tax income stream earned by the corporation. However, unless the cash-flow gains to the corporation from lower taxes are completely paid out in the form of higher dividends, the distribution of the after-tax benefits from corporate tax cuts will tend to be proportional to dividend income. This occurs because the additional income available at the corporate level will not immediately be taxed at the marginal rates of shareholders. If these cash flows are retained by the corporation, the values of corporate stock may increase and while corporate shareholders have experienced a gain in wealth as a result, there is no immediate increase in tax liability. Thus, the greater progressivity from eliminating the double tax is due to the fact that the additional income accrues at the shareholder level, rather than at the corporate level, and, therefore, it is subject to a progressive structure of marginal tax rates.

It should be pointed out, however, that while eliminating the double tax on dividends may be more progressive among shareholders than are cuts in taxes on corporations, nonetheless, all investment stimulus measures which reduce taxes on capital income are regressively distributed in general. This is true because capital income tends to be concentrated among higher income taxpayers as a whole. It need not follow, of course, that a complete tax reform package cannot be progressive if stimulation capital formation is to be one of its objectives. But in order for the program to be progressive in its total impact, it must take into account the effect of measures to stimulate investment.

Here again there are trade-offs. While eliminating the double tax may be more progressive per dollar of revenue loss, the investment tax credit and accelerated depreciation may require fewer dollars of revenue loss to achieve a given short-run investment effect. In any event, the long-run effects of higher rates of capital formation on the distribution of income will be quite different from the immediate impacts. Over time, the benefits associated with real productivity gains will be generally distributed throughout the economy.

Let me conclude by assuring you that this Administration is greatly concerned about the failure of our economic system to perform up to its potential over the past 10 years. We have taken seriously the need to provide adequate incentives for capital formation and risk taking. In the tax program which we shall later be presenting, this objective will be addressed in a significant way. At the same time we are also committed to developing a tax system which is more equitable and simpler. I shall look forward to working with you in the future as we present our proposals to achieve these ends.

Senator DANFORTH. I would very much appreciate that, if you could, with your evaluation as to how you would rate them on a scale, with a special reference to business taxes, the difference between the corporate rate reduction, the expansion of investment credit, and so forth.

Secretary BLUMENTHAL. Right.

If I may make one more point, Mr. Chairman, it also depends to some extent, whether you wish to stimulate capital investment generally, across the board, or whether you wish to use tax policy to stimulate it in certain areas. Obviously, the investment tax credit, or the investment tax credit for certain purposes, will stimulate it in the areas to which you are targeting. If you want it untargeted or targeted, but we will try to spell that out.

The CHAIRMAN. Senator Hathaway?

Senator HATHAWAY. Thank you very much, Mr. Chairman.

Mr. Secretary, yesterday I submitted a bill which was a substitute to the House-passed bill. In that bill I have incorporated a bill introduced by Senator Weicker and I which incorporated the so-called Amex plan for stimulation of investment. It would allow a tax credit for those who invested in certain small businesses up to \$750 for a single person and \$1,500 for a married couple.

Have you had a chance to examine this? If you have, I would like you to comment on the proposal.

Secretary BLUMENTHAL. I have only had a very brief opportunity to look at it. As I understand it, there is some concern and some preference for a benefit that is targeted based on the gain that you actually make, so that you use whatever limited revenue you have available to provide an incentive for the winner, rather than for everybody.

The other problem is clearly that of defining what is a new equity issue, and the tax policy people are still struggling and not clear that they can solve the problem of how to prevent abuses in this definitional problem.

I personally happen to have some sympathy for ways of stimulating equity investment because, part of the overall problem that industry faces is that quite clearly, in my judgment, we have in this country moved too much to debt financing. The debt-equity ratios have really turned upwards so much that there is not enough equity financing.

This is related, to some degree, with the problem that Senator Danforth raised.

So I have some sympathy for trying to stimulate new equity investment. I think that given the overall state of the economy, we should do that in large extent. But then when you get to this, you just do not want to use a lot of revenue to give it to everybody, because you are going to have a lot of cats and dogs, if you will, that are going to—everybody is going to go into equity, including people who should not. And people are going to be investing their money in a lot of stuff that is money down the drain.

So the focusing and defining is the real problem.

Senator HATHAWAY. With those reservations, however, you think it is generally a good plan?

Secretary BLUMENTHAL. Stimulating of equity investment is a good idea. Whether this particular proposal will do it and do it at a cost that is bearable, we are not sure.

The question, of course, is what it would substitute for, because we cannot have these add-ons without getting out of the ballpark in terms of the total cost.

Senator HATHAWAY. Fine. Thank you.

Thank you very much, Mr. Chairman. I have some other questions, but I will wait until this afternoon.

The CHAIRMAN. Senator Dole.

Senator DOLE. Thank you, Mr. Secretary. We appreciate your patience. Is there anything you wanted to raise that has not been asked.

Secretary BLUMENTHAL. Oh, Senator Dole, I am dumbfounded.

Senator DOLE. We are all trying to make points. Maybe you missed one that you wanted to make.

Secretary BLUMENTHAL. I think I have done pretty well.

I do want to issue this note of concern. I hope the Committee will not—

Senator DOLE. You have about 1 minute.

Secretary BLUMENTHAL. It is a short note, but a serious one, Senator Dole. I hope the committee will not let its enthusiasm run away and report out a bill that is too big. We really cannot afford a deficit larger than what we are talking about these days, and we are trying to cut expenditures. As you well know, this is a difficult thing to do in the Federal Government. The President's hands are tied in so many areas. We have gotten it down for 1979. We are working like the dickens on 1980, and it is going to be substantially reduced. But we do not want to have a tax bill that is too big.

So the target that I referred to in my testimony is about all I think we can afford.

Senator DOLE. I appreciate that.

Would you like to have this done before or after the election?

Secretary BLUMENTHAL. I take it that you are going home before the election and do not plan to come back afterward. If you feel you would give us a better tax bill right after the election, I would be all in favor of inviting you back.

Senator DOLE. I notice you spent some time on the so-called Archer amendment. You are very concerned about indexing.

Would that suggest that you would prefer a broader indexing package, that some of us would like to propose?

Secretary BLUMENTHAL. No, Senator. The last point I made in my testimony is really, in many ways, the critical one. I always remember my friend and colleague, the Brazilian Minister of Finance, who has had to struggle with inflation rates much higher, who has told me on more than one occasion, Mike, if there is one thing you must prevent, it is to get into indexing, because once you have it in the economy, you cannot get it out. You validate it.

You know, if you have a 30-percent inflation rate as they have had, or even more, and you index everything, you cannot ever get away from it. We have gone too far in this country, in my judgment already.

Half the payments that people receive are indexed, and that is one of the reasons why, when people say do something about inflation, you say to them, what? Do you want to eliminate the indexing? We have it on social security, we have it in all the cost-of-living contracts that private corporations have, and that makes it so tough to get rid of the inflation problem.

If you now expand it to build it into the tax code, you are really in trouble, and we have got to get the inflation rate down to 6 percent, 5 percent. We used to have 2 percent or 3 percent inflation. We have to get back to that.

It will take years, but we will not do it if we index. That is why I certainly do not suggest that you extend Archer. I am indicating that if you do Archer, in addition to doing something that is wrong in the first place, you are also doing something that is most inequitable. Because what I would do is I would go out and borrow—once I got out of this job, I would borrow up to the hilt, and then go for capital gains, which are indexed.

No indexing on what I owe; I am bound to make money.

Senator DOLE. We are just trying to have some input into the bill.

If you had a choice, would you rather have the Hansen-Steiger amendment, or the Roth-Kemp? Or none of the above?

Secretary BLUMENTHAL. There may be a third choice, which is I could commit public hara-kiri.

I think both of those are the wrong approach, Senator, and by now, anybody who does not know why I feel so has not been paying attention.

Senator DOLE. We are in a very friendly spirit. I thought you might have had a change of heart.

Secretary BLUMENTHAL. I am always in friendly spirits, particularly before this committee.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Mr. Secretary, first, I wanted to express support for your present position in regard to social security. It seems to me we should be very careful about moving toward financing social security through general revenues.

I have listened very carefully to your presentation of the Archer amendment. While I have not made a firm decision, it seems to me that you make very good points in regard to indexing. I am fearful that if we begin to index, that, just as you mentioned, what happened in Brazil could well happen here if we go too much to indexing. As you have indicated, we have gone pretty far already in that regard. So I have a great question about the Archer amendment.

I do support strongly Senator Hansen's proposal, which I know you oppose.

To get back to the rather severe and, I feel, alarming drop in the value of the American dollar in international markets, you did not express it, but I take it that you do feel it is a matter of great concern. Am I correct?

Secretary BLUMENTHAL. I referred to the President's statement expressing his concern, and I certainly share it.

Senator BYRD. You put great emphasis on energy imports. I do not know that I can really accept that argument, in view of the fact that Japan imports virtually all of its oil; Germany imports virtually all

of its oil; Switzerland imports virtually all of its oil; and yet the American dollar has been losing value tremendously to the currencies of those countries.

I notice in your reply to my question, you did not mention the huge and accumulating Federal deficits. Is that not a major factor?

Secretary BLUMENTHAL. Senator, I referred to the perception by the foreign financial community of the two fundamental factors in the U.S. economy. One is inflation. I did not specifically mention the budget deficit, but clearly our strong efforts to reduce that is related to our concern with inflation.

Senator BYRD. To put it another way, the deficits are a factor in the depreciation of the dollar overseas?

Secretary BLUMENTHAL. The deficits, when we are operating, as we are at the present time, relatively close to full employment tend to increase inflation which is why, quite frankly, the Kemp-Roth proposals are not acceptable at the present time.

Senator BYRD. How do you see inflation by the end of the year?

Secretary BLUMENTHAL. Our best judgment at the moment is that the cost of living will rise at an annual rate, for the second half of the year, at about 6.5 percent, giving us the average between the 10.4 percent and the 6 to 6.5 percent. We think that going into next year we will be at a rate which will give us a lower average for 1979 than the average for all of 1978. It is still much too high.

Senator BYRD. You feel the average for 1978 will be what?

Secretary BLUMENTHAL. I think the underlying rate of, right now, about 7 to—a little more than 7 percent, perhaps. If the measures that have already been taken, the strong anti-inflationary emphasis that we will continue to have, and even intensify, I hope, are effective, we should next year go back, go below the 7-plus rate, go back to the 6 to 6.5 percent. That is about all you can expect in the course of a year, and then we have to continue working.

Senator BYRD. What do you foresee for interest rates by the end of the year?

Secretary BLUMENTHAL. I really find it difficult to predict interest rates, Senator, particularly in public. I just cannot say.

Senator BYRD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. Secretary, the President has announced the goal of reducing spending as a percentage of GNP to 21 percent. Now, do you not believe that if we passed tax legislation covering the next several years that we would be in a better position to meet this goal of reducing the percentage of GNP spent by the Federal Government? It is roughly 23 percent today, and the President has urged a goal of 21. Some of us think 20 percent would be preferable.

It is going to take some doing. But if we knew what the future revenues were going to be, does that not bring some order and some planning into the picture—and some discipline, I might say?

Secretary BLUMENTHAL. I think that the more preferable way is to work on the spending and as we get it down, to reduce the taxes commensurately. The reduction of spending to 21 percent of GNP is a difficult task.

Senator ROTH. It would take several years.

Secretary BLUMENTHAL. It is intended to be, I believe, by fiscal 1981. We were at 23 percent, 22.4 percent now. We are trying to bring it to 22 and then to 21.

I think that the very major tax decreases now would require going below 21 percent, really, in order to make up for that, and I really do not think we can go past that.

Senator ROTH. I think the commitment now, Mr. Secretary, that we are going to return this revenue to the American people is an essential factor in planning ahead and reducing the spending that you are now espousing.

Let me go to this question of inflation. We recently had Mr. Miller before the Joint Economic Committee, of which I am a member, and he said that the increase in the minimum wage is going to be very inflationary. Do you share that concern and, if you do, do you recommend that this Congress take action?

Secretary BLUMENTHAL. I think that the mandated increase in the minimum wage is going to be inflationary. I think if the Congress is going to look at actions to counteract inflation, it should be one of the factors that should be looked at. That is my view.

Senator ROTH. Mr. Secretary, there is also \$100 billion new budget authority included in this current budget. And at these same hearings, it was pointed out that that is one of the seven largest increases during the last 25 years, 6 of those years being war years.

You talk about holding down spending in the future. How is that possible when the current budget authority has been increased \$100 billion? Where is the discipline?

Secretary BLUMENTHAL. The rate of increase in spending and in the budget authority has been pushed down for this next year as opposed to the past two previous ones, if memory serves me right, and the President is doing all he can to accelerate that trend.

We expect to have a substantially smaller deficit. That is only possible by just extending present programs without any new programs, and would involve a continuing increase of the kind you are talking about.

Senator ROTH. But, Mr. Secretary, there is new budget authority of \$100 billion. That is one of the seven largest increases in the last 25 years. So on the spending side, there is no discipline. That is spending for the future.

The reason I think Roth-Kemp is antiinflationary and the only antiinflationary measure before the Congress is the fact that we are making a commitment now to return roughly \$120 billion to the American people.

There have been some discussions that we ought to offset the increase in taxes to the American people. I would like to point out what the American people are faced with. In 1979, the increased taxes due to inflation—and these are Joint Tax Committee figures, not mine, Mr. Secretary—and social security will be \$26.4 billion. The 1980 impact is \$40.9 billion. It goes up, by 1983, to roughly \$110 billion in additional taxes.

That reminds me, Mr. Secretary, I agree with you when you made the statement earlier that the Treasury is always interested in additional revenue, and I think that is what your message is today. The Roth-Kemp proposal barely offsets, the increased taxes that would be paid by the American people due to inflation and social security.

Mr. Chairman, I would, at a later time, like to continue.

Senator BYRD. Senator Haskell?

Senator HASKELL. Mr. Secretary, we have talked about inflation. We have talked about fiscal policy. We have talked about monetary policy, and we have talked about balance of payments. It seems to me that there is one thing that we have not addressed, and I just wondered what your opinion was. That is, generally the problem of the price-wage spiral.

For example, I remember about 6 months ago steel went up 3 percent. Someone patted them on the back. I wanted to find out how many previous increases had occurred during the year. The total increases were 9. If you annualize it, it is 18, and this, of course, brings on wage demands. This wage-price spiral is one of the central—at least, in my view—one of the central problems that we face as a nation.

I would like to know what your views are as to how to combat this problem.

Secretary BLUMENTHAL. I think you are quite right, Senator Haskell. At the center of our difficulties of reversing and pushing the rate of return down are the rigidities in the economy with prices chasing wages and wages prices, and the difficulty of getting a hold on it. Some of this is because of the built-in factor that we have talked about.

I feel strongly that one tool that has been used once before in the early 1970's, that of mandatory control, is totally unacceptable. It proved to be a complete failure, and we cannot try it again.

That means that we have to find some other means for encouraging and inducing the cooperation and support of management and labor.

The President, in his April 11 anti-inflation statement, suggested a deceleration standard. It is somewhat too early to tell what the impact of it is, but it may well not be sufficient. Clearly, additional measures have to be considered.

I have said publicly that we are taking a close look on an analytical basis at tax-based programs to encourage people in this regard. There are enormous difficulties with that, and I do not know whether we can overcome them, but since we use the tax code for many purposes, we should not reject, out of hand, the notion that we may be able to use it for this.

It may be that greater standards of behavior, stronger standards of behavior by both labor and business may be promulgated. It may be that the Government will have to be more active in inducing with its own interests compliance by labor and management in that. It may be the way in which the Government purchases its products in a variety of ways. We can find the means to induce the people to help us break through that spiral.

It is the central issue, and there are no good answers. Everybody wants to fight inflation, but nobody has any good way of doing it. We all know what we are against, but we have great trouble coming to some agreement.

Senator HASKELL. As of now, this is an area that you personally and others in the administration are exploring?

Secretary BLUMENTHAL. We are actively at work at that.

Senator HASKELL. I have another question.

I have difficulty with the remission of the value-added tax that the common market gives its exporters. It seems to me that it is the clearest kind of subsidy—and incidentally, I happen to agree with you on DISC. I do not believe that is a very fruitful program. But it seems to me that the United States merely as a matter of self-protection might consider, in addition to the emergency clause in the GATT treaty, imposing a tariff equal to the remission in Europe of half of their value-added tax? I would like to ask your reaction to this.

Secretary BLUMENTHAL. The rules under which we are operating, to which we have agreed as a signatory under GATT, allow the remission at the border of indirect taxes, but not of direct taxes. I think there are elements of inequity in that, that the greater element of inequity really leads to the substantial degree of subsidies that are clear subsidies that exist in many countries.

We have had some cases of that recently, subsidies on credit, for example. Competition with the United States through subsidies and location to provide tax breaks and cheap plants and those kinds of things.

Ambassador Strauss is actively negotiating in Geneva on a subsidy code that would put us all on an equal basis, and that would eliminate that. That is what I think the better approach is.

You referred to the emergency situation that exists at the moment. If we were to do what you suggest, we would not only be in violation of our international agreements, but we would also be discriminatory in that we would be hitting countries to the degree that they have indirect taxes which, under the present rules, they are allowed to rebate. So we would be changing the rules unilaterally, unclearly. Whatever the emergency in this country, that would be a very serious step.

Senator HASKELL. I realize that. Thank you, Mr. Chairman.

Senator BYRD. Senator Hansen?

Senator HANSEN. Mr. Secretary, you expressed concern earlier for the impact that the various proposals that are before the Congress might have on the budget deficit. Are the changes the House made in capital gains taxation an acceptable mechanism to provide the stimulation in jobs and in the economy?

Secretary BLUMENTHAL. I think in capital gains you have a peculiarity, Senator, in that you have an initial impact which is different from the cutyear impact because if the theory is right, and I suspect it is, and it is that—which I think Professor Feldstein has taken into account—that if you substantially reduce the capital gains tax, you would unlock a lot of unrealized capital gains. People would sell assets because they would feel they could afford it now.

The first year out, you could well have a bump in the amount and in the curve on the amount of taxes that you collect from capital gains taxes. There are some offsetting factors, but you might well have an increase. That would not be true once you have that out of the system.

To answer the specific question, therefore, that you raised whether or not reduction in capital gains taxes would provide stimulation that creates more jobs, I am sure it would, to some extent. I am sure of it. So would a reduction in the corporate tax rate provide that. So

would an investment tax credit increase that leads to more building activity. So would individual tax reductions that lead to more spending, therefore more demand.

The question is not whether it would or not, but whether it does so most efficiently. And we think if properly targeted, it would. It could do so rather efficiently.

We have some other ideas that are more efficient, but it has to be properly targeted. Our concern with the House-passed version is that it is not sufficiently targeted.

Senator HANSEN. There has been a rather dramatic drop in the number of investors on the market.

Would you not anticipate a change in the tax on capital gains would result in an overall and continuous stimulation of interest in the purchase of corporate stocks on the stock exchange?

Secretary BLUMENTHAL. I think, Senator, that there is no doubt that a substantial reduction in capital gains taxes is more likely to help the market than hurt it. I think on balance that it would help the market.

Senator HANSEN. Would that not result in the collection of more tax revenues over a period of time? You spoke earlier about this 1-year bump. Would that not bring about a continuing favorable response as far as Treasury is concerned?

Secretary BLUMENTHAL. If we reduced taxes in other ways, for example, taking an extreme case, if we put everything into a corporate rate reduction, reduced it from 48 to 38 or 40, and put a major push into that, that also would substantially increase the return on capital and therefore increase the attractiveness to invest in the market.

Also, if we can bring inflation rates down, that is one of the important reasons why people are not putting their money in the stock market. They are afraid of inflation. They are better off buying land, or other things.

I think it would help, to some extent, but it is always a question of that compared to what else.

Senator BYRD. The Senator from Texas, Mr. Bentsen.

Senator BENTSEN. Mr. Secretary, the Council of Economic Advisers in 1977 said that American business would have to put 12 percent of GNP in fixed investments if we were going to develop full employment and certain environmental objectives and increase our productivity and greater energy independence. By 1976, we saw it hit a 13-year low in investment. It went down to 9.1. In 1977, it was at 9.4. And we see the lowest percentage invested back in fixed investments of any major Western nation.

England is next to us, but we see the problems there. I am pleased to see that you support making the 10-percent investment tax credit permanent.

It seems to me that we have two types of credits that we need: investment credits and capital gains reductions. On the first one, you have the corporate investment in fixed equipment, but on the second one, you have the entrepreneurial investment.

I think that, with all the bad news we have had in the way of balance of trade and inflation, I find it difficult to understand the increase in the values of the stock market, unless part of it is in anticipation of lowering capital gains. The price multiples have been so low that the

debt ratios you referred to have made it more reasonable to go to debt than to go to equity. With the market going up, it can tilt it the other way.

Would you agree with that kind of an analysis?

Secretary BLUMENTHAL. Senator, we are not opposing a reduction in capital gains taxes if it meets some of the criteria that I have laid out, and in my testimony, I have reiterated some suggestions as to how that might be done.

It may well be that the anticipation of a capital gains tax reduction is what is behind the rise in the stock market. I would like to think, since none of us really know, that it may also be that investors by now have formed a conclusion somewhat different than that suggested by Senator Roth, that the economy is not in such terrible shape that the prospects for the next year and beyond are pretty good, and the continued growth of the economy does provide opportunities for additional profit for most companies listed on the exchange.

The irony of it is, as I have gone around the country—certainly in Texas, you must have had the same experience—and I meet with business groups and I start you out by asking them how is business, they say good. How is it this year compared to last year? Fine. Do you expect another record year next year? Yep. How do you feel about the future? Lousy.

I think that it may be that the market is more efficient in that regard in recognizing that next year is going to be better than this year, maybe for broader reasons than just that one.

Senator BENTSEN. In looking at our devaluation of the dollar, and particularly against the yen, that is a mixed result. It gives us some advantages and some disadvantages.

One of the advantages, of course, is that our product ought to sell a little cheaper to the Japanese. One of the things that concerns me, when I see General Motors—in one newspaper story I saw where it said the price of the Toyota increased so much because of the change in the devaluation of our currency, that General Motors had increased the price of the Chevette by an identical amount.

Are we seeing that happen across the country, or are we actually seeing some gain in this devaluation of the dollar? Or are manufacturers just raising their prices proportionately?

Secretary BLUMENTHAL. As far as we can tell, there are two effects. One of them—of the devaluation of the dollar, Senator—one of them is the short-term inflationary effect. That comes from two sources; one, imported goods become more expensive, Toyota raising its prices. Second is that U.S. producers have a higher ceiling because competitive things can go up.

I do not think that you are entirely fair to get General Motors in this regard.

Senator BENTSEN. I hope not. I just looked at one newspaper account, so I very carefully stated that that is what I had seen. I wanted to know if that was the general result.

Secretary BLUMENTHAL. I followed those numbers carefully, not only because I know the industry well, but because I was interested in that particular product to see what was happening. General Motors has been increasing prices. Also, American industry has been getting market share, and the prices for competitive costs have been increased

somewhat less. So that the increasing in the market share is due, I believe, to increasing their prices not quite as much, not as much as the imported product, therefore widening the price gap and therefore getting a larger share.

Senator BENTSEN. We are getting some advantage on that side.

Secretary BLUMENTHAL. Some advantage. If they had not increased prices at all, they would have had more advantage. That is the first point. It does raise the lead to inflation.

In the longer run, clearly by making our exports more competitive and imports less, though, we do get an impact on the trade balance and we are beginning to see that.

The last few months have shown some pretty good evidence in that regard. Our concern over recent days, of course, has been the disorder that has existed in the market, which is a different problem, than a gradual adjustment which, in a freely flowing system, always occurs.

Senator BYRD. Senator Danforth?

Senator DANFORTH. Mr. Secretary, back to the question of capital formation and productivity, I wonder if—is the administration flexible at this point in wanting to talk about the business tax provisions?

Would it be possible to maybe work out some more creative approaches to business taxes than I think are presently in this bill, or would that be automatically shot down by the administration?

Secretary BLUMENTHAL. It would not. Senator. Yes; we are flexible. The President has indicated that he will look at the final bill and in the light of that, determine his reaction to it.

I think the overall amount of the cut would be a problem. If you were to substantially increase that, I think we would have a serious problem. If you were to substantially change the proportions between taxes for individuals and taxes for business, that might be a serious problem, but if you stay within the general proportions that have been talked about in the past by the House, and then look creatively, as you put it, at how best to use that, we certainly would want to work with you to see what we come up with.

Senator DANFORTH. I very much appreciate it. I am very concerned about the productivity-capital formation problem and a little bit fearful of being branded as a Republican tool of capitalist interest for expressing that kind of concern, but I take it that it is a concern which Democrats also can share. I think Senator Bentsen has expressed his concern in this regard.

Secretary BLUMENTHAL. Senator, I would not be too worried about that. If you are branded in that manner, I will be branded as a Democratic tool of capitalist interests, and I have no problem with that at all. I am proud that we have a capitalist economy, and we want to stimulate and provide jobs.

Senator DANFORTH. Let me just pour out some thoughts to you and see if this kind of thing would be fruitful to work on.

First of all, I am told by people who know much more about economics than I do, that if you could project out into the future cuts in the corporate tax rate, even though those cuts would be accomplished, at some future time, that the anticipation of them would have a definite beneficial effect in stimulating corporate investment, looking toward a rate of return, say, 5 years down the road.

Would it be possible to have a bill which starts out fairly modestly on corporate tax reductions—I think the House bill just goes down to

46 percent—starts out fairly modestly for a couple of years, but over a period of, say, 5 years, takes the corporate rate down to 42 percent. Would that be totally beyond the realm of possibility? It would seem that that kind of phase-in would have a minimum revenue effect and a maximum effect on stimulating business confidence and investment.

Secretary BLUMENTHAL. I think we have to be a little careful that we do not have—first of all, there is very little time left. That is one of the problems with this kind of proposal. You only have a few weeks. We have to be a little bit careful that, as we make that decision, that we recognize that we have foreclosed, then, making a decision—unless we change it, which would be contrary to what you want to achieve—that we have foreclosed the notion of dealing with the double taxation of dividends, looking at depreciation schedules, looking at other things that are useful to do. And I am not totally sure whether industry would really believe it because they know that what Congress can enact one year they can change the next and they know you are going to take another look at this.

Senator DANFORTH. Right. What I am saying to you is that it would seem to me to be possible, looking at a time segment of, say, 5 years, to create a tax package with phased corporate tax reductions, with changes in the accelerated depreciation range, expansion of that, which really is a question of moving taxation from 1 year to another. Perhaps increase in the investment credit, which would have some revenue effect, granted, but which would be putting the tax relief in a place which would have maximum positive effect on the economy.

If you did it in a phased way which was predictable and yet phased, you could create such a package and that it would really do a world of good for business confidence.

Secretary BLUMENTHAL. I would not rule that out. I think it is worthwhile looking and working with you on it.

Senator BYRD. Before we recess, I would like to ask you one question.

Did I understand correctly your reply to my question earlier that you thought at the end of the year the inflation rate for the second 6 months would be 7 percent?

Secretary BLUMENTHAL. I indicated, Senator, that I expected the rate for the second half to be an annual rate of 6 to 6.5 percent, which would give us an average for the year of something like 8, and I expect that the rate next year will be below that average.

Senator BYRD. Below the 8-percent average?

Secretary BLUMENTHAL. Right.

Senator BYRD. But you expect for the second half of this year that the inflation rate will be reduced to 6.5 to 7 percent?

Secretary BLUMENTHAL. We had very important increases in the first half, and particularly in the food sector and one or two others, and those are coming down fairly substantially.

Senator BYRD. Why do you think the rate will be down that much for the second half of the year? Entirely on food?

Secretary BLUMENTHAL. That is a large portion.

Senator BYRD. Interest rates have increased since the budget estimate of \$56 billion was submitted to the Congress as the amount of interest that the Government will pay on the national debt. Do you anticipate that the \$56 billion estimate will be increased?

Secretary BLUMENTHAL. It depends on what assumptions we make about level of interest rates. Here is another factor, Senator. There have been substantial increases in interest rates for the first 6 months. I would certainly not anticipate that the rate of increase—I am not predicting whether there is going to be any increase, but certainly we can look forward in the second half to the same kind of interest rate increases that we have had in the first half, so that also would have a positive impact on the rate at which inflation increases in the second half as compared to the first.

Senator BYRD. Mr. Secretary, the committee would like to reconvene at 2 o'clock. Would that be satisfactory to you?

Senator BLUMENTHAL. I will return at 2 o'clock, Mr. Chairman.

Senator BYRD. Thank you, sir.

The committee will stand in recess until 2 o'clock.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 2 p.m. this same day.]

AFTER RECESS

The CHAIRMAN. Mr. Secretary, in this morning's session, you made the point that you did not want us to have too big a tax cut bill. Let me assure you that we are not going to vote out of this committee a tax cut as large as you recommended in the beginning, because the budget resolution will not let us recommend that much.

I read in the newspapers that the people on the Budget Committee visited with the President and they said we ought to cut the tax cut down, and the President agreed with it. As I understand it, under that budget resolution, the most that we are permitted to recommend is \$20 billion. Is that not about the size of it?

STATEMENT OF HON. W. MICHAEL BLUMENTHAL—Resumed

Secretary BLUMENTHAL. I think that is the annualized rate, that is correct. There were a number of different numbers that I heard yesterday. I think that it may be now a little less than \$20 billion, \$19-some billion. That is it.

The CHAIRMAN. That is how much of a tax cut the bill will have when it goes to the President's desk? The Senate might add a lot more on out there on the floor. This committee will stay within that budget resolution and will see if they let stay within that amount on the floor. I hope you can help us to keep the bill from becoming too expensive on the floor, because you have some influence around this place, and so does the President. If not, when we go to conference, we will just have to find a way to squeeze the total back down where it meets those budget resolution requirements. We have done that sort of thing before, and I think that I can assure you that we are not going to go beyond what we have in the budget resolution.

The Senate may do that for us; if so, we will come back to it.

Secretary BLUMENTHAL. Right.

The CHAIRMAN. Senator Ribicoff has not had his turn yet, and I would like to call on Senator Ribicoff.

Senator RIBICOFF. Thank you very much.

My apologies, Mr. Secretary, but I had to chair the Government Affairs Committee on a major markup, so I had to leave.

If you have responded to these comments, I will read the record.

To me, I look at this tax bill as intertwined today with the decline of the dollar, inflation, and the problem of how do we increase American productivity. And I think that the problem of inflation in dollars and what is happening in our trade to a great extent depends upon our competition with an 8-percent Japanese productivity annual increase, a West German 6-percent rate, and we were 2 percent. Now, with the last figures I saw, we are down to about zero.

Talking for myself, as I vote on the various elements of this particular bill, it is just my single vote, but I am concerned with what provisions in this tax bill, or what provisions that could be in this tax bill, which would have a definite impact on the growth in inflation, would have a definite impact on increasing American productivity, would have a definite impact in helping our trade balance.

These are the important factors. Everything else that we are talking about, whether it would be giving somebody a tax cut or not giving somebody a tax cut, are inconsequential to the bigger issue.

Now you, more than anyone else in this administration, has the responsibility in all these fields as Secretary of the Treasury. I am glad that the President has asked you and Mr. Miller to be concerned about the decline of the value of our dollar. I know that the problems of inflation have to be with you every day.

I realize from your experience, not only in this job but also as our trade representative during the Kennedy round, the implications of productivity and America's position in all of these fields is born anew every day.

What is there in this bill that in one way or another affects all of these interrelated financial and economic problems? What in this bill is bad for the economy? What is in this bill that is good for these problems? What should we be putting in this bill to help solve these problems?

I know that this is a pretty big plate that I put before you and I do not expect you to have all the answers. We are going in to mark-up after these hearings—I do not know how long these hearings will be. Mr. Chairman, a week, 10 days. Personally, whatever influence I can bring to bear, and every vote that I will make in this committee will, in one way or another, address those basic problems. They are a lot more important than what I can see in this bill at the present time.

Would you want to make a general comment, with the understanding that I do not expect all the answers? But I would like an analysis from you and your economists in the Treasury.

Secretary BLUMENTAL. Senator Ribicoff, these matters were indeed touched on this morning, and I commented this morning that along the lines that are completely in accord with what you say.

I think that inflation and our trade imbalance are two very serious matters that the foreign observers look at when they look at the U.S. economy. At the same time, related to that is the low productivity growth that you referred to which, in turn, is related to the inadequate level of investment and capital accumulation.

Obviously no one bill—and that includes this tax bill—in every aspect addresses itself to all these problems. This bill does do so in a number of ways. Certainly the business tax proposals that we have been discussing this morning and are contained in the House bill as

they were in a somewhat different form in the original administration bill are designed to stimulate investment.

That is the cut in the corporate tax rate which provides greater cash flow, more profitability, more money going into the stock market, a higher return, would do that. The investment tax credit, which provides for incentive to invest in structures does that.

The shift that the committee has done in the House Committee to capital gains taxes does that, to some extent, and I indicated in my testimony that we are not opposed to capital gains tax cuts per se, as long as they were reasonably progressive and did not give all the money to the highest income groups, and as long as they were directed very importantly to this issue of capital accumulation.

These things will help productivity and therefore to counteract inflation, because as we invest more, we eliminate potential bottlenecks in the economy that would be inflationary.

The general maintenance of economic activity which this bill intends to assure also is important, because it maintains the competitiveness of American industry which enables us to go out and export more. We have a high level of economic activity in this country. Our costs rise. It is hard for us to be as competitive abroad as when conditions in our own country are good.

I do want to add one other point, and that is the need to deal with the energy problem, which I mentioned this morning also, which is also related to the dollar problem and the trade problem. But what we do not want to do is to cut out tax cuts particularly for low and middle income people, who would be hit particularly hard by inflation, as a means of balancing the budget or eliminating the imbalance, and use that as an argument that we are fighting inflation.

We have reduced the deficit from originally, we thought, \$60 billion in fiscal year 1979 down to now a little more than \$40 billion. That is one-third.

We have reduced the amount of the tax cut. Originally the President proposed a \$25 billion packet. As the chairman just indicated, we are talking about a \$20 billion packet.

To go beyond that and say, well, we will just cut it out for individuals in order to fight inflation, that, I think, would not be justified and would increase unemployment and hurt the people who could least afford it.

Senator RIBICOFF. I would like to get your reaction to one phase of the House bill and that gives a once in a lifetime capital gain exemption on the sale of a house of up to \$100,000. It strikes me there is an element of unfairness to that in favor of higher income people and older people; people who are older and have higher incomes are more apt to have their \$100,000 capital gains exemption.

But you take younger people who are just starting out. I just think of the staff man on this committee against the Senator sitting here—a man in his thirties earning a salary of \$25,000 or \$30,000. He probably has a modest home and gets a shift in his job to Chicago and he sells his home. He might make a \$15,000 to \$25,000 profit, and he gets an apartment because he does not know whether he is going to keep his job.

And so he has \$20,000 for his life, where an older, wealthier person gets \$100,000. I am doing something on the capital gain exemption for the sale of a home; but, would it not be more equitable to give

everybody a lifetime exemption up to \$100,000? Make sure you have all the conditions—that is, for a home that they have actually occupied, if it is 2 years, for the 2-year period.

But there is a sense of unfairness here that is weighed for the older, wealthier people as against the younger people.

Secretary BLUMENTHAL. Senator, I think that we have to make the following distinction. The normal homeowner, other than those when they get up into the upper age bracket, do not pay capital gains taxes on the sale of a home. Under the rollover provision, if they buy a new home—and most of us, I think, as we have sold our homes and moved into others and had a capital gain on the first one, we have been able to avoid the payment of taxes.

This particular provision, I think, is primarily oriented towards those—you get up to 55, 60, 65, and the children are grown up. You move out of the home. You may move into a rented place, or you may no longer wish to live in the home.

Then, as you have a very substantial gain, if you have not moved more than once or twice during your lifetime, there is an argument that inflation really has accounted for a lot of the increase and you should not be taxed on this.

It may well be as you say that the \$100,000 might be too much. There is a pretty heavy loss of revenue involved to the Treasury which, as I indicated this morning, might well be used better or more effectively, for example, for some of those productivity creating or antiinflation goals that you mentioned.

I do suggest that the committee might want to look at a smaller package here, one that might be less than \$100,000 or more focused, really, to people who sell it at the end of their homeownership cycle, about 55 years of age, for example, and that could reduce it. And the example that I had from the \$700 million loss to the \$300 million loss which would give you \$400 million for some other purpose.

Senator RUBINOFF. Thank you very much.

The CHAIRMAN. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, in your testimony, you cited a Roper poll in favor of tax reform and urged the committee to be guided by it in our deliberations.

Are you familiar with the August 8 Roper poll that shows the American people favor a one-third cut in taxes by a 2 to 1 margin? It was 48 to 21 percent. And I wonder, in this particular instance, should the committee be guided by this poll?

Secretary BLUMENTHAL. I was not referring to that and I had not had a chance to see that. I was referring to a very detailed study which was commissioned, I think, by H. R. Block and Co. I was referring to a very detailed study, Senator, that was commissioned by a private company, H. R. Block and Co., that Roper did. I have not seen the one that you referred to.

Does it have a note in there as to what percentage favor that kind of tax cut together with the high rate of inflation that it would produce?

Senator ROTH. The question asked was: "everything considered, on balance, do you think it would be a good thing or a bad thing if all taxes were cut by one-third." 48 percent said good; 31 said bad; 21

percent said it depends on which taxes were cut; 10 percent said they did not know.

Mr. Roper has stated publicly this poll indicates overwhelming support for my proposal. He also pointed out that the American people thought inflation would be reduced because of less Government spending if my bill was enacted.

Mr. Secretary, I want to make it clear that my questions are not directed to you personally. I recognize that you represent the administration and may or may not personally agree or disagree with all I say. But I have great respect for you.

Going back to this inflationary program of this administration, do you think that the recent settlement of the coal strike, which was pretty much engineered by the administration, was noninflationary or inflationary? Would you be satisfied if that were used as a model for other settlements?

Secretary BLUMENTHAL. I certainly would not. I think it would be inflationary, if it were to become a model for other settlements. I think that the coal settlement with a number of coal industries, coal mining, is a rather special case, it had some special features to it.

The need to expand—keep up and expand production in the coal mines relating to that whole energy problem, I think, is a very important point, and while the administration certainly—not I personally, but while the administration helped to get a settlement, it is always a question of alternatives as to what it might have been.

I would say on balance that it is not a good settlement if it were duplicated elsewhere, but in the coal mines it was the best thing that we could have gotten.

Senator ROTH. Mr. Secretary, is it not true that the impact of the \$240 tax credit and the repeal of certain itemized deductions would increase taxes on middle-income taxpayers?

Secretary BLUMENTHAL. No. We would want to work with the committee to construct a set of tax tables such as the combined impact would not result in increases in taxes for those people but really make the tables more progressive and the taxes paid more progressive for people below \$50,000.

The House bill tends to put a lot of the money, or too much of the money, above \$50,000 and we would want to correct that, and I think we could do that with a combination of the two. Both the credit and rates could be adjusted in such a way that what you take away on eliminating itemized deductions gets put in the tables where it helps people below \$50,000.

The Chairman's suggestion that we also have a floor on a lot of people who have extraordinary losses in one of those so that they could still itemize that, even though they take the standard deduction. That would also help to work in the direction you are interested in.

Senator ROTH. One of the things that bothers me is that here we are in August, late August, and we really do not have even the specifics of the Treasury proposal. You talk about making changes in the tax rates, but as I understand it, you have not yet specified exactly what those would be. When would you have the specifics ready?

Secretary BLUMENTHAL. Senator, of course we have made one proposal that remains before the Congress. Now, that has been overtaken, I take it, by the action that the House has taken. In the case of that consideration on the House side, we did support the Corman-Fisher alternative.

If the Finance Committee wishes to go back to the original proposals we made, fine. If you wish to change them, then we will work with you. But we cannot make constantly new, specific proposals. We are going to respond to whatever changes you wish to make in the House bill before you.

Senator ROTH. Mr. Secretary, it was my understanding that you were presenting to us today the present administration recommendations. In view, I guess, of the changes that were made on the House side, I think the question that we need to answer here is what specifically do you expect to do in respect to the tax rates.

I will get to that later. My time is up. I would like to go further.

Thank you, Mr. Chairman.

Senator HASKELL. Would you like to do it now?

Senator ROTH. If I could. I will not be much longer.

Let me ask you this question, Mr. Secretary. You do agree that the type of tax cut does make a difference as to what happens to the economy?

Secretary BLUMENTHAL. It definitely can.

Senator ROTH. Do you think, for example, a \$50 rebate or a \$240 tax credit has more impact on the demand side or on the supply side of the economy?

Secretary BLUMENTHAL. Those are two different things. A \$50 rebate clearly has an impact primarily on the demand side. In the first instance, it works itself through, hopefully, an additional expansion of capacity, but primarily on the demand side.

The \$240 credit really, as I said in my testimony, Senator, is a part of the overall individual tax cut. We have to see it together with the tax table.

Senator ROTH. My question was focusing on the \$240 credit itself. Does that provide much additional incentive, or promote the concept of savings?

Secretary BLUMENTHAL. I think I know what you mean.

The individual tax cuts, which include the \$240 credit and whatever cuts made in the rate schedule do not, in and of themselves, work in the first instance on the supply side. They work on the demand side.

Senator ROTH. On the other hand, if we direct our attention to the tax rates—for example, if you take the man or woman who is paying a marginal tax rate of 50 percent. If we reduce that to 35 percent we would provide some additional incentive to work and to save. Would you agree with that?

Secretary BLUMENTHAL. It is interesting that, historically, you would think that it does. But when we look at the actual experience, you get mixed results.

In this country, we have found that as people's earnings increase above a certain level, particularly when you get to the 50-percent level, people choose to work less, take more vacations, to retire earlier. They do not necessarily go out and work harder.

You would think that if you reduced their rate to 35 percent, people would rush out and work longer hours. They work less hours, play golf more. They do that.

Senator ROTH. Of course, for a long time many economists were claiming that tax changes had no impact on savings. But the latest thinking of some economists is that tax rate changes would have a very substantial effect on savings. I think that you would agree with me that the savings rate of this country is less compared to others, so that this should be a matter of grave concern in the overall picture as far as getting the economy moving up.

The President himself has in the past talked about trying to reduce the tax rates down to 10 percent on the low side and 50 percent on the high side.

Does this still remain a goal of the administration?

Secretary BLUMENTHAL. Yes. We have never formally put that forward. We would certainly like to get those rates down.

I would be very much in favor of having a tax rate that never exceeds 50 percent. I think that would be a desirable thing.

Of course, when we do that, we have to have a host of other reforms we have to cut out, other deductions and exceptions, so that we get the revenue for it. That idea of having a maximum rate of 50 percent, incidentally, will not please a lot of people these days, within the context of raising the capital gains rates to the same 50 percent, but also eliminating the double taxation of dividends, doing a lot of things all at once.

I think that there is some merit to that, but we seem to be going a different way and we just do not have the revenues at the moment to do that.

Senator ROTH. One of my concerns is that the Treasury and many other Keynesian economists, at least in their models, have been static. They, in no way, recognize the feedback. I think the chairman of this committee has expressed serious concern about the lack of consideration given to the feedback of a properly tailored tax cut.

You do agree that a well-shaped tax cut could move the economy up, and that there is feedback, both in the sense of growth and in taking people off of welfare, and that should be the goal of our tax program.

Secretary BLUMENTHAL. Yes, Senator.

There is attached a rather long, and, I think, professionally done appendix in which we in the Treasury have attempted to put together the whole rationale on the feedback effects and their impact on revenue estimation. I think that you will find it of great interest.

Clearly there are feedback factors. We have explained when we do and when we do not take them into account and why, and also it needs to be remembered that the feedback effect, when you are close to full employment, is different than when you have a lot of excess capacity in the economy, at least in terms of its impact on inflation, if you are bumping up against a ceiling. Certainly you cannot just use a static analysis. We do not do that in macroeconomic terms and we look at the economy as a whole. We say so much spending and so much tax cuts will lead to such and such GNP in the economy, and we build in what the feedback effect would be. What we do not do is do it for each individual component of a tax bill, just as we do not say when we appropriate money to build a bridge in the State of Delaware, we do not

say that costs \$100 million, but, really, it only costs \$40 million, because spending the \$100 million will employ people and give you money back. We do not do it on each individual item.

Senator ROHR. I am at the end of my questioning, Mr. Secretary, but I would like to reiterate once more what concerns me, and I hope in the coming weeks everybody can work together in trying to get the economy moving.

What concerns me the most about the administration's program, to the extent I understand it, is that it is directed only at short-range problems. It does not provide any new direction, or any real hope for working out of this very serious economic problem that we face.

I do not see anything, to be perfectly candid, in this package proposed by the administration that really is going to provide some bouyancy in the economy to provide more jobs in the private sector, or to do something about the dollar.

It seems to me that the best way of doing it is to try to tailor a tax program that is going to provide some incentives for economic growth.

I hope that you and the other members of the administration would take a look at some of the things we are talking about, in the hopes we could move in that direction.

Secretary BLUMENTHAL. Mr. Chairman, I would like to make one comment on that, because I think Senator Roth's point is a very important one.

We may have one difference, Senator, and that is this: You refer, from time to time, about the need to get the economy moving. I suppose that we operate on the basis of the assumption that the job is not to get it moving, but to keep it moving.

We think the economy is moving pretty well. Last year we moved to a growth rate of 5.5 or more percent in real terms. We are moving about 4 percent in real terms at the present time. The long-term, sustainable rate of growth is about 3.5 percent.

So we are moving, and we are moving in the right direction and at the right speed.

What we want to, at this point, make sure is that it keeps going.

Turning to the longer run things that you were talking about, I think that there is a need, having achieved that, to getting to a budget balance, maintaining the kind of job creation and we have job creations, the biggest in peacetime, in the post-war period, that we have ever had. We have created, I think, something like 6 million jobs this year alone.

That is a world record. It shows what a free enterprise economy can do. As we get this behind us, I think you are right. We need to look at more capital accumulation-type activities. We need to do more about productivity. We need to look at some of the other long-run concerns. We need to do more about the hard core unemployed which, in some places in this country, is still too high, and add to part of the game plan, such as are getting Government spending down to 21 percent of GNP, doing some of those things. We need to add to it along the lines that you suggest.

Even after last year, 1980, 1981, and 1982, we can be sure that it keeps moving in the right direction. That is the only slight difference I would have with your presentation. I think it is an important point.

Senator ROTH. Just commenting on what you said, short-range, it bothers me. In essence, you are really saying higher taxes for most Americans and you are saying the economy is doing all right. But many people feel that next year it could be running into real difficulty.

I really think, rather than wait until some later date, that we ought to try to have a game plan now, a long-term game plan. For that reason, I think that it is desirable to say in the area of revenue what commitments we are going to make. If we make that commitment now, I believe very strongly that it would be anti-inflationary. That puts all of us in Congress on notice what our revenues are going to be and what we have to live within, and that is the real way to get the President's goal of reducing spending to 21 percent of GNP.

I also think that it would have the beneficial effect of building confidence in the private sector. We would be giving a signal the same way that Jack Kennedy did back in the sixties. We would signal the American people that we are going to free up the private sector and give it a chance to show what it can do.

I am pleased to think that the employment picture has improved, but I have been here 12 years and every President makes that same claim. During the campaign 2 years ago, President Ford was always pointing out that there was a greater number of Americans employed than ever before. As I recall, President Nixon and President Johnson did the same.

While there is some validity and truth in what you are saying, the fact is that it is not adequate.

We have some very, very serious problems, as you and I both agree, on the economy. That is the reason that I would hope that something could be adopted along the lines of Roth-Kemp—and we all realize that there may have to be accommodations and changes made, but something has to be done that would point the country and the economy to growth without inflation, that will provide more jobs in the private sector.

I thank you, Mr. Secretary, for your helpful testimony.

Senator HASKELL. Mr. Secretary, let me turn to what I mentioned this morning a little bit. I come from quite a different direction, obviously, than Senator Roth does. However, it seems to me that, with unemployment going down and with plant utilization going up, we have got a pretty good economy at the moment, and if we add to the demand side of that economy by a tax cut, we cannot but, it would seem to me, feed the inflation side.

Now, what is bothersome is that on the monetary side, we have the Home Loan Bank Board, for example. Their mortgage rates are the highest ever. The discount rate—the Federal Reserve has gone up two points in the last year. The Federal funds rate, I saw this morning, was raised by one-eighth of 1 percent. It is very high; I forget exactly where it is.

Secretary BLUMENTHAL. 8 percent.

Senator HASKELL. It went from $7\frac{7}{8}$ to 8 percent.

Secretary BLUMENTHAL. It has been hovering about $7\frac{7}{8}$. It hits 8 once in a while. It is at 8 now.

Senator HASKELL. It was at 8 yesterday. When you have a restrictive monetary policy, it seems to me that history says you create addi-

tional inflation by high interest rates and you run the danger of contracting the economy and going into a recession. It just seems to me that we were pursuing two entirely different courses—one a fiscal course, the other stimulation. I think that things have changed and we should not do it.

We are running a monetary restrictive course and the two conflict. I suppose that the administration clearly has already made up its mind, but I would like to know if this type of thinking went into your considerations in preparing this package?

Secretary BLUMENTHAL. Senator Haskell, it definitely did. I would not characterize this tax cut as being designed as being stimulative in the sense of creating additional demand, such as the idea which never was carried forward of the \$50 rebate would have been.

Senator HASKELL. What we did in 1975, for example.

Secretary BLUMENTHAL. That is right, because conditions are quite different.

There are two things to remember. One is that we have a substantial trade deficit that is a drag on the economy, so the Federal deficit, which has been reduced from \$60 billion to \$43 billion has to overcome that drag, plus the surplus that actually exists at the present moment in the budgets of the State and local governments.

When you add those two together, you have what the economists call a fair amount of drag, fiscal drag, that has to be overcome. This is not in defense of the \$43 billion deficit. I would like to see it at zero, and the President is committed to move in that direction, but it puts that cut for next year of three-quarters of \$19 billion into some perspective. It keeps things going. It is not designed to push it up further.

We just made a choice, and that is that we did not want these tax increases that worry Senator Roth so much, and he would even go further than we would with these tax increases on social security and on inflation to impact people, the taxpayers that really would suffer from it.

I have discussed this with Chairman Miller, and before him, with Chairman Burns on many, many occasions. I know the President has; I was present at those discussions, that we have to seek to coordinate monetary and fiscal policy.

And we explained to Chairman Miller that we would be running a very tight ship, an increasingly tight ship. That is why we went out and we recommended a reduction in the tax cut. That is why we went out and recommended some spending cuts to get that deficit down. That is why the President is committed to a substantial further reduction last year, hoping that that was in concert with monetary policy, and not against monetary policy.

So it is a policy that we are working and following together and I spend a fair amount of my time with Chairman Miller just for this kind of coordination.

Senator HASKELL. Thank you, Mr. Secretary. I hope that you are following the right course. As you can gather from my questions, my viewpoint is slightly different. I appreciate, very much indeed, your explanations.

Senator Hansen?

Senator HANSEN. Senator Curtis was unable to be here this morning. If I may, I would like to defer to him.

Senator HASKELL. Senator Curtis?

Senator CURTIS. Thank you very much.

Mr. Secretary, Senator Hansen said I was unable to be here. I was unable to hear your statement, but I was very much interested and I will be giving it further attention, and I will not take your time at this time for questioning.

Thank you, Mr. Hansen.

Senator HASKELL. Senator Hansen?

Senator HANSEN. Mr. Secretary, you have certainly been a dedicated witness. I do have just one question.

In discussing with Senator Roth, as you did, the state of the economy, did I understand you to say the real growth rate presently is running 4 percent?

Secretary BLUMENTHAL. About 4 percent.

Senator HANSEN. About 5.5 percent last year?

Secretary BLUMENTHAL. That is right.

Senator HANSEN. And you made the long-term prediction of maybe 3 or 4 in the future, was that right?

Secretary BLUMENTHAL. We estimate, Senator, and clearly these are not totally precise numbers, that in order to keep unemployment from rising, you need a real growth rate of 3.5 percent. Some people say 3, but 3 to 3.5 percent.

But what I am saying is, we are still above that line. We are still eating into the unemployment numbers, which have come down quite a bit.

If we drop to 1, 2 or 2.5 to 3 percent, then we are growing too slow to absorb all the new people coming into the labor force.

Senator HANSEN. And your estimate is that 3 or 4 will just about balance out with the increased demands for jobs coming from people who are in the labor market?

Secretary BLUMENTHAL. That is correct.

Senator HANSEN. I have no further questions.

Senator HASKELL. Thank you very much. We all appreciate your patience.

Secretary BLUMENTHAL. I thank all of you gentlemen. Thank you very much.

[The prepared statement of Secretary Blumenthal follows:]

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Mr. Chairman and members of this distinguished Committee, the Committee begins consideration today of H.R. 13511, the Revenue Act of 1978. This bill, recently adopted by the House of Representatives, would reduce tax liabilities by \$16.3 billion in calendar year 1979. Of this amount, \$10.4 billion is attributable to personal tax relief, \$4.0 billion to business tax reductions, and \$1.9 billion to a cut in capital gains taxes.¹

My testimony will assess the House-passed bill in light of the objectives outlined in the President's tax message last January. One goal emphasized by the President is to provide substantial tax relief for individuals especially those persons in the low and middle-income categories. Another objective is to furnish

¹ These revenue figures do not include "feedback" revenues that might be generated through economic stimulus. The Appendix describes the role of "feedback" effects in Treasury revenue estimating procedures.

efficient investment incentives that encourage businesses to modernize productive facilities and to create permanent, meaningful jobs. We also believe that the income tax structure should be improved through reforms that make the system more equitable and simpler for average taxpayers.

H.R. 13511 takes some steps toward these goals, but there is substantial room for improvement. The size of the net tax reduction—about \$16 billion—is within a reasonable range of tax cuts that will maintain growth without increasing inflationary pressures. Moreover, the bill's split between personal and business relief is acceptable. But we do not like the distribution of the cuts among taxpayers. In my statement, I will describe ways in which we believe the relief can be distributed more equitably.

I will also suggest additional structural tax changes for the Committee's consideration. We are pleased that the House adopted some of the tax reform proposals recommended by the President. The bill includes new tax shelter restrictions, simplification of the itemized deduction schedule, elimination of the tax exclusion for unemployment benefits at high-income levels, and repeal of the special alternative tax ceiling on the capital gains of persons in the top rate brackets. We urge the Committee to build upon these reforms now contained in H.R. 13511.

In this regard, the results of a recent Roper survey are illuminating. The survey, released last month, indicates that the American public considers tax reform the third most pressing national problem, ranking behind only controlling inflation and lowering the crime rate; and significantly, "tax reform" to the Roper respondents is equated much more frequently with tax fairness than with tax reduction. This timely expression of public sentiment should provide a useful guide for your deliberations.

THE ECONOMIC NEED FOR A PRUDENT TAX REDUCTION

Before turning to specific proposals in the House bill, let me discuss the size of tax reductions needed in 1979—an evaluation that must be made in the light of recent economic developments. In many ways, our economy has performed remarkably well over the past year and a half. The unemployment rate at the end of 1976 was 7.8 percent; that rate has now dropped to 6.2 percent in July. Almost 6 million more people are employed now than were employed at the beginning of this Administration, and a larger percentage of the working age population now holds jobs than ever before. In the fourth year of our recovery from recession, we are still experiencing a real growth rate of about 4 percent.

To maintain this recovery, tax policy must take account of several factors. In 1979, social security tax liabilities will be increased over 1977 levels by \$4 billion due to previously scheduled rate increases and by an additional \$7 billion due to changes enacted in 1977. Other tax increases will result as a higher cost of living pushes individuals into higher rate brackets without increasing real incomes. An income tax cut in 1979 will help to compensate for these factors and thereby to maintain adequate purchasing power to continue our economic growth.

Perhaps the most significant risk in the economic outlook is inflation. Over the first half of 1978, the consumer price index has risen at an annual rate exceeding 10.4 percent. We believe that the inflation rate for the second half of this year will be substantially lower, by perhaps one-third, and that the annual rate will be more moderate in 1979 than in 1978. Nevertheless, inflation will continue to be a troublesome problem.

In recognition of the need to restrain accelerating inflationary pressures, the Administration has called for a reduction in the size of the 1979 tax cut, from the \$25 billion figure recommended in January to \$20 billion. Moreover, we have urged Congress to trim an additional \$3 billion from Federal budget outlays for fiscal year 1979 in order to reduce the deficit for that year to \$43.5 billion. Budgetary restraint is essential.

Tax and budget policy must address another threat to continued economic recovery: sluggish business investment. Investment in new plant and equipment now accounts for only one-tenth of our Nation's real gross national product, a much smaller share than is needed to provide the tools of production for a full-employment economy in the 1980's. Manufacturing capacity has increased at an average annual rate of only 3 percent over the past 4 years, as compared to a 4½ percent capacity growth rate during the post-war period through 1973. Incentives, in the form of business tax cuts, are needed to improve this disap-

pointing record of business fixed investment and to avoid inflationary capacity bottlenecks in the years ahead.

We believe that the tax reduction contained in the House bill for 1979 represents generally an appropriate fiscal response to these economic concerns. The magnitude of the cut in H.R. 13511 is about \$1.2 billion less than that recommended by the Administration.³ Tax relief of this size would help maintain the economic recovery, without bloating the deficit and exacerbating inflation. We recommend that the Finance Committee adopt a tax cut of approximately the same magnitude.

A tax cut substantially larger than that in the House bill would create serious risks to our economic recovery, in particular the creation of inflationary pressures. Whatever temporary benefits might be obtained through lower tax burdens would be quickly negated by the resulting rise in prices and interest rates; increased after-tax incomes for individuals would be illusory, and the tax incentives for business investment and job creation would be undermined. These economic risks should not be taken. We ask this Committee not to adopt a significant increase in the tax reduction now contained in H.R. 13511.

PERSONAL TAX CHANGES

Tax relief for individuals

In fashioning the portion of the tax cut relating to individuals, the Committee is urged to bear in mind a fundamental principle of tax equity: taxes should be imposed in accordance with ability to pay. The tax program recommended by the President reflects that principle. We are convinced that tax reduction should be focused on individuals in middle and low-income brackets; these are the persons most in need of relief from tax burdens. The tax bill adopted by the House does not adequately respond to this critical principle of tax equity.

H.R. 13511 would effect the tax cut through several changes. Individual rate brackets would be expanded by about 6 percent. The zero bracket amount ("standard deduction") would be increased from \$3,200 to 3,400 for joint returns and from \$2,200 to \$2,300 for single returns. The personal exemption would be raised from \$750 to \$1,000, with the general tax credit being eliminated. Rates would be cut in certain brackets.

In the abstract, these changes may appear to have merit. Yet, when one examines the impact of H.R. 13511 on specific taxpayers, the inequities become apparent. As H.R. 13511 was adopted by the House, a typical four-person family with wage income of \$10,000 would receive an income tax reduction of only \$62—a cut one-fifteenth the size of the reduction provided to a family with salary ten times as large. Relief for the typical four-person family at the \$20,000 income level would be less than one-sixth of the tax cut enjoyed by a \$100,000 income family.

An examination of combined income and social security tax changes reveals the same disturbing pattern. For a family of four at the \$15,000 wage level, combined income and social security taxes would be reduced \$35 in 1979 in comparison to 1977 levels. The net income and social security tax reduction at the \$100,000 level would be \$485—a cut 15 times as large even though income is only 7 times as large.

Moreover, it is important to recognize that these figures, relating to personal income tax relief, do not present the bill in its full perspective. The comparisons I have just discussed do not include the impact of capital gains relief in H.R. 13511. The proposed capital gains tax changes for 1979 and the subsequent inflation adjustment for capital assets would provide capital gains relief amounting to nearly \$7 billion annually in 1983. Like any cut in capital gains taxes, this \$7 billion would be enjoyed primarily by persons in higher income brackets. As a result, the inclusion of capital gains cuts in the bill makes it especially important that the personal cuts be focused on middle and low-income groups.

The Administration recommends that the distribution of tax relief be altered to provide greater tax reductions than the House bill for all income classes through \$50,000. We would reduce some of the bill's bountiful tax cuts for persons in income classes above \$50,000 and increase cuts for taxpayers with incomes under \$20,000. The share of the total individual tax cut going to persons below \$20,000 should be increased from 25 percent to about 40 percent while

³ Using the same estimating assumptions, the tax cut in H.R. 13511 is \$18.8 billion, compared to the Administration's \$20 billion recommendation. The Administration did not count the expiration of the \$2.5 billion general jobs credit in its tax program as a revenue-raising provision. It was, however, accounted for elsewhere in the budget.

the share for those above \$50,000 should be reduced from 24 percent to about 10 or 15 percent. This distribution of relief reflects much more accurately the tax principle of ability to pay.

As you know, the distribution of personal tax relief in the bill depends upon two factors: rate changes and the size of the exemption or credit for dependents. Neither of these factors can be viewed in isolation. Changes in tax rates can be combined with an exemption or credit to produce virtually any degree of progressivity the Committee desires.

We suggest that a \$240 credit for each dependent be combined with generous rate cuts in the middle-income brackets to achieve the recommended tax cut distribution—increased tax savings in the bill for all income categories through a level of about \$50,000. The new credit would replace the current \$750 exemption for each dependent and the general tax credit, which is equal to the greater of \$35 per dependent or 2 percent of the first \$9,000 of taxable income. By eliminating this complicated scheme of exemptions and alternative forms of credits, the \$240 personal credit would achieve the same simplification as the \$1,000 exemption in the House bill.

The \$240 credit would provide a more equitable tax differential for various family sizes than would the \$1,000 exemption in H.R. 13511. The members of this Committee are well aware of the advantages of providing tax savings through a credit. Since the personal credit would be subtracted directly from tax liability, each additional dependent would furnish \$240 in tax savings to a taxpayer regardless of his income level. By contrast, a \$1,000 exemption would result in a \$700 tax benefit for each dependent in a top-bracket family and a \$140 benefit for each dependent in the lowest-bracket family.

In addition to equalizing the tax savings for dependents, the \$240 credit would raise the level of earnings at which an income tax begins to be imposed. For example, the tax-free level of income for a family of four would rise from \$7,200 under present law to \$9,200. This figure compares with a tax-free level of \$7,400 under the House-passed bill.

This Committee now has the opportunity to review the tax rate schedules, the exemptions and credits that are proposed for 1979. I urge you to reject the House bill in these areas and to substitute a \$240 personal credit and a new rate schedule that direct greater relief to middle and low-income families. A sense of fairness demands these changes to benefit the vast majority of American taxpayers.

Changes in itemized deductions

The House responded favorably to a number of personal tax changes recommended by the President. Among these proposals are changes in itemized deductions. I ask that you accept these provisions in order to continue the tax simplification effort that began last year.

In the Tax Reduction and Simplification Act of 1977, Congress worked with the Administration to enact changes that incorporate the standard deduction in the tax tables, lessen the number of computations made by taxpayers, and simplify the total reporting and recordkeeping burden. As a result of these changes, approximately 40 percent of all individual taxpayers were able to file a short Form 1040A for tax year 1977, and the number of lines on that form was reduced from 25 to 15. The error rate of taxpayers was decreased dramatically, from 9.1 percent to 6.5 percent for the long Form 1040 and from 12 percent to 5.1 percent for Form 1040A.

We hope to sustain this encouraging progress. Itemized deduction changes in the House bill would accomplish further tax simplification without creating significant controversy. The bill would simplify or eliminate a number of deductions that add complexity to the tax system and that do not advance any major objective of public policy.

1. *State and local taxes.*—H.R. 13511 would eliminate the deduction for State and local gasoline taxes. We urge the Committee to adopt this provision of the House bill.

The administrative problems associated with the gasoline deduction are large relative to the tax savings involved. Taxpayers using the standard deduction receive no tax benefit. The tax savings of a typical itemizer are calculated arbitrarily and amount to only about \$25. Most taxpayers use gasoline tax tables prescribed by the Internal Revenue Service and guess at the number of miles driven in a given year—a fact which must be known for proper utilization of the tables. Therefore, calculation of the gasoline tax paid is seldom accurate, and the Internal Revenue Service has no adequate way to check the mileage claimed by taxpayers.

In addition to creating these administrative problems, the deductibility of gasoline taxes represents bad substantive policy. Current law lowers the net price of gasoline by the value of the deduction, thereby encouraging the purchase of gasoline relative to other goods. Eliminating the deduction would advance the governmental policy of discouraging the consumption of energy.

We recommend that the Committee also eliminate the special deduction for general sales taxes, personal property taxes and miscellaneous taxes while retaining deductions for State and local income and real property taxes. State sales taxes, like gasoline taxes, are usually determined arbitrarily with reference to published tables that provide nearly uniform deductions and result in a relatively small tax benefit. Since the tax benefit for itemizers is generally modest and since there is no benefit at all for the 69 percent of individuals claiming the standard deduction, deductibility is not a major factor for State and local governments in determining the rate of tax to impose. By extending H.R. 13511 to remove deductions for these other forms of State and local taxes, the Committee could achieve further tax simplification; and tax increases could be avoided by using the revenue raised from these changes to provide larger rate reductions.

2. *Political contributions.*—The House adopted the Administration's proposal to simplify the confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim itemized deductions for the first \$200 of contributions. In lieu of the deduction, he may claim a credit for one-half of his political contributions, with a maximum credit of \$50. The House bill would repeal the political contribution deduction while retaining the credit. As a result, the incentive of the tax subsidy for political contributions would be available equally to itemizers and non-itemizers and would not rise with the income level of the taxpayer.

3. *Medical and casualty expenses.*—The current provision for medical deductions is unnecessarily complicated. Twelve lines on schedule A for Form 1040 are devoted to computation of the deduction for dental and medical expenses. Currently, one-half of the first \$300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses are deductible to the extent they exceed 3 percent of adjusted gross income, with this latter category of deductibility including the remaining portion of health insurance premiums and including medicines and drugs in excess of 1 percent of adjusted gross income.

The House has accepted the President's proposal to treat medical premiums, drugs and medicines in the same manner. All of these expenditures would be subject to the same floor—in the House bill, 3 percent of adjusted gross income. This change would greatly simplify return preparation. However, for those who now itemize their medicines and drugs, the House bill would have the effect of reducing the overall floor from 4 to 3 percent. This change by itself would increase the number of itemizers.

The Committee may wish to consider additional simplification measures in this area. Since normal medical expenditures average about 8 percent of income, the floor for medical deductions could be raised—perhaps to 5 percent of adjusted gross income. This would accord with allowing deductions for hardship cases, but leaving the normal amount of expenses as an element of the standard deduction. On the same theory, casualty losses, now deductible for amounts in excess of \$100, could be subjected to an additional floor of 5 percent of adjusted gross income. There is no reason the government should in effect insure property damage losses at a lower threshold than personal injuries or sickness. By substituting rate cuts for the lost deductions, over one million taxpayers would be able to switch to the standard deduction.

Unemployment compensation

The House also adopted the Administration's recommendation that the current tax exclusion for unemployment compensation benefits be phased out as an individual's income rises above \$20,000 for a single person or \$25,000 for a married couple. Under the bill, 50 cents of unemployment compensation would be taxed for every dollar of taxable income (including unemployment compensation) received in excess of these income ceilings.

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

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

Earned income credit

The House bill would extend and simplify the earned income credit—an important provision developed by the Chairman of this Committee to assist workers at lower-income levels. Under H.R. 13511, the earned income credit would be made permanent rather than allowed to expire after 1978. In addition, there would be changes in the calculation and determination of eligibility for the credit. These changes would make the credit easier to compute and would enable the IRS to determine more readily those eligible individuals who fail to claim the credit.

Currently, taxpayer mistakes are caused by difficult computations and by eligibility criteria that differ from the criteria for determining filing status and claiming exemptions. The House bill would achieve substantial simplification through the elimination of calculations and the substitution of published tables for hand computations. In addition, the bill would make it possible to determine eligibility for the earned income credit from the information supplied in claiming dependent exemptions or head of household status. The Administration has strongly supported these efforts, and we believe that enactment of the House bill would result in simplification for both the taxpayer and the Internal Revenue Service.

Deferred compensation arrangements

In order to provide similar tax treatment for persons in the same economic circumstances, the tax law generally requires income to be reported by employees regardless of the form in which compensation is received. It is thought that a person who receives cash wages and uses those wages to save for retirement, to purchase insurance, or to make other investments should not be taxed more heavily than the person who receives those benefits through arrangements with his employer.

As exceptions to this general rule, preferential tax treatment is now provided for various employee benefits, including certain pension plans, group life insurance plans, and medical insurance plans. The Administration believes that a tax preference for employee benefits can be justified only as a means of ensuring that a wide range of employees is protected against such contingencies as sickness, disability, retirement, or death. Accordingly, the President's tax program recommended that tax-favored status be withheld from certain kinds of employee benefit plans that discriminate against rank-and-file employees.

Included in the President's recommendations was a nondiscrimination requirement for "cafeteria plans." A cafeteria plan is an arrangement under which a participating employee elects the type of fringe benefits to which employer contributions will be applied on his or her behalf. H.R. 13511 contains a provision which is substantially similar to the President's proposal, and we urge that this Committee retain that provision.

Other sections of the House bill would enable employees to defer taxation under certain plans that permit an employee to elect whether or not to receive a current cash payment. One type of plan covered by the House bill is an unfunded "salary reduction plan"; another type is a "cash or deferred profit sharing plan." We believe that preferred tax treatment for these plans should also be based on a requirement of nondiscriminatory coverage. The Treasury Department is working on a detailed proposal in this area, and we will be happy to consult with the Committee members in designing a fair and reasonable provision.

Tax shelters

Tax shelters are devices used by taxpayers to generate artificial paper losses to offset income from other sources. There are at least two undesirable by-products of tax shelter activity. First, such tax avoidance by high-income persons is demoralizing to average taxpayers bearing a substantial tax burden on all their income. Second, many shelter activities drain investment funds from productive enterprises into schemes designed primarily to generate tax losses.

In 1976, this Committee received extensive evidence regarding tax shelter abuses. You responded with several tax changes. Tax shelter restrictions are among the most significant reforms contained in the Tax Reform Act of 1976.

Unfortunately, shelter gimmicks have now assumed forms intended by promoters to avoid the restrictions in the 1976 Act. Tax shelter activity may have actually increased during 1977. The National Association of Securities Dealers reports that over \$1.8 billion of shelters were publicly offered by its members during 1977—a 50 percent increase over offerings in 1976. And there is some evidence that private shelter deals may have increased even more dramatically.

In an effort to combat the newer shelter devices, the House adopted an extension of the current "at risk" rules recommended by the President. The "at risk" limitation denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability. The 1976 Act extended coverage only to partnerships and to a few specified activities of individuals. Under the House bill, the "at risk" rule would be broadened to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons. This important provision in H.R. 13511 should be retained.

The President has also recommended that the Internal Revenue Service be authorized to implement tax audits of partnerships and to resolve tax issues at the partnership level rather than being forced to proceed against each partner individually. H.R. 13511 now contains only minor portions of the President's proposal: a civil penalty for late filing of partnership returns, and a very narrow version of a proposal to extend a partner's statute of limitations with respect to partnership items. We would like to work with you to adopt additional portions of the Administration's partnership audit proposals.

Entertainment expenditures

Perhaps no proposal in the Administration's tax program has received as much public attention as the recommended limitation on deductions for entertainment expenditures. This attention is not surprising. For many average taxpayers, the unfairness of current tax law is brought home most vividly by the fact that a few taxpayers are able to spend before-tax dollars to purchase some of the items most taxpayers must buy with income that has already been taxed.

Allowing entertainment expenses to be deducted, without taxing the related personal benefits to the recipient, offends fundamental principles of tax policy because it seriously distorts income measurement. The effect is to provide these benefits partially at public expense. The Federal Treasury loses about \$2 billion each year on account of entertainment deductions—a revenue loss that must be recovered from other taxpayers.

The public resents this form of subsidization of personal luxuries through the tax system. The July Roper poll indicates that 69 percent of Americans believe that there should be no deduction for the "cost of membership in (a) club if (the) job requires entertaining customers and prospects". Seventy-five percent thought there should be no deduction for the cost of theatre and sporting tickets purchased to entertain business customers, and 76 percent of respondents would not allow a full deduction for business lunches.

H.R. 13511 now contains none of the restrictions on deductibility of entertainment expenditures recommended in the President's program. We continue to believe that these proposals are in accord with sound principles of tax policy and, more importantly, address the overwhelming sentiment of the American public for reforms in this area. We urge that the Finance Committee take account of this attitude of average taxpayers and, at least, deny a deduction for the expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and for fees paid to social, athletic or sporting clubs.

BUSINESS TAX CHANGES

Corporate rate reductions

Present law taxes the first \$25,000 of corporate income at a 20 percent rate and the second \$25,000 at 22 percent; income over \$50,000 is taxed at a 48 percent rate (a normal tax of 22 percent plus a surtax of 26 percent). The House bill provides for a corporate rate schedule that is much more steeply graduated than the current rate structure. Under H.R. 13511, the corporate rate would be 17 percent on the first \$25,000 of corporate income, 20 percent on the second \$25,000, 30 percent on the third \$25,000, 40 percent on the fourth \$25,000, and 48 percent on corporate income exceeding \$100,000.

The corporate rate reductions in the House bill differ from the cuts proposed by the President. In the President's tax program, he recommended a reduction from 20 to 18 percent on the first \$25,000 of corporate income, a reduction from 22 percent to 20 percent on income between \$25,000 and \$50,000, and a reduction

from 48 percent to 44 percent on income exceeding \$50,000. The Administration believes that this proposal provides the best means of reducing corporate rates. In our view, the top marginal rate should continue to apply to corporate income in excess of \$50,000—the amount of the current “surtax exemption.” Certainly, the level of graduation should not be raised above that in the House bill.

A graduated corporate rate structure raises troubling questions of tax equity. It should be borne in mind that individuals are the ultimate taxpayers; therefore, the tax policy goal of progressivity has meaning only as it relates to the impact of the system on individuals. Viewed in this light, a steeply graduated corporate rate schedule is actually regressive.

The principal beneficiaries of the House provision are individual owners of closely-held corporations—persons who are generally in higher income brackets than the owners of publicly-held companies. Corporations whose shareholders are in lower personal income tax brackets tend to elect subchapter S. In a group of tax returns studied by the Treasury Department, the average income of shareholders in closely-held corporations exceeded \$50,000. By contrast, the average income of all individual shareholders receiving corporate dividends was about \$25,000.

Moreover, most of the corporate relief would be provided in corporate income brackets from \$50,000 to \$100,000, the brackets affected by increasing the surtax exemption above the current \$50,000 level. The proposed increase in the surtax exemption would provide no relief for small corporations with no taxable income or with taxable income of less than \$50,000. Only 10 percent of all corporations would receive any tax reduction from the increase in the surtax exemption. These corporations represent less than 1.5 percent of all business entities.

We fear that an unintended result of the House changes would be the aggravation of tax-shelter abuses by many high-income individuals. To many owners of closely-held corporations, the corporate income tax—far from being an additional burden—is actually a relief from taxes which they would otherwise pay if all the income of their corporation were attributed directly to them. The sheltering of income at the corporate level would be made still more attractive if substantial capital gains tax cuts, such as those in H.R. 13511, were adopted; capital gains tax reductions would increase the tax advantage of avoiding the receipt of annual dividends and postponing a shareholder's realization of corporate profits until he sells his stock. In short, potential for tax abuse might be increased significantly by the use of the close corporation—a device already advertised widely as the “ultimate tax shelter.”

Investment tax credit

As part of his program to encourage business investment, the President recommended that the 10 percent investment tax credit be made permanent and be extended to a wider range of taxpayers and a broader scope of investments. Most of these recommendations were adopted by the House.

1. *Permanent investment credit.*—The present 10 percent credit is now scheduled to revert to a 7 percent level after 1980. The House accepted the President's recommendation that the credit be made permanent at a 10 percent rate so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures. We hope the Finance Committee will follow this course.

2. *Increase in tax liability ceiling.*—Under current law, the investment credit claimed during any taxable year cannot generally exceed \$25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a a three-year carryback and a seven-year carryforward). The Administration proposed that the tax liability ceiling be raised to 90 percent of tax liability in excess of \$25,000. We also recommended that a taxpayer be entitled to offset no more than 90 percent of the first \$25,000 of tax liability.

The House bill would phase in an increase in the tax liability ceiling, with a 90 percent ceiling to be applicable after 1981 for tax liability exceeding \$25,000. We support this provision in H.R. 13511 as a constructive step to make the investment credit more fully available to businesses with high investment needs and low profitability. However, to ensure that no firm will be able to use investment credits to eliminate its entire tax liability, we continue to recommend that the 90 percent ceiling also be applicable to the first \$25,000 of tax liability—a limitation not included in H.R. 13511.

3. *Eligibility for the rehabilitation of structures.*—The House bill would allow the investment credit for investments made to rehabilitate existing structures

such as industrial buildings, commercial buildings and retail establishments. Present law generally limits the credit to expenditures made to purchase machinery and equipment. In our view, the extension of the investment credit to the rehabilitation of structures would encourage the renovation of buildings and would thereby assist in the redevelopment of decaying urban areas. For this reason, the Administration generally supports this provision. However, there may be serious problems in defining those structures eligible for the credit and the type of investment that qualifies as a "rehabilitation" expenditure; we would like to consult with this Committee in developing provisions that mitigate these definitional problems.

4. *Distressed area credit.*—In the President's urban program, he recommended that an additional 5 percent credit be available for investments, certified by the Commerce Department, in economically distressed areas. Adoption of this proposal would furnish additional incentives for urban investment.

5. *Pollution control facilities.*—Certain pollution control facilities can now qualify for special tax treatment under two separate Code provisions. These facilities can generally be financed through the issuance of tax-exempt industrial development bonds. In addition, pollution control equipment installed in pre-1976 plants is eligible for special five-year amortization. However, if rapid amortization is elected, only one-half of the full investment credit can be claimed.

H.R. 13511 would generally permit pollution control equipment to qualify for the full 10 percent credit even if rapid amortization is claimed under the provisions of existing law. There would be an exception to this rule. To the extent pollution facilities were financed with tax-exempt industrial development bonds, a taxpayer could not combine a full investment credit with rapid amortization.

The Administration originally proposed the extension of the full investment tax credit⁴ to pollution control facilities, but this recommendation was accompanied by a proposal (discussed below) to repeal the tax-exempt status of pollution control bonds. By coupling these two proposals, our intention is to provide tax relief that is more efficient and does not disrupt the market for state and local government bond issues. We will support the extension of the full investment tax credit to facilities being rapidly amortized only if tax-exempt financing for investments in pollution control facilities is repealed.

Industrial development bonds

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

The President's tax program recommends the termination of tax-exempt status for certain industrial development bonds. Our proposals would provide substantial assistance to State and local government financing efforts and would also improve the equity of the tax system. These important provisions are not included in H.R. 13511—an omission we consider to be a serious defect in the bill.

1. *Termination of exemption for pollution control bonds, bonds for the development of industrial parks, and private hospital bonds.*—The Administration recommends that there no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. We believe the exemption should also be removed for bonds issued to finance construction of hospital facilities for private, nonprofit institutions unless there is a certification by the State that a new hospital is needed.

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

Municipal financing is injured particularly by the abundance of pollution control bonds in the market place. In 1977, there was nearly \$3 billion of tax-exempt borrowing for pollution control, accounting for 6.6 percent of all tax-exempt financing and 86.2 percent of all industrial development bonds. Substitut-

ing a liberalized investment tax credit in place of tax-exempt financing for pollution control facilities would provide Federal assistance in bringing existing plants into compliance with environmental standards without undermining the ability of State and local governments to borrow funds.

2. *Small issue exemption for economically distressed areas.*—Under the House bill, the small issue industrial development bond limit would be increased from \$5 million to \$10 million. We oppose this change. By increasing the exemption limit generally, this proposal would not improve the competitive position of depressed localities in seeking funds; it would serve only to increase the supply of tax-exempt bonds and to impair borrowing capacity for governmental purposes.

The Administration recommends that the financial assistance be targeted. The existing "small issue" exemption should be retained only for economically distressed areas; and, with respect to those areas, we recommend that the \$5 million exemption be raised to \$20 million.

Targeted job credit

In April, 1978, the President announced his urban program to encourage employment of those individuals who have been experiencing the most difficulty in finding jobs. A targeted employment tax credit was proposed to replace the general jobs tax credit that will expire at the end of 1978. Under the Administration's program, employers would earn a tax credit for employing disadvantaged youth and handicapped individuals.

As modified by the House, the targeted jobs tax credit would provide a maximum credit per employee of \$3,000 for the first year of employment and \$1,000 for the second year of employment. Eligible employees would include WIN registrants, vocational rehabilitation referrals, youths and Viet Nam veterans eligible for food stamps, SSI recipients, general assistance recipients, and cooperative education students. Like the Administration's proposal, the House bill would avoid discrimination by company size, industry and region; it places no absolute limitation on the amount of credit claimed by an employer and does not restrict the availability of the credit to companies that have employment growth.

The Administration generally supports the targeted jobs credit contained in H.R. 13511. This proposal is very similar to the recommendation made by the President. The targeted jobs credit is urgently needed to provide job opportunities for economically disadvantaged young people and for others who have not been reached by more general programs to encourage business expansion and to increase employment.

We believe it is especially important that these young people be aided in their efforts to find private employment before they are drawn into the welfare system. For other eligible groups, the incentives offered by the tax credit should be fully coordinated with Federal job placement programs to provide necessary assistance and information and to assure uniform eligibility standards. The Administration would like to assist the Committee in developing technical provisions to reflect these objectives more fully.

Small business proposals

We urge the Committee to retain in H.R. 13511 two provisions recommended by the President to provide specific relief to small corporations. First, the Subchapter S rules that treat certain small corporations as partnerships would be simplified and liberalized. Second, risk-taking would be encouraged by doubling (from \$500,000 to \$1 million) the amount of a small corporation's stock that can qualify for special ordinary loss treatment, by doubling (from \$25,000 to \$50,000) the amount of losses that can be claimed by any taxpayer with respect to such stock, and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

We do not support a provision in the House bill that increases the first-year depreciation allowances for certain businesses. Under the House bill, the maximum amount of first-year "bonus" depreciation that could be taken would be increased from \$2,000 to \$5,000, and this special provision would be limited, for the first time, to taxpayers with less than \$1 million of depreciable property.

This new "bonus" depreciation provision would add further complications to a system that is already confusing for many small businesses. Far more valuable assistance can be provided to small businesses by simplifying the depreciation calculations that must now be made. We repeat here our recommendation, outlined in H.R. 12078, for a new, simple table for equipment depreciation tantamount to a streamlined ADR system for small business.

Farm accounting

The Tax Reform Act of 1976 generally requires farming corporations to use the accrual method of accounting in order to match properly farming expenses with farming income. That Act contains exceptions from the accrual accounting requirement for certain corporations. One of the exceptions is for corporate farms with annual gross receipts of \$1 million or less; another exception is for farms controlled by one family, without regard to size or the extent of public ownership.

The Administration has recommended the repeal of the one-family corporation exception, so that large corporate farms would be subject to accrual accounting requirements regardless of whether they are family owned. We have also recommended an extension of the accrual accounting requirement to farm syndicates. There is no reason to permit multi-million dollar corporations and tax shelter syndicates to utilize a cash accounting privilege designed for unsophisticated taxpayers.

In lieu of the Administration's proposal, the House adopted an additional exception to the accrual accounting rules for certain farm corporations owned by two or three families. The stated purpose of the House provision is to avoid competitive advantages for one-family corporations now permitted to use cash accounting. We feel that the President's proposals provide the appropriate means of eliminating the competitive imbalances caused by the accrual accounting exceptions. However, if this Committee decides not to adopt the President's recommendations in this area, we will not object to the additional exceptions in the House bill.

H.R. 13511 would also revoke an IRS ruling which requires farmers, nurserymen, and florists who use the accrual accounting method to inventory growing crops. On July 28, 1978, the IRS issued Revenue Procedure 78-22, which allows any farmer, nurseryman, or florist who is on the accrual method of accounting to change to the cash method. This revenue procedure should eliminate any undue hardship that may have been caused by the previous ruling. The House provision is not needed to provide relief, and we oppose its adoption.

Domestic International Sales Corporation (DISC)

In its tax program, the Administration recommended that the large cuts in corporate tax rates be combined with the elimination of two costly tax preferences for firms conducting international business operations. One proposal would have phased out the foreign tax deferral provision, which permits domestic corporations to avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. Another proposal would have phased out the DISC tax preference. Neither of these proposals is contained in H.R. 13511.

I would like to discuss the DISC provision in some detail. The President's program would eliminate, over a 3-year period, the special tax benefits granted for exports channeled through a company's specially created subsidiary—a paper entity known as a Domestic International Sales Corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of "incremental" DISC income is deferred as long as these profits are invested in export-related assets.

There are numerous problems with the DISC program. It is incredibly complicated; over 50 pages of fine print in the International Revenue Code and Treasury Regulations are devoted to describing this special tax program. DISC is inequitable; special tax benefits apply only to exporters who establish these paper subsidiaries, and well over one-half of DISC benefits is realized by only 2 percent of the DISCs. DISC is expensive; it costs U.S. taxpayers over \$1 billion per year in lost Treasury revenues. And there is little evidence that this enormous cost has resulted in a significant increase in exports.

We need to stimulate exports, but the current DISC provision is the wrong approach. If a DISC program is to be maintained, we would like to work with you to focus it more effectively. Many DISC benefits now go to exporters with large profit margins—companies that would obviously be exporting in the absence of any special tax incentive. The Committee may wish to consider the elimination of the "50-50" rule that permits one-half of those large profits to be allocated to the DISC. Another possible restriction would place a dollar limitation on DISC benefits in order to target the relief to small companies that may

experience difficulties entering the export market. These modifications would result in an export incentive that is much more cost effective and equitable.

CAPITAL GAINS

H.R. 13511 contains significant changes in the tax treatment of capital gains. Following a recommendation of the President, the House bill would repeal the special 25 percent alternative tax that now applies to the first \$50,000 of capital gains of high-income individuals. A one-time exclusion would be permitted for up to \$100,000 of gain on the sale of a principal residence. The bill would also eliminate capital gains as an item of tax preference for purposes of the individual and corporate minimum tax and as a preference offset to the amount of personal service income eligible for the 50 percent maximum tax ceiling. Capital gains in excess of \$20,000 would be subject to a new alternative minimum tax of 5 percent if that tax exceeded regular tax liability. Finally, in determining capital gains or losses, an inflation adjustment would be provided after 1979 for common stock, real estate and tangible personal property. Taken together, these changes would reduce capital gains tax liabilities by \$1.9 billion in 1979, with that figure expanding to nearly \$7 billion annually by 1983.

If capital gains relief is provided, we recommend consideration of several modifications in the House-passed version of H.R. 13511:

First, to limit tax avoidance by wealthy individuals, a reasonable alternative minimum tax on large capital gains should be adopted in place of the token "micro-mini" tax in the House bill.

Second, the existing minimum tax on the capital gains of corporations should be retained.

Third, the exclusion for residences might be altered to reduce the revenue loss.

Fourth, the special inflation adjustment for certain capital assets should be eliminated.

I will discuss each of these modifications in some detail.

Adoption of a true alternative tax on capital gains

In attempting to provide relief for persons with significant capital gains tax liabilities, the House created an undesirable by-product: H.R. 13511 would exacerbate the problem of tax avoidance by wealthy individuals making extensive use of tax shelters. Eliminating the current minimum tax provision would reduce the top rate on capital gains to 35 percent; that result appears to be the objective sought by the House. But the replacement of the current minimum tax with the new "micro-mini" tax also has the effect of reducing from 7½ percent to 5 percent the maximum capital gains rate paid by individuals who have completely sheltered millions of dollars of capital gains from regular tax liability. A present minimum tax with a modest impact on sheltered capital gains would be diluted.

An example derived from actual tax files may help to illustrate the increased sheltering opportunities that would be available under the House bill. An individual with \$2,184,962 of capital gains uses \$1,095,057 of shelter losses to eliminate all regular tax liability; the regular tax that would normally be paid on one-half of capital gains (\$1,092,491) is offset completely by tax losses. Under current law, he would pay a minimum tax of \$160,984—an effective tax rate on capital gains of 7.4 percent. If the "micro-mini" tax in the House bill were adopted in place of the current minimum tax, this person's minimum tax liability would fall to \$108,249—a tax rate of less than 5 percent on capital gains exceeding \$2 million.

Viewed in the context of the capital gains changes in H.R. 13511, there is no justification for an alternative minimum tax that is so insignificant. The current minimum tax rate was kept low because it affects unsheltered taxpayers; it can add several percentage points to an effective tax rate that is already substantial. If the current "add-on" minimum tax on capital gains is eliminated in favor of an alternative tax approach, a graduated alternative minimum tax can be adopted so that persons with very large capital gains would have to pay more than a token 5 or 7½ percent tax.

Such a graduated "true alternative tax" is reflected in the amendment we supported on the House floor—an approach we commend to this Committee. This amendment would affect only persons with ordinary losses exceeding ordinary income. For those individuals, the true alternative tax would simply require that ordinary losses be offset against capital gains before the special capital gains

deduction (equal to one-half of total gains) is applied. This new limitation would never reduce the amount of the special capital gains deduction below \$5,000, nor would it apply in a manner to reduce the benefits of charitable deductions.

The "true alternative tax" approach would provide a much more reasonable minimum tax liability for the individual, described earlier, who has sheltered over \$2 million of capital gains from all regular tax liability. He would be required to pay tax on about one-fourth of his total capital gains. Rather than paying a "micro-mini" tax of only \$103,249 imposed under the House bill, this taxpayer's liability would be \$345,628 under the "true alternative tax." The effective tax rate on \$2 million of capital gains would rise from 5 percent in the House bill to nearly 16 percent under the amendment.

Mr. Chairman, you and other members of this Committee have played an instrumental role in developing a minimum tax concept—an effort to minimize the extent to which high-income taxpayers can use various preferences to eliminate all or most tax liability. The Treasury Department will release today its High Income Report for tax year 1976. This report will show that provisions in the Tax Reform Act of 1976 have succeeded in reducing dramatically the number of high-income, nontaxable returns; in 1976, the number of nontaxable returns for individuals with expanded incomes over \$200,000 fell by 75 percent, from 210 in 1975 to 53 in 1976. The number of nontaxable individuals with adjusted gross incomes over \$200,000 fell from 260 to 22, a decrease of over 90 percent.

The results of this report should not lead to complacency. There are still nontaxable returns with high economic incomes that, for various reasons, do not fit into the categories of "expanded income" or "adjusted gross income." Moreover, for every nontaxable high-income return, there are still ten or more "nearly nontaxable" returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits.

We believe that the true alternative tax on capital gains represents a significant effort to continue the important work already performed by this Committee in reducing large-scale tax avoidance. It begins to focus on the problem of the "nearly nontaxable" return. You may wish to expand the alternative tax concept to include preferences other than capital gains. Whatever course of action is selected, we believe it is critical to amend H.R. 13511 to avoid a serious setback to important minimum tax reform efforts.

Retention of minimum tax on capital gains of corporations

A corporation can now elect to have its capital gains taxed at a 30 percent alternative rate, as opposed to the top rate of 48 percent under the regular corporate schedule. The corporate alternative tax on capital gains is considered a preference item for minimum tax purposes. But unlike the individual minimum tax, the corporate minimum tax adds a very insignificant amount to the effective capital gains rate—a maximum increase of only 1.125 percentage points even if all a corporation's income is eligible for the capital gains preference.

Other provisions in the House bill would cause a corporate minimum tax on capital gains to be even less burdensome than it is now. If the corporate rate schedule in H.R. 13511 is enacted, the impact of a corporate minimum tax would be reduced still further to a maximum 0.717 percentage point addition to the capital gains rate. Moreover, by providing a 30 percent corporate rate on ordinary income between \$50,000 and \$75,000, the House bill would reduce the number of corporations that would elect the alternative capital gains tax and subject themselves to an additional minimum tax liability.

We see no reason for eliminating the corporate minimum tax on capital gains, as proposed in H.R. 13511. Even with the individual capital gains relief in the House bill, the maximum corporate rate on capital gains would still be more than 4 percentage points below the maximum individual rate. In our view, the elimination of the corporate minimum tax can be justified only if the alternative capital gains rate for corporations is raised to the maximum individual level—35 percent.

Reduction in revenue cost of exclusion for residences

The Administration believes that capital gains relief should be provided for homeowners. In the Administration's tax program, we recommended that the gain on sales of residences be excluded as a tax preference item for purposes of both the minimum tax and the maximum tax.

Additional homeowner relief may be appropriate. However, the \$100,000 exclusion in H.R. 13511 is extremely costly. It would result in an annual revenue loss of approximately \$700 million.

To provide significant capital gains tax cuts to homeowners at a reduced revenue cost, the Committee may wish to consider excluding from taxation the gain attributable to the first \$50,000 of sales price on residences for persons age 55 or older. This would represent an expansion of the exclusion in current law for gain attributable to the first \$35,000 of sales price for persons age 65 and over. Under this approach, the revenue cost of homeowner relief would be reduced to approximately \$300 million.

Deletion of inflation adjustment

We believe that the Archer amendment, which would provide inflation adjustments for certain capital assets, reflects a serious mistake in the House. This provision is unfair, complicating and very costly. It should be eliminated from H.R. 13511.

The Archer amendment is inequitable because it selects for inflation adjustments only one aspect of the tax law—the income of persons who already enjoy the benefits of the capital gains preference. It is difficult to justify an inflation adjustment for owners of capital assets while ignoring the effect of inflation on the savings account depositor. Nor is it fair to permit the holder of debt-financed property to adjust the asset's basis for inflation while making no allowance for the fact that the debt is being repaid with cheaper dollars.

These inequities are illustrated graphically by considering three hypothetical taxpayers:

(1) Taxpayer A has a \$100,000 certificate of deposit, which bears interest at the rate of 5 percent.

(2) Taxpayer B purchases a capital asset for \$100,000; he sells it for \$105,000 after it appreciates 5 percent in one year.

(3) Taxpayer C purchases a capital asset for \$200,000, financing the purchase with \$100,000 of debt bearing 5 percent interest; this asset is sold for \$210,000 after it also appreciates 5 percent in one year.

At the end of one year, each of these taxpayers has an additional \$5,000 in cash and is in the same economic position before taxes; however, the Archer amendment would result in disparate tax treatment. Assume an inflation rate of 5 percent. Taxpayer A has an additional \$5,000 of taxable income and receives no relief under Archer. Taxpayer B has no additional taxable income because the inflation adjustment equals his appreciation. Taxpayer C is in a better position than either A or B; although he has \$5,000 more cash upon the sale of his capital asset (\$210,000 less the \$100,000 initial cash investment and less repayment of \$105,000 principal and interest), he will show a loss for tax purposes equal to the \$5,000 of interest paid. Such disparities make no tax sense and will distort investment and borrowing decisions.

The economic distortions and tax shelter possibilities of the Archer amendment are only beginning to be analyzed by tax specialists. For example, the special inflation adjustment granted to owners of corporate stock would undoubtedly lead to the subterfuge of incorporating assets not eligible for the adjustment. Indexing the basis of depreciable assets only for purposes of measuring gain would encourage businesses to engage in unproductive asset exchanges, using an inflation adjustment to avoid reporting gain on the exchange while taking a stepped-up basis to increase depreciation allowances for the newly acquired equipment.

The amendment would introduce staggering new complexities into the tax law. Taxpayers and the Internal Revenue Service would have to make determinations such as: (i) whether a particular asset qualifies for indexation, either in whole or in part; (ii) if an asset qualifies only in part, the portion of the asset's basis that is "adjustable"; (iii) whether a particular transaction is one in which indexation is allowed; and (iv) the holding period for measuring adjustments where, for example, the basis of an asset is the sum of the cost of numerous property improvements made through the years. The answer to each of these questions might differ from that applied for other tax purposes. Recordkeeping and return preparation burdens for taxpayers would be increased substantially, and disputes with the IRS would arise more frequently.

The revenue cost of the Archer amendment would exceed \$4 billion annually by 1983. This cut is twice as large as all the other forms of capital gains reductions in the bill. In combination with the other capital gains changes and tax reductions on business and investment income, this amendment would result in a tax bill that provides 71 percent of the total relief to the owners of capital. As H.R. 13511 now stands with the Archer amendment, it is a bill tilted far too heavily away from American wage earners.

In addition to this proposal's inequity, complexity and excessive cost, there is a problem with Archer that is even more fundamental. Indexation is a response to high inflation rates, but the proliferation of indexation schemes tends to make those rates an accepted fact of economic life. The economic defect becomes institutionalized. Rather than accommodating to inflation, we should bend all efforts to control it.

CONCLUSION

As I conclude my remarks, it is appropriate to acknowledge the time constraints under which you are working. The Committee is considering this bill late in the legislative session. For this reason, we are not proposing that you consider far-reaching structural changes in H.R. 13511 that would consume an inordinate amount of time. In fact, we are recommending that the Committee delete from the bill proposals, such as the Archer amendment, that can be considered properly only after extensive testimony and debate.

The recommendations I have outlined today are designed to bring the House bill closer to the tax policy objectives outlined by the President. We urge that greater tax relief be provided to middle and low-income families. We believe the investment incentives in H.R. 13511 should be modified in order to increase their efficiency and fairness. And we are suggesting a reasonable extension of the tax reforms in the House bill so that the system can be made more equitable and simpler. The Administration is anxious to work with this Committee to accomplish these objectives.

APPENDIX: FEEDBACK EFFECTS AND REVENUE ESTIMATION

The term "revenue feedback effect" refers to the fact that the actual change in revenues resulting from a tax revision will depend upon economic responses to that revision. There is general agreement that such feedback effects can be important. To understand more clearly the implications of feedback effects for revenue and receipts estimation, it is useful to separate economic responses into three types.

First, there are short-run responses to changes in spendable income that result from tax increases or reductions. A tax cut, for example, will raise the amounts of after-tax income available to households and to business firms. If there is sufficient additional capacity, higher after-tax incomes will lead to increased consumption and investment which in turn will generate higher incomes and higher revenues. A number of standard macro-economic forecasting models are usually employed to estimate the magnitude of these short-run income effects.

A second type of feedback effect deals with long-run factor-supply responses to tax changes. Taxes alter the after-tax returns for work effort and for saving and thus will influence the supply of labor and capital offered to the market. The size of the capital stock and labor force will in the long run determine economic capacity and, therefore, the income base potentially available for future revenues.

The third type of feedback effect is the behavioral response to price increases or decreases brought about by tax changes. As tax changes alter relative prices, households and business firms tend to shift patterns of consumption and investment away from those activities that have increases in price or cost toward those that have decreases. That is, taxpayers will move into activities which have been granted a tax benefit and away from activities which have lost such a benefit. The result influences the allocation or composition of economic activity and also the volume of Federal revenues.

Therefore, to estimate all potential revenue feedbacks requires determination of (1) the increase or reduction in spending due to changes in income, (2) the changes in economic capacity due to changes in the supply of labor and capital, and (3) the substitution of lower cost for higher cost activities. In general, estimating procedures currently used by the Treasury do incorporate such feedback effects. Budget receipts for each fiscal year include the impact of tax changes on aggregate demand. Longer-run receipt projections allow for the likelihood of tax-induced changes in the capacity of the economy. Furthermore, whenever it is reasonable to do so, the allocation effects of price changes resulting from tax revisions are incorporated into revenue estimates. Each of the three types of feedbacks is discussed in more detail below.

MACRO-ECONOMIC RESPONSES

According to the macro-economic models, tax law changes which reduce government revenues will, over time, increase demand, resulting in higher GNP, personal incomes and corporate profits and higher tax receipts. Consequently, estimates which do not take into account these short-run multiplier effects tend to overstate revenue losses resulting from proposals which reduce tax rates or narrow the tax base and overstate revenue increases resulting from proposals to raise taxes. Treasury estimates are alleged to suffer from this defect.

However, this criticism is based on a misunderstanding of the longstanding Treasury practice to provide two types of revenue estimates for proposed changes in tax law. The first type of estimate is made for the complete program of tax changes in the President's budget. Feedback effects on incomes and tax receipts resulting from short-run multiplier effects are always incorporated in these figures to show the actual impact of the President's program on the economy.

For example, Treasury estimates of total tax receipts during the 1963-1968 period incorporated such feedback effects. The stimulative effects of the Kennedy tax cut along with anticipated growth in the population, the labor force, prices and productivity were more than enough to fully offset the reduced revenues resulting directly from lower income tax rates. While total receipts were projected to rise over this period, it is generally agreed that the 1964 tax cut by itself, could not have induced an economic response sufficient to restore the initial revenue loss. The figures in Table 1 demonstrate that Treasury anticipated the feedback revenues. The estimating errors taken from the annual budget documents for that period ran about 4½ percent, far too close to the mark for estimates which did not accurately include short-run feedback effects.

In the context of the current tax debate, Table 2 illustrates the impact on receipts of short-run multiplier effects resulting from the President's proposed \$20 billion tax reduction program. The Midsession Review of the 1978 Budget shows estimated unified budget receipts of \$448.2 billion in 1979 and \$507.3 billion in 1980. These figures include proposed tax reductions of \$14.1 billion and \$21.8 billion, respectively. However, in the absence of these proposed tax reductions, revenues are estimated to be \$459.3 billion in 1979 and \$521.1 billion in 1980. Thus, the net cost to the Treasury of the President's proposed program is \$11.1 billion in 1979 and \$13.8 billion in 1980. These net tax program figures include \$3 billion and \$8 billion of offsetting revenues attributed to short-run multiplier effects. These feedback revenues are included in the receipt totals but are not separately identified in the published Midsession Budget Review.

The estimation of multiplier effects requires making a number of critical assumptions, including actions the Federal Reserve may take to adjust the money supply and interest rates. These assumptions can influence the multiplier effects on the economy and the resulting revenue feedback. However, there are no plausible assumptions under which induced feedback effects from tax cuts will lead to an increase in tax receipts over what they otherwise would have been. In fact, none of the macro-economic models of the United States economy predict revenue feedback sufficient to offset the initial revenue loss.

The second kind of estimate made by Treasury involves the revenue change from specific proposals without feedback effects (except to the extent Treasury is able to estimate price effects as described below). This kind of estimate is also appropriate for the kind of policy questions which may arise. For example, great attention is focused on the distribution of tax changes among taxpayers at different income levels. For distributional analysis policymakers should look at the direct impact on taxpayers engaged in a particular activity, such as paying private school tuition, or on those receiving a particular source of income, such as capital gains.

In contrast to the tax side of the Budget, there is general agreement that feedback effects are not appropriate for the expenditure side of the budget.—Congressional decisions concerning the expenditure side of the budget are also properly made on the basis of gross expenditures. We should not estimate, for example, that a dam, highway, harbor, or even aircraft carrier costs only 60 percent of its initial outlay on the argument that the Federal government recoups the rest in the form of higher revenues. A dollar of outlay costs a dollar in resources used up and a dollar of tax reduction releases a dollar for use in the private sector. The macro-economic feedback effects of both of these changes

are important, but it is also important to evaluate the initial impacts correctly.

Treasury policy to include multiplier effects when overall positions of fiscal policy are being established, as described earlier, is consistent with excluding multiplier effects when alternative programs are being considered that do not markedly alter the desired fiscal posture. The assumption is made that each separate tax proposal being considered is designed to be incorporated into a comprehensive package of proposals, with net tax reductions consistent with the overall fiscal policy. In this framework, it is clearly incorrect to include offsetting multiplier effects in revenue estimates for individual tax proposals. This is because the budget receipt estimates already include the feedback effect of the aggregate change in taxes. To again include feedback effects, as each component of an overall tax package is being considered, would be to double count induced revenue changes and misguide policymakers as to the size of the budget deficit or surplus.

CAPACITY RESPONSES

Much attention has recently been focused on the potential for increasing economic capacity by reducing rates of tax. Since income taxes necessarily reduce the reward from additional work effort or from adding to savings or investment, reductions in rates of income taxes—especially reductions of the highest marginal rates—would increase significantly the aggregate amount of work effort and capital supplied in the economy. This increased work effort and larger capital stock would provide increased capacity to produce income that is subject to tax, offsetting at least some of the initial revenue lost by tax reduction.

The fundamental logic of this argument is sound, but there are a number of practical considerations that recommend against regularly reporting separate estimates of these aggregate capacity, or "supply side", effects of tax changes. There are presently no economic models that fully incorporate supply effects and that have also developed a track record over a period of years. In fact neither the magnitude nor the timing of such effects is well known and there is consequently wide professional disagreement about their importance. For example, some advocates of the Roth-Kemp tax reductions claim that induced supply responses would be so large that general rate reductions would bring about higher revenues than would occur without them. Some of these advocates argue that the responses would be so rapid that revenue increases from induced supply would occur in the first year. Other analysts, including those who have developed the well-known econometric forecasting models, predict that in the first few years following a tax change, there will be no significant increases in economic capacity resulting from higher wages or increased returns to saving.

In the case of induced labor supply even the direction of change is at issue. Historically, there has been a tendency, as incomes have increased, for the average worker to work shorter hours and to retire at an earlier age. When taxes on labor income are reduced, the positive response to higher after-tax earnings will be offset, perhaps completely, by this tendency to take some of the increased potential earnings in the form of increased leisure.

The greatest weight of professional opinion is that increased capacity in response to reduced tax rates will take effect much more slowly than the demand effects induced by higher incomes. Any tendency for labor supply to respond to increases in after-tax wages will be translated into increased economic capacity only over a period of years. In part, this is because it takes time for households to adjust—to seek out a second job, to arrange for child care, to take more schooling, and the like. More important, however, is that it takes time for businesses to make the additional investment necessary to accommodate the increased labor supply.

Nevertheless, these long-run supply effects are very important since they will help to determine the underlying growth and composition of employment and output in the future. Significant supply side factors are not ignored in deriving the long range receipts projections that are included in the budget. These projections show the path of Federal receipts through time that are consistent with attainable increases in capacity and aggregate demand.

The Treasury has been devoting substantial resources to understanding and estimating supply effects. We also closely monitor new research in this area. Analysis of the longer-run implications of tax policy will build upon new research findings as they become available.

PRICE EFFECTS

Tax policy changes have consequences for economic behavior other than their aggregate demand effects and supply side responses. A further important effect of tax policy changes is that they alter the relative prices or costs of particular types of consumption and investment goods. As a consequence, households and firms respond by changing their consumption and investment patterns. Not all tax changes have significant price effects. Changes in exemptions, the standard deduction, and even across-the-board cuts in tax rates do not bring about significant changes in relative prices. However, when such relative price effects do occur and when there is broad agreement as to both the magnitude and the direction of these impacts, revenue estimates incorporate the behavioral responses to the relative price changes. There are numerous examples of such behavioral responses. They include:

TABLE 1.—COMPARISON OF ESTIMATED AND ACTUAL UNIFIED BUDGET RECEIPTS, FISCAL YEARS 1963-68

(Dollar amounts in billions)

	Fiscal years—					
	1963	1964	1965	1966	1967	1968
1963 budget (January 1962).....	\$113.5					
1964 budget (January 1963).....	105.4	\$109.3				
1965 budget (January 1964).....	106.6	111.3	\$115.9			
1966 budget (January 1965).....		112.7	114.6	\$119.8		
1967 budget (January 1966).....			116.8	124.7	\$141.4	
1968 budget (January 1967).....				130.9	150.3	\$158.6
Actual receipts.....	106.6	112.7	116.8	130.9	149.6	153.7
Estimating errors:						
Estimate made 18 mo prior to yearend minus actual receipts.....	+7.0	-3.4	-.9	-11.0	-8.1	+4.9
Error as percent of actual receipts.....	+6.5	-3.0	-.8	-8.4	-5.4	+3.2

¹ Denotes actual level of unified budget receipts.

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

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, July 14, 1978

TABLE 2.—PROPOSED TAX REDUCTIONS INCLUDED IN THE ADMINISTRATION'S MIDSSESSION BUDGET REVIEW

(In billions)

	Fiscal year—	
	1979	1980
Unified budget receipts published in the Midsession Review.....	448.2	567.3
Receipt effects of the President's tax reduction and reform proposals:		
Gross change in receipts.....	-14.1	-21.8
Offsetting induced receipts.....	3.0	8.0
Net change in receipts.....	-11.1	-13.8
Unified budget receipts in absence of the President's tax reduction and reform proposals.....	459.3	521.1

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Aug. 16, 1978.

The taxable bond option, where it is assumed that some fraction of municipal debt will be issued on a taxable basis as a result of the lower interest costs of issuing subsidized taxable debt compared to the prevailing rate on tax-exempts.

The automobile efficiency tax, where consumers are assumed to modify their pattern of automobile purchases in response to the increased prices of gas-inefficient vehicles.

Residential and business thermal efficiency and solar tax credits, where the reduction in prices of the subsidized activities are assumed to induce households and firms to install more insulation and to use lower cost sources of energy;

Any new program such as subsidies for exports (DISC) or for new retirement programs (IRA), where the revenue estimates depend upon the extent to which the new provision will be used;

Integration of corporate and personal taxes, where an increase in corporate dividends would be expected to accompany the reduction in the combined level of personal and corporate taxes on these dividends.

In all of these cases, there may be disagreement over the magnitude of the behavioral responses. Nevertheless, a good faith effort is made to incorporate behavioral responses into the revenue estimates where the behavioral responses will obviously occur and they are believed to be substantial. But we do not try to estimate feedback effects where the predominant responses are unpredictable or where there is no objective basis for making a judgment.

Two specific cases of tax induced price changes are currently of particular interest. They are the cuts of capital gains taxes and the reduction of top marginal tax rates. It has been alleged in both cases that the price effects of the tax change will induce a flood of new revenues to the Treasury, outweighing the initial revenue loss. In the case of capital gains cuts, the claim is made that the increased realizations will be so large as to yield an increase in tax receipts on capital gains. In the case of a reduction in the top marginal tax rates, the switch of investment from sheltered to unsheltered activities along with a vast increase in work effort are the alleged sources of the higher tax receipts.

Claims have been made that solid empirical analysis underlies both behavioral responses. But these claims are greatly overstated. The empirical work to date concerning the response of gains realizations to changes in capital gains tax rates has not distinguished between short-run transitional effects and long-run effects. Further, if the results are interpreted as estimates of permanent long-run effects, they imply such enormous reductions in the average holding periods of assets as to be totally at variance with the observed historical stability of these holding periods. Also, the estimates assume that every investor has an unlimited amount of unrealized accrued gains just waiting to be realized at lower tax rates, an assumption surely contrary to the facts. Moreover, it may be very difficult to separate statistically the effect of the marginal tax rates from the effect of high itemized deductions for medical expenses or casualty losses. Higher realization of capital gains may be due to high itemized deductions rather than to low marginal rates themselves.

Attempts to adduce the likely responses of high income taxpayers to reductions in their marginal tax rates by examining historical data for the years before and after the 1964 tax cut also are seriously deficient. While it may be true that at substantially lower marginal tax rates individuals would find tax shelters of much diminished economic advantage and would therefore tend to invest more in fully taxed assets, the likelihood and magnitude of such a response cannot be determined by merely looking at the income taxes paid by those in the upper income classes before and after the tax cuts of 1964. The upper income group did, in fact, pay more in taxes after their marginal rates were cut, but all income classes experienced tax cuts and all realized significant increases in incomes along with the general expansion of the economy in 1964-66. The share of before-tax income reported by the highest income classes was remarkably stable over the entire period from 1952 through 1972. In addition, it should be pointed out that most of the increased taxable income in these income groups was from higher realized capital gains. But the 1964 Revenue Act did not change the 25 percent alternative tax on capital gains. Thus while it may be desirable to reduce marginal tax rates to provide additional incentives to work and to save, there is little evidence for claiming large revenue gains to the Federal Treasury as a result of tax-induced price effects.

CONCLUSION

First, estimates of aggregate budget receipts do include the additional receipts resulting from the impact of tax changes on aggregate demand. However, estimates for particular tax changes, just like estimates for particular expenditure changes, do not include feedback effects. To do so when they are already in the aggregate estimates would be double counting.

Second, projections of long-run budgetary figures also accommodate the impacts of tax changes on economic capacity. As research sheds more light on the nature of these effects, it may be possible to incorporate them more formally into longer-run projections.

Third, Treasury does incorporate estimates of changes in specific types of investment or consumption induced by relative price changes whenever it appears the effects are important and it is possible to make reasonable estimates.

APPENDIX

(From the Washington Star, Sunday, Aug. 13, 1978)

(By Eugene J. McCarthy)

CAPITAL GAINS AND CARTER'S ECONOMICS

Harry Truman said once, or possibly more than once, that he was looking for a one-armed economist; because every economist he knew, when talking of economic matters, always said, "On the one hand . . ." and, "Then, on the other hand . . ."

If one takes President Carter's comments on proposals to reduce the rate of taxation on capital gains as economic rather than political judgments, one must conclude that the president is consulting neither one-handed nor two-handed economists. One must conclude that he has become his own economist.

The president has called the proposed reduction "a high tax windfall for millionaires" and "two bits" for the average American (the latter phrase reportedly coming from the resident White House image maker, Gerald Rafshoon). Treasury Secretary Michael Blumenthal, who should know better and probably does, joined in with the suggestion that the legislation be referred to as the "Millionaires' Rellife Act of 1978." Given these comments, it may be in order to look at some economic and political realities.

One basic economic fact, on which there is general agreement among economists and businessmen, is that the American economy needs an infusion of new capital. The economic and political reality is that there are three major sources for this needed capital.

One is the government itself, which could provide capital through loans or grants to business and industry, similar to those given to the ailing Penn Central Railroad. This method is not generally favored by either businessmen or politicians, and has not proved to be a very reliable source of investment funds.

A second source is earnings retained by industry and business. The amount of capital available from this source depends on corporate tax rates, investment credit allowances, depreciation schedules and so forth. There is, however, little political support for any major concession in these areas.

The third possible source of funds, and the most desirable from a social point of view, is non-governmental and non-business. It is investment by individuals, either directly or through financial institutions which act as their agents.

Increased investment by individuals could be encouraged most immediately and effectively through a reduction in capital gains rates. That action should be sustained by changes in income tax policies which would permit or assist persons below the "millionaire" category to accumulate earnings to be used for investment.

Administration opponents of the reduction in the capital gains tax rate, as well as other opponents and critics of it, make the obvious point that its initial benefits would go to upper-income persons who have the largest investments.

This is not a compelling argument against reduction of capital gains tax rates. It is a compelling reason for looking at other aspects of the tax system. And it is a compelling reason for looking at the operation of the American economy, which makes it difficult for persons in every income bracket (unless they already have wealth) to accumulate property through savings and investment.

It is important to note that, because of the great increase in value of homes and farms and small-business properties middle-income persons would benefit significantly from reduced capital gains taxes.

Among the benefits likely to flow, in some measure, from reduced capital gains tax collection are these:

1. The encouragement of savings and investment.

2. The unlocking of assets and the more normal transfer of them, and the discouragement of the present "until death do we part with capital assets" policy and practice.

3. A clear and immediate benefit to home owners who sell and also to those who buy.

4. A reduction of the unhealthy corporate debt-equity ratio.

5. Some aid to U.S. businesses that compete with businesses from Japan and Germany and other countries which do not impose capital gains taxes.

6. An increase in jobs.

7. An increase in the Gross National Product.

8. And, depending on other things being more or less equal, a reduction in the federal budget deficit.

[Thereupon at 2:45 p.m., the committee recessed, to reconvene at the call of the Chair.]