91st Congress }
1st Session }   COMMITTEE PRINT

TAX REFORM STUDIES AND PROPOSALS
U.S. TREASURY DEPARTMENT

JOINT PUBLICATION

COMMITTEE ON WAYS AND MEANS

OF THE

U.S. HOUSE OF REPRESENTATIVES

AND

COMMITTEE ON FINANCE

OF THE

U.S. SENATE

FEBRUARY 5, 1969

PART 2

NOTE: This document has not been considered by either the Committee on Ways and Means of the House of Representatives or the Committee on Finance of the Senate. As indicated in the letters of Chairman Mills and Chairman Long, the document is being printed for information purposes only so as to make it generally available.

U.S. GOVERNMENT PRINTING OFFICE

24-472 O   WASHINGTON : 1969

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 65 cents

NINETY-FIRST CONGRESS

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WILBUR D. MILLS, Arkansas, *Chairman*

HALE BOGGS, Louisiana
JOHN C. WATTS, Kentucky
AL ULLMAN, Oregon
JAMES A. BURKE, Massachusetts
MARTHA W. GRIFFITHS, Michigan
DAN ROSTENKOWSKI, Illinois
PHIL M. LANDRUM, Georgia
CHARLES A. VANIK, Ohio
RICHARD H. FULTON, Tennessee
JACOB H. GILBERT, New York
OMAR BURLESON, Texas
JAMES C. CORMAN, California
WILLIAM J. GREEN, Pennsylvania
SAM M. GIBBONS, Florida

JOHN W. BYRNES, Wisconsin
JAMES B. UTT, California
JACKSON E. BETTS, Ohio
HERMAN T. SCHNEEBELI, Pennsylvania
HAROLD R. COLLIER, Illinois
JOEL T. BROYHILL, Virginia
JAMES F. BATTIN, Montana
BARBER B. CONABLE, JR., New York
GEORGE BUSH, Texas
ROGERS C. B. MORTON, Maryland

WILLIAM H. QUEALY, *Minority Counsel*

JOHN M. MARTIN, Jr., *Chief Counsel*
J. P. BAKER, *Assistant Chief Counsel*

COMMITTEE ON FINANCE

U.S. SENATE

RUSSELL B. LONG, Louisiana, *Chairman*

CLINTON P. ANDERSON, New Mexico
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
FRED R. HARRIS, Oklahoma
HARRY F. BYRD, JR., Virginia

JOHN J. WILLIAMS, Delaware
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
EVERETT McKINLEY DIRKSEN, Illinois
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
PAUL J. FANNIN, Arizona

TOM VAIL, *Chief Counsel*
EVELYN R. THOMPSON, *Assistant Chief Clerk*

NOTE: Letters of request and transmittal appear at pages III and V in Part 1.

CONTENTS

[This table of contents has been expanded by the printer to include subheadings]

PART 1

PART 2

PART 3

V. INDIVIDUAL INCOME TAX PROPOSALS

General and Technical Explanations

V-A. LIBERALIZATION OF THE MINIMUM STANDARD DEDUCTION

GENERAL EXPLANATION

BACKGROUND

Under existing law taxable income is computed by subtracting a taxpayer's allowable deductions and personal exemptions from adjusted gross income. As an alternative to itemizing his allowable deductions separately, a taxpayer may elect to claim a standard deduction equal to 10 percent of his adjusted gross income up to a maximum of $1,000 ($500 for married persons filing separately). A separate minimum standard deduction provides that in all events an electing taxpayer is entitled to a minimum deduction of $200 ($100 for married persons filing separately) plus an additional $100 for each exemption claimed subject to a ceiling of $1,000.

PROPOSAL

It is recommended that the minimum standard deduction be increased from $200 plus $100 for each exemption to $600 plus $100 for each exemption (subject to a ceiling of $1,000).

The minimum standard deduction represents the most equitable and efficient method available of directing tax relief to persons in the lowest income ranges. As shown in table 1, under the present tax system, there are single individuals as well as families who are paying income tax even though their total incomes are below the poverty level. The proposed increase in the minimum standard deduction would drastically alter this situation. It would greatly reduce the income tax payments of all persons at or near the poverty level and would completely exempt from tax the majority of those persons below the poverty level who now pay income tax.

TABLE 1.—BEGINNING TAX LEVELS AND POVERTY LEVELS

	Exemption and minimum standard deduction	Poverty income levels, 1969[1]	Estimated number of poor family units (thousands)	
			Total	Presently taxable
Family size:				
1	$900	$1,735	4,620	1,150
2	1,600	2,240	2,600	620
3	2,300	2,755	880	150
4	3,000	3,535	640	120
5	3,700	4,165	520	50
6	4,400	4,675	430	40
7 or more[2]	5,800	5,755	940	50
Total family units			10,630	2,180

[1] Assumed to be 6 percent above the HEW nonfarm poverty levels for 1966.
[2] Averages 8 per family.

In addition, just as the proposed increase in the general standard deduction will benefit a wide range of taxpayers by bringing that general provision into closer alinement with today's relative cost and expenditure patterns for deduction items, so, too, the increase in the minimum standard deduction will provide benefits for those taxpayers above the poverty level who are in the lowest income ranges.

EFFECTS OF THE PROPOSAL

The income levels at which individuals would become subject to tax would be increased under the proposal, as shown in table 2. Under present law a single individual begins paying tax at an income level of $900. With the new provision he would not incur any tax liability until his income exceeds $1,300, a level at which he pays $56 in tax under present law. Presently, a married couple with two children begins to pay tax when their AGI exceeds $3,000. With the proposed revisions they would not begin to pay tax until their income exceeds $3,400, a level at which they currently pay $56.

About 28 million taxpayers, of which almost two-thirds have incomes less than $5,000, would benefit from the proposed changes in the minimum standard deduction—about 2.4 million of these becoming completely nontaxable. Most of those taken off the tax rolls would be in the under $3,000 group.

Table 2 shows, by family size, the estimated distribution of poor people, the number made nontaxable by the minimum standard deduction change, and the number that would receive some tax reduction without becoming nontaxable as a result of the change. Out of about 11 million poor families, about 2.2 million are taxable under present law. Of the latter number, 1¼ million would become nontaxable and 1 million would still be taxable but would get tax relief, all as a result of the higher minimum standard deduction.

In terms of the number of poor peope, there are almost 28 million poor, of which 4.3 million are now taxable. The minimum standard deduction change would result in 2.6 million of these becoming nontaxable.

TABLE 2.—EFFECT OF CHANGES IN THE STANDARD DEDUCTION UNDER THE PROPOSAL ON PERSONS BELOW THE POVERTY LINE, CALENDAR YEAR 1969

Family size	Exemptions and minimum standard deduction allowed		Poverty income levels, 1969 [1]	Estimated number of poor persons (in thousands) [2]			
	Present law	Proposal		Total	Number of poor now taxable	Number made nontaxable	Number helped, but still taxable
1	$900	$1,300	$1,735	4,620	1,150	550	600
2	1,600	2,000	2,240	5,200	1,220	790	430
3	2,300	2,700	2,755	2,640	460	400	60
4	3,000	3,400	3,535	2,550	490	360	130
5	3,700	4,000	4,165	2,620	270	220	50
6	4,400	4,600	4,675	2,590	250	180	70
7 or more [3]	5,800	5,800	5,755	7,600	450	50	400
Total				27,820	4,290	2,550	1,740
Total family units				10,630	2,180	1,250	940

[1] 1969 poverty levels are assumed to be 6 percent above the HEW nonfarm level for 1966. This conforms to the method by which the number of poor was projected.
[2] Includes both adults and children.
[3] Averages about 8 persons per family.

(A high proportion of poor persons in one- and two-person families are aged, and almost all of these are presently nontaxable. Also, about 42 percent of the 28 million poor are children.)

The higher minimum standard deduction in addition would *grant relatively more tax relief to single persons than to other taxpayers.* This is done by increasing relatively more for single persons the income levels at which people become taxable; for example, an increase of 44 percent as compared to 25 percent for married couples. Of the 28 million taxpayers who would get tax relief from the higher minimum standard deduction, about 17 million are single persons.

Tables 3 and 4 show for single persons and married persons (two children) respectively the tax relief accorded at selected income levels by the liberalization of the standard deduction and the minimum standard deduction.

TABLE 3.—TAX DECREASE FROM $600 + $100 MINIMUM STANDARD DEDUCTION ($1,000 CEILING) AND 14 PERCENT STANDARD DEDUCTION ($1,800 CEILING), SINGLE INDIVIDUAL WITH STANDARD DEDUCTION

Wage income	Present tax	Tax decrease	New tax	Percentage tax decrease	Tax decrease as a percent of income
$2,000	$161	$61	[1] $100	38	3.0
$3,000	329	70	[1] 259	21	2.3
$5,000	671	38	[2] 633	6	.8
$7,500	1,168	70	[3] 1,098	6	.9
$10,000	1,742	112	[3] 1,630	6	1.1
$12,500	2,478	240	[3] 2,238	10	1.9
$15,000	3,334	288	[3] 3,046	9	1.9
$20,000	5,350	348	[3] 5,002	7	1.7
$25,000	7,730	400	[3] 7,330	5	1.6
$35,000	12,980	440	[3] 12,540	3	1.3
$50,000	21,630	480	[3] 21,150	2	1.0

[1] Taxpayer elects the minimum standard deduction rather than the standard deduction.
[2] Taxpayer pays the same amount of tax with either the minimum standard or the standard deduction.
[3] Taxpayer elects the standard deduction rather than the minimum standard deduction.

TABLE 4.—TAX DECREASE FROM $600 + $100 MINIMUM STANDARD DEDUCTION ($1,000 CEILING) AND 14 PERCENT STANDARD DEDUCTION ($1,800 CEILING), MARRIED COUPLE, 2 DEPENDENTS, WITH STANDARD DEDUCTION

Wage income (1)	Present tax (2)	Tax decrease (2)—(4) (3)	New tax (4)	Percentage tax decrease (5)	Tax decrease as a percent of income (6)
$2,000	0				
$3,000	0				
$5,000	$290	$60	$230	21	1.2
$7,500	686	56	630	8	.7
$10,000	1,114	76	1,038	7	.8
$12,500	1,622	165	1,457	10	1.3
$15,000	2,172	176	1,996	8	1.2
$20,000	3,428	218	3,210	6	1.0
$25,000	4,892	256	4,636	5	1.0
$35,000	8,504	312	8,192	4	.9
$50,000	15,360	400	14,960	3	.8

The tax relief from the liberalization of the minimum standard deduction amounting to more than $1 billion *would go to the lower incomes.* More than 70 percent would go to the under $5,000 group and 18 percent would go to the $5,000 to $7,500 group. (See table 5.)

Taxpayers with AGI less than $3,000 would receive the largest percentage decrease in tax liability under the minimum standard deduction increase. Tax liability would decrease by 36 percent. The $3,000–$5,000 group would receive a 13 percent decrease in tax liability.

The higher minimum standard deduction would also enable many low-income taxpayers to *shift from the complex itemizing procedure to the use of the simple standard deduction.* Table 5 shows that the revisions would result in a shift from itemization to the minimum standard deduction by 3.4 million taxpayers, most of them in the $0–$7,500 AGI group.

TABLE 5.—EFFECT OF INCREASING THE PRESENT $200 PLUS $100 MINIMUM STANDARD DEDUCTION TO $600 PLUS $100 WITH $1,000 CEILING

[Dollar amounts in millions; number of returns in thousands]

AGI (in thousands of dollars)	Present law tax	Tax decrease	Tax decrease as percent of present law tax	Number of returns with tax decrease	Number of returns made nontaxable	Number of returns shifting to standard deduction
0 to 3	$1,159	$415	35.8	9,760	2,025	870
3 to 5	3,177	420	13.2	7,870	320	1,120
5 to 7	5,439	200	3.7	5,940	15	980
7 to 10	13,925	95	.7	4,330		400
10 to 15	18,916					
15 to 20	7,550					
20 to 50	12,795					
50 to 100	6,326					
100 and over	6,202					
Total	75,490	1,130	1.5	27,900	2,360	3,370

Note: Details may not add to totals because of rounding.

V-A. LIBERALIZATION OF THE MINIMUM STANDARD DEDUCTION

TECHNICAL EXPLANATION

PRESENT LAW

Under existing law each taxpayer may, as an alternative to itemizing his personal expense deductions, elect to claim a standard deduction equal to 10 percent of his adjusted gross income subject to a $1,000 ceiling. For electing taxpayers the law presently provides a minimum standard deduction of $200 plus $100 for each exemption subject to a ceiling of $1,000.

BASIC PROPOSAL

Under the proposal the minimum standard deduction available to electing taxpayers would be increased from $200 plus $100 for each exemption, to $600 plus $100 for each exemption. Thus, a single person would have a minimum standard deduction of $700, a married couple $800, a married couple with two dependents $1,000.

LIMITATIONS

$1,000 ceiling.—The provision of existing law which limits the minimum standard deduction to $1,000 would be retained. Thus a married taxpayer with two dependents would be entitled to a minimum standard deduction of $1,000 and the amount of the deduction could not exceed this amount even if the particular taxpayer had more than three dependents. A married taxpayer with two dependents who did not itemize his deductions would be using the minimum standard

deduction unless his income exceeded $7,142. If adjusted gross income exceeded that amount, the taxpayer would find it advantageous to use the new general standard deduction of 14 percent.

Married taxpayers filing separate returns.—For a married taxpayer filing a separate return, the minimum standard deduction would be $300 (rather than $600) plus $100 for each exemption and would be subject to a $500 ceiling (rather than a $1,000 ceiling).

As under existing law, if a taxpayer is married and files a separate return, he may not use the general standard deduction if his spouse itemizes deductions and may not use the minimum standard deduction if his spouse either itemizes deductions or uses the general standard deduction. If a taxpayer's general standard deduction is greater than the minimum standard, he may nevertheless elect to use the minimum standard if his spouse's minimum standard deduction is greater than the general standard deduction.

Dependents of other taxpayers.—Under the proposal the minimum standard deduction may not be used by taxpayers who are claimed as dependents by other taxpayers.

Under existing law a taxpayer is entitled to a $600 dependency exemption for each of certain specified relatives who receive more than half of their support from the taxpayer and have less than $600 of gross income. An exception to the gross income limitation is made in the case of children of the taxpayer who are under 19 or students. As a consequence, under existing law children of the taxpayer may have gross income in excess of $600 as to which they may claim their own $600 personal exemption and also claim the minimum standard deduction even though they are supported by a parent who also claims them as a dependent for tax purposes.

The minimum standard deduction is intended to aid taxpayers and their families in the lowest income ranges. There is no justification for permitting that deduction to taxpayers who, while nominally in the lower income ranges, are in fact receiving in addition to their own income more than half of their support from parents. For example, were the proposed minimum standard deduction extended to such persons, a wealthy parent would be able to create $1,300 of tax-free income annually for each child by transferring property yielding that amount to each child.

Under the proposal a dependent would still be permitted to claim a $600 exemption against his own income even though the person supporting him also claimed a $600 exemption, but the dependent would not be permitted to use the minimum standard deduction as an alternative to the general standard deduction.

PERSONS OVER AGE 65

Persons over age 65 will be entitled to the same minimum standard deduction as persons under age 65. However, as a consequence of the proposed revision of the tax treatment of the aged, the interrelationship of the minimum standard deduction and the aged exemption will considerably reduce the tax burden on persons over age 65 who are in the lower income ranges.

Under the aged proposal social security benefits will no longer be exempt and the retirement income credit and extra $600 aged exemption will be repealed. As a consequence of the repeal of the extra $600 personal exemption the extra $100 of minimum standard deduction will be eliminated. However, these provisions will be replaced by a uniform aged exemption of $2,500 for single taxpayers and married couples with one spouse age 65 or over, and an exemption of $4,200 for a married couple where both are age 65 or over.

As a consequence of the aged proposal and the change in the minimum standard deduction a single individual over age 65 would not pay taxes until his income exceeded $3,800 and would switch to the general standard deduction at $5,000. A married couple with one spouse under age 65 would pay no tax until their income exceeded $4,500 and would switch to the standard deduction at $5,714, and a married couple where both are over age 65 would always find it advantageous to use the general standard deduction and would not become taxable until their income exceeded $6,279.

EFFECTIVE DATE

The recommended changes in the minimum standard deduction would be applicable to tax years beginning after December 31, 1969.

V-B. MINIMUM INDIVIDUAL INCOME TAX

General Explanation

BACKGROUND

Present law accords preferential tax treatment to certain types of income through their total or partial exclusion from the income tax base. Some individuals have structured their income to receive so much of one—and often a combination of several—of these items of excluded income that they are not making a fair tax contribution to the Government in relation to the amount of their true income.

This situation has seriously impaired the progressivity of our tax system. For example, even after the other reforms in the program, almost 50 percent of individuals with income from taxable sources of between $500,000 and $1 million and over 50 percent of individuals with adjusted gross income of $1 million or more will pay tax at an effective rate of less than 30 percent of their true income; that is, their income from both taxable and excluded sources. On the other hand, about 65 percent of the individuals with adjusted gross income between $50,000 and $100,000 will pay tax at an effective rate of more than 30 percent even when their excluded income is considered. In other words, a larger percentage of the taxpayers in the $50,000 to $100,000 group will pay tax of over 30 percent than in the over $500,000 income group.

PROPOSAL

In order to more nearly equate tax liability with an individual's ability to pay and with that of other taxpayers with similar incomes but from taxable sources, a mandatory graduated *minimum* income tax, computed on an expanded income base, would be added to the tax structure. This minimum tax would have the effect of placing a

50-percent ceiling on the amount of an individual's total income that could enjoy tax-exempt status.

Under the proposal individuals who receive a substantial amount of fully or partially tax-exempt income in relation to their taxable income would be required to compute a minimum tax on an expanded income base (including both taxable income and the exempt income) and to pay this tax if it is higher than the tax computed under the normal rates. The minimum tax rates which would be applied against this expanded income base would be graduated from 7 to 35 percent. These rates have been established to effect a tax that will be approximately the same as that imposed under the present rules on one-half as much income. Thus, the effect of the minimum tax is to place a ceiling of 50 percent on the amount of an individual's total income which may be excluded from his tax base.

An overall limitation on the amount of tax benefits which can be claimed has ample precedent in the present tax law. For example, the amount of percentage depletion that can be claimed cannot exceed 50 percent of the taxable income from the property; the charitable contribution deduction is limited to a specified percentage of income; and the maximum investment credit is limited to the first $25,000 of tax liability plus 50 percent of the tax liability in excess of that sum. However, there is no limitation on the extent to which some tax preferences—such as the exclusion for State and local bond interest and the special treatment for capital gain income—may be claimed, and there is likewise no limit on the extent to which even those preferences with ceilings may be combined. It is the basic purpose of the minimum tax to impose such an overall limitation.

Composition of Expanded Income Base.—The expanded income base to which the minimum tax rates would be applied would consist of taxable income plus the following four major sources of excluded income:

(1) *Interest* on State and local bonds.

(2) The excluded portion of *net long-term capital gain*. For individuals below the 50-percent tax bracket who presently deduct one-half of their gains from income, this item will increase their minimum tax base by this one-half of capital gains. Those in the higher tax brackets who pay the alternative flat rate of 25 percent on all their long term capital gains have been, in effect, excluding more than one-half of their capital gains since the tax at the 25-percent rate is less than the tax that would result by applying the regular tax rates to one-half of those gains. The full amount of this exclusion will be returned to the tax base for purposes of computing the minimum tax.

(3) The amount of *percentage depletion* claimed after the cost of the property has been recovered.

(4) The amount of *appreciation on property contributed to charity* to the extent taken as a deduction under the normal limitations.

In order to maintain a simple structure for the minimum tax, relatively minor items of excluded income—for example, sick pay and the dividend exclusion—would not be included in the expanded base. For similar reasons, tax preferences which represent a *deferral of tax*, rather than an *exemption from tax*, would be excluded in defining the expanded income base. In these deferral cases, a tax will eventually be paid assuming adoption of the proposal for including in income the appreciation on property at the time it is given away or transfered on the death of the owner.

In computing his minimum tax base, the individual would be allowed all of his deductions. Moreover, in lieu of these deductions, he may elect a special alternative $10,000 standard deduction, if this would be more advantageous to him. Thus, by virtue of the special deduction, the minimum tax will not apply to any individual whose expanded income is less than $10,000 (plus his personal exemptions). This will insure that the effect of the minimum tax is limited to individuals who are deriving substantial benefits from the tax preferences involved.

Computation.—The actual computation of the minimum tax would be relatively simple for affected taxpayers: The individual would add to his adjusted gross income, as computed under present law, the amounts he received of the various exempt items to be included in the expanded base; he would then subtract all the deductions to which he is now entitled (without reduction under the proposed allocation of deductions provision), or a minimum deduction of $10,000, whichever is larger, and also subtract his present law personal exemptions; the remainder would be his minimum tax base, to which he would then apply the minimum tax rate schedule to compute the amount of his minimum tax. He would pay this if it is higher than his tax under the regular rates.

The existing 25-percent alternative capital gain tax rate would, however, be retained with respect to capital gain income representing appreciation of property held by the taxpayer at his death or given away during his lifetime. This gain would be included in the regular tax base under another proposal in the program. The special rule for this income recognizes that capital gain income on death or at the time of a large gift may be abnormally large (and, thus, result in a minimum tax) in relation to what the taxpayer might have realized in any one year had he disposed of his investments over a period of years rather than in a single year.

Relationship of Minimum Tax and Allocation of Deductions Proposals.—The allocation of deductions proposal included in the program would, in general, require an individual to allocate his nonbusiness expense deductions between taxable and exempt income, and would allow these deductions only to the extent allocable to taxable income. This is a basic reform of the deduction provisions and is justified no matter how large or small the individual's exempt income is in relation to his taxable income. However, it would not adequately correct the tax situation of an individual whose total income significantly exceeds his nonbusiness deductions and consists of a disproportionate amount of exempt income in relation to taxable income. This situation would be corrected by the proposed minimum tax, which as indicated above, generally applies if an individual's exempt income exceeds his taxable income. In determining whether the minimum tax is larger than the regular tax and therefore is to be paid for a year, the allocation of deductions proposal will apply in computing the regular tax, but not the minimum tax where the exempt items themselves are included in the expanded income base. Thus, the allocation of deductions proposal will have its impact in cases where an individual has less exempt income than taxable income.

Corporations Not Affected.—Like the allocation of deductions proposal, the minimum tax would not apply to corporations. The corporations whose income would include the four tax-exempt items to any significant degree are found mainly in only a few industries. The question of whether the tax structure for these specific industries should be altered depends upon an analysis of their particular economic and competitive positions. On the other hand, with respect to individuals, the impact of the minimum tax is not so localized. Moreover, the minimum tax is directly associated with the progressive nature of the individual income tax.

Effects of the Proposal.—The minimum tax would affect approximately 40,000 tax returns, and, based on 1969 income levels, would result in an estimated annual revenue increase of $420 million. The bulk of this revenue increase—60 percent—would be paid by taxpayers with $500,000 or more of exempt income each year. Another 25 percent would come from individuals with between $100,000 and $500,000 of exempt income. The revenue effects of the proposal are set forth in more detail in table 1.

The minimum tax would have a substantial impact on bringing the effective tax rates of high-income individuals with large amounts of exempt income more in line with their ability to pay and with the rates being paid by taxpayers with similar—but fully taxable—incomes. More specifically, with the enactment of the minimum tax along with the other reforms in the program, the proportion of taxpayers with incomes from taxable sources of between $500,000 and $1 million who would pay tax at an effective rate of over 30 percent on the basis of all their income, both taxable and exempt, would increase from about 5 out of 10 to over 8 out of 10. In the class of taxpayers with adjusted gross incomes of $1 million or more, about 98 percent would pay tax at an effective rate of over 30 percent, as compared with only about 50 percent without the minimum tax. However, since the minimum tax rates progress only up to 35 percent, the minimum tax would not increase any person's effective tax rate above 35 percent.

TABLE 1.—EFFECT OF MINIMUM TAX

AGI class (in thousands of dollars)	Tax increase (in millions)	Percentage tax increase [1]	Number of returns with tax increase (in thousands)	Percent of returns with tax increase	Average tax increase
Under 10 [2]	$12	(3)	23	(3)	$520
10 to 15 [2]	8	(3)	4	(3)	2,000
15 to 20	2	(3)	3	0.1	505
20 to 50	30	0.2	3	.1	8,670
50 to 100	6	.1	(3)	.1	12,000
100 to 500	105	2.2	4	5.8	24,140
500 to 1,000	90	13.5	1	42.5	91,370
1,000 and over	167	18.2	(3)	48.3	334,000
Total	420	.6	40	.1	10,500

[1] Percentage tax increase for those with an increase.

[2] The returns in these classes affected by the minimum tax have total income generally well in excess of $20,000. Their excluded income is not included in adjusted gross income so the returns appear in the lower AGI classes.

[3] Less than 1/10 of 1 percent.

Note: Averages computed from unrounded data.

Table 2 indicates the effect of the minimum tax on effective tax rates at various income levels. As this table shows, there would still be some high-income individuals paying very low effective rates of tax even after the adoption of a minimum tax, the allocation of deductions proposal, and the other provisions in the reform program. These are primarily individuals with only relatively small amounts of exempt income, but with large amounts of deductions of the type normally taken by taxpayers at all income levels.

TABLE 2.—COMPARISON OF EFFECTIVE TAX RATES BEFORE AND AFTER MINIMUM AND MAXIMUM TAX:[1] PERCENTAGE DISTRIBUTION OF RETURNS BY EFFECTIVE TAX RATE CLASSES

AGI class (in thousands of dollars)	Effective tax rate classes[2]									
	Under 10	10 to 20	20 to 25	25 to 30	30 to 35	35 to 40	40 to 45	45 to 50	50 to 60	Over 60
20 to 50	0.6	21.1	55.8	17.1	4.4	0.8	0.2			
	(1.0)	(25.0)	(51.9)	(16.9)	(4.2)	(.7)	(.2)			
50 to 100	.4	3.1	9.7	20.0	36.1	22.6	6.3	2.0		
	(.5)	(3.5)	(10.0)	(21.8)	(33.5)	(22.6)	(6.3)	(1.5)	(.5)	
100 to 500	.4	.7	5.6	18.3	12.5	14.9	20.1	27.4		
	(.6)	(1.0)	(8.5)	(16.1)	(11.4)	(14.9)	(20.1)	(15.2)	(11.0)	(1.2)
500 to 1,000	.8	.6	.2	16.4	37.7	5.9	5.2	33.4		
	(.9)	(.4)	(6.0)	(40.1)	(8.0)	(5.9)	(5.2)	(4.4)	(9.2)	(19.8)
1,000 and over	1.6	.6		.4	55.8	7.2	3.1	31.5		
	(1.8)	(.7)	(3.4)	(44.6)	(7.7)	(7.2)	(3.1)	(2.2)	(7.1)	(22.1)

[1] Numbers in parentheses are after reform proposals concerning deduction changes but before minimum and maximum tax. The numbers above those in parentheses are after these provisions. The difference between the two rows of figures in the under-35-percent classes shows the effect of the minimum tax. The difference in the 45-to-50 and 50-and-over classes shows the effect of the maximum tax.

[2] Tax as a percent of amended taxable income, which is taxable income after reform proposals concerning deduction changes plus the excluded part of net long-term capital gains, tax-exempt interest, and excess of percentage depletion after recovery of basis.

Note: Percentages may not add to 100 percent because of rounding.

V-B. MINIMUM INDIVIDUAL INCOME TAX

TECHNICAL EXPLANATION

GENERAL OUTLINE OF THE MINIMUM TAX

This proposal would establish a minimum limitation on the total tax which an individual would be required to pay with respect to his income for any one year. Under the proposed minimum tax, an individual would apply a special tax rate schedule to an expanded income base. If the resulting tax is larger than the tax computed under the present system, he would pay the minimum tax.

MINIMUM TAX BASE

The proposed minimum tax system would build upon the income concepts applicable under the regular income tax. Thus, *minimum* *tax gross income* would be defined as gross income (as computed for purposes of the regular income tax) increased by (1) the amount of any interest excluded from gross income under section 103(a), and (2) the amount of any appreciation in the value of property (other than cash) donated to charity to the extent a deduction is allowed for such appreciation.

Minimum tax adjusted gross income would be defined as *minimum tax gross income* reduced by the same deductions allowed under existing law in computing adjusted gross income, except that (1) no deduction would be allowed for capital gains under section 1202, (2) the deduction for depletion would not be allowed after the taxpayer has recovered his basis for cost depletion in the property, and (3) certain conforming modifications would be required in computing the amount of the net operating loss deduction.

Minimum tax taxable income would be computed by reducing *minimum tax adjusted gross income* by the same deductions by which adjusted gross income is reduced in computing taxable income under existing law, except that the proposed allocation of deductions computation would not apply. Moreover, additional deductions would be allowed for expenses related to the exempt interest included in the tax base. Furthermore, a special $10,000 minimum tax standard deduction would be available in lieu of itemized deductions or the regular standard deduction.

There follows a more detailed discussion of the exempt income items that would be included in the minimum tax base:

Exempt Interest.—Minimum tax gross income would include the interest on any obligations described in section 103(a) (as limited by sec. 103(b)). Thus, interest (including original issue discount) on State and municipal bonds is included in the minimum tax base.[1]

Charitable Contributions of Appreciated Property—Minimum tax gross income would also include appreciation in the value of property donated to charity. The amount so included is limited to the amount allowable as a deduction for the taxable year under the normal limitations of section 170.[2]

The appreciation on property donated to charity represents income that has accrued during the period the property was held. The transfer of the property by the taxpayer is the event which properly triggers recognition of such income as an untaxed item to be included in the minimum tax base, since at the time of transfer it becomes evident that the donor will pay no regular tax on such appreciation. Moreover, the donation to charity of such income gives rise to a charitable deduction which includes the appreciation in value.

As indicated above, the amount of appreciation to be included in the minimum tax base is limited to that for which a tax deduction is

[1] Futhermore, any tax-exempt interest that is currently being paid on U.S. bonds or on obligations of certain corporations organized under an act of Congress will be included in the minimum tax base to the extent that, to do so, would not interfere with a contractual obligation guaranteed by the Constitution.

[2] For the minimum tax treatment of those individuals who qualify for the unlimited charitable deduction, see the explanation of the proposal to repeal the unlimited charitable contribution deduction.

obtained under the normal percentage limitations of section 170. In this context, it should be noted that as part of the allocation of deductions proposal, the income base upon which the maximum charitable contribution deduction is determined would be expanded to include exempt income items (in excess of $5,000) which are taken into account under the allocation of deductions and minimum tax provisions.

When the value of the donated property plus other contributions exceeds the applicable charitable deduction limitation, only so much of the appreciation element shall be considered as an excluded item as is equal to the difference between (a) the deduction limitation, and (b) the sum of the cash and the basis of the property contributed. In other words, if a taxpayer's section 170(b) limitation is $40,000, as computed on the proposed expanded base, and he has contributed to charity cash of $10,000 and property with a tax basis of $13,000 having a fair market value of $50,000, only $17,000 would be included in the minimum tax base for the taxable year in which the contribution is made.[1] The $20,000 in excess of the deduction limit which may be carried over and deducted in a subsequent year would be included in the minimum tax base for the year to which it is carried.

Long term capital gains and losses.—The one-half of net long-term capital gains which is presently deducted under section 1202 in computing adjusted gross income may not be deducted in determining minimum tax adjusted gross income. Moreover, there would be no general alternative 25-percent tax rate under the minimum tax. The existing 25-percent alternative tax rate would, however, be retained even under the minimum tax with respect to capital gain income which, under a separate proposal, would arise as a result of the transfer of appreciated property held by the taxpayer at his death or given away during his lifetime. Thus, like the normal tax, the minimum tax may be computed either by including the entire capital gain in the minimum tax base, or by adding 25 percent of the capital gain to the tax determined on a minimum tax base which excludes the capital gains. Whichever of these is lower would then be compared with the taxpayer's normal tax, and the taxpayer would pay the larger amount.

Under the proposed minimum tax, long-term capital losses would be permitted to offset ordinary income only to the same extent as under present law, that is, up to $1,000 in any one taxable year. The alternative of allowing an unlimited deduction on the ground that long-term capital gains are fully included under the minimum tax would cause distortion in the interplay of the regular tax and the minimum tax. It would be possible for an individual to obtain a double benefit from a loss—once in the year in which incurred under the minimum tax and once in a carryover year under the regular tax. On the other hand, the separate proposal for restricting the deduction of long-term capital losses to one-half the amount of these losses would not apply under the minimum tax.

---

[1] This computation is made without regard to the 3-percent threshold for charitable deductions, which is the subject of another proposal.

Percentage depletion.—No deduction would be allowed for minimum tax purposes for any percentage depletion once the cost of the applicable property has been recouped through prior depletion deduc-
50-percent-of-taxable income limitation on the allowance of percentage depletion under existing law.
tions. This provision would apply on the basis of the same property aggregations required to be used by the taxpayer in determining the
The deductions allowed in computing the minimum tax base are generally the same as those allowed under the regular tax base, with the following modifications:

Deductions allocable to exempt interest.—Expenses disallowed as deductions under section 265 in the regular tax computation because they are related to exempt income would be allowed as deductions for minimum tax purposes, since the exempt income itself is included in the minimum tax base. For the same reason, a deduction for amortizable bond premium on bonds yielding exempt interest would be permitted for minimum tax purposes.

No allocation of deductions.—The deductions allowed in computing minimum-tax taxable income would not be subject to the proposed allocation of deductions provisions. The reason for requiring an allocation of deductions is not applicable to the minimum tax system since the exempt income items (to which the deductions would be allocated) are themselves included in the minimum tax base.

Minimum tax standard deduction.—An individual would be permitted to elect a special standard deduction in lieu of itemizing his deductions for the purpose of computing his minimum taxable income. The amount of the minimum tax standard deduction would be $10,000 for a married couple filing a joint return and for an unmarried individual, and $5,000 for a married individual filing a separate return. This relatively large minimum tax standard deduction will limit the application of the minimum tax to individuals with substantial amounts of exempt income. As in the case of the regular standard deduction, a married individual would not be permitted to elect the minimum tax standard deduction unless his spouse does likewise. Furthermore, estates and trusts and other taxpayers (except nonresident alien individuals) who are ineligible under section 142(b) to elect the standard deduction for regular tax purposes would also be ineligible to elect the minimum tax standard deduction for minimum tax purposes.

Net operating losses.—For minimum tax purposes, certain adjustments would be required in computing the amount of a net operating loss, to take account of the additional income items in minimum tax gross income and the deductions disallowed for minimum tax purposes.

Since the amount of the net operating loss for a year generated under the regular tax system may differ from that under the minimum tax, separate carryback and carryover accounts would be required. For example, if a single taxpayer has exempt interest of $25,000, nonbusiness deductions of $12,000, and a net business loss of $40,000, the computations would be as follows:

	Regular tax computation	Minimum tax computation
Exempt interest		$25,000
Less business loss	($40,000)	(40,000)
Less nonbusiness deductions	(1)	(12,000)
Net operating loss	(40,000)	(27,000)

[1] Under present law, no deduction for personal exemptions is allowed in computing a net operating loss and nonbusiness deductions are generally allowed only to the extent of nonbusiness income.

For this taxable year, the taxpayer has a minimum tax net operating loss of $27,000, and a regular tax net operating loss of $40,000, both of which may be carried backward and forward to other taxable years.

If the carryback and carryover of these losses were left to operate completely independently it would be possible that the regular tax net operating loss and the minimum tax net operating loss might be carried to different taxable years and produce a double tax benefit for the taxpayer. To prevent such a double benefit, a taxpayer choosing to use a regular tax net operating loss in a year subsequent to a year in which he used a minimum tax net operating loss arising in the same taxable year would be required to recompute his minimum tax for the earlier year without regard to the minimum tax net operating loss deduction.

Estates and trusts.—The minimum tax imposed on individuals would apply in the same manner to estates and trusts. Distributions to beneficiaries consisting of exempt income would be allowed as deductions in computing the minimum tax base, and these amounts would be included in the minimum tax base of the recipients.

Nonresident alien individuals.—The minimum tax gross income of a nonresident alien individual would include only his minimum tax gross income which is effectively connected with the conduct of a trade or business within the United States. Thus, the minimum tax would not be imposed on the investment income of nonresident alien individuals, which is generally taxed at a flat 30-percent rate or pursuant to treaty provisions.

Under the regular tax, deductions are allowable to a nonresident alien only against income effectively connected with a U.S. trade or business and then only if the deduction (except the personal exemption, the charitable contribution deduction, and the deduction for certain losses) is effectively connected with such income. This concept would be carried over to the minimum tax. As a corollary, since the charitable contribution deduction would be allowable whether or not connected with income which is effectively connected with a trade or business within the United States, any appreciation in property included in that deduction would be included in the minimum tax base as though it were effectively connected with such trade or business.

Nonresident alien individuals would be eligible for the special $10,000 minimum tax standard deduction, although they are ineligible to claim the regular tax standard deduction. Thus, as is the case with other taxpayers, nonresident alien individuals without substantial amounts of exempt income would not be affected by the minimum tax.

MINIMUM TAX RATES

In general, the minimum tax rates have been established to effect a tax that is approximately equal to that imposed by the regular tax rates on one-half as much income. The following rate schedule would apply to single individuals:

If the minimum tax taxable income is:	The minimum tax is:
Not over $1,000	7% of the minimum tax taxable income.
Over $1,000 but not over $2,000	$70, plus 7% of excess over $1,000.
Over $2,000 but not over $3,000	$140, plus 8% of excess over $2,000.
Over $3,000 but not over $4,000	$220, plus 9% of excess over $3,000.
Over $4,000 but not over $8,000	$310, plus 10% of excess over $4,000.
Over $8,000 but not over $12,000	$710, plus 11% of excess over $8,000.
Over $12,000 but not over $16,000	$1,150, plus 12% of excess over $12,000.
Over $16,000 but not over $20,000	$1,630, plus 14% of excess over $16,000.
Over $20,000 but not over $24,000	$2,190, plus 16% of excess over $20,000.
Over $24,000 but not over $28,000	$2,830, plus 18% of excess over $24,000.
Over $28,000 but not over $32,000	$3,550, plus 20% of excess over $28,000.
Over $32,000 but not over $36,000	$4,350, plus 21% of excess over $32,000.
Over $36,000 but not over $40,000	$5,190, plus 22% of excess over $36,000.
Over $40,000 but not over $44,000	$6,070, plus 24% of excess over $40,000.
Over $44,000 but not over $52,000	$7,030, plus 25% of excess over $44,000.
Over $52,000 but not over $64,000	$9,030, plus 26% of excess over $52,000.
Over $64,000 but not over $76,000	$12,150, plus 28% of excess over $64,000.
Over $76,000 but not over $88,000	$15,510, plus 29% of excess over $76,000.
Over $88,000 but not over $100,000	$18,990, plus 30% of excess over $88,000.
Over $100,000 but not over $120,000	$22,590, plus 31% of excess over $100,000.
Over $120,000 but not over $140,000	$28,790, plus 32% of excess over $120,000.
Over $140,000 but not over $160,000	$35,190, plus 33% of excess over $140,000.
Over $160,000 but not over $180,000	$41,790, plus 34% of excess over $160,000.
Over $180,000 but not over $200,000	$48,590, plus 34% of excess over $180,000.
Over $200,000	$55,390, plus 35% of excess over $200,000.

Income splitting and head of household benefits are applicable to the minimum tax in generally the same manner as under chapter 1. Thus, a married couple filing a joint return (or a surviving spouse) may apply the income-splitting provisions in computing their minimum tax. For heads of household, a special rate table would apply which places their minimum tax about halfway between that of married couples and that of single individuals with the same income.

As indicated above, capital gain income arising from the appreciation in property held at death or given away by gift would be taxed at a maximum rate of 25 percent.

CREDITS AGAINST MINIMUM TAX

The determination of whether the minimum tax or the regular tax is the greater and which therefore is to be paid would be made before the allowance of credits against tax. The same type of credits would be allowed against the minimum tax as are allowed against the regular tax,[1] and, in most cases these credits will be identical in amount. However, where the minimum tax is applicable, the amount of the limitation upon the investment credit and the foreign tax credit would be increased.

Foreign tax credit.—In a year in which the minimum tax applied, the applicable limitation imposed by section 904(a) upon the foreign tax credit would be increased. The amount by which the limitation would be increased would be (1) the amount by which the minimum tax exceeds the regular tax, multiplied by (2) the ratio of the taxpayer's exempt income which is from sources without the United States to his total exempt income. An individual would be required to use the same limitation (i.e., either the overall limitation or the per country limitation) for both regular tax purposes and minimum tax purposes.

Investment credit.—The limitations on the credit allowed under section 38 would, in a year in which the minimum tax is applicable, be applied to the minimum tax liability rather than the regular tax liability. Thus, the amount of the investment credit for such a year could not exceed $25,000, plus 50 percent of any minimum tax liability in excess of $25,000.

EFFECTIVE DATE

The minimum tax would be applicable to taxable years beginning after December 31, 1969.

V-C. ALLOCATION OF DEDUCTIONS

GENERAL EXPLANATION

BACKGROUND

Under present law an individual can receive two kinds of income: income which is subject to tax such as salary and business income, and income which is exempt from tax, such as interest received from State and municipal bonds and one-half of long-term capital gains. The law also allows an individual to reduce the amount of his income which is subject to tax by deductions for various personal expenses, even though it is fair to assume that a part of such expenses is paid out of the tax-exempt income. In this situation, the present tax structure enables the taxpayer to receive a double benefit from his tax-exempt income: Such income is not included on his tax return because of its tax-exempt status, *and* he is permitted to reduce his other income which is subject to tax by the *full amount* of his deductible expenses. These expenses, however, are not directly associated with the taxable income

---

[1] The retirement income credit would be repealed (and, thus, not applicable under either the regular tax or the minimum tax) under a separate proposal.

in the sense of contributing to its being earned, and thus are as allocable to tax-exempt income as they are to the taxable income.

An example will clearly illustrate this unwarranted result: Assume an individual receives total cash income of $50,000, which includes a salary of $20,000 and a long-term capital gain of $30,000. He makes charitable contributions of $9,000 in the taxable year. His income subject to tax is $35,000 ($20,000 of salary, plus $15,000 representing the taxable one-half of capital gains), and his tax exempt income is $15,000 (the other one-half of his capital gains). It is only reasonable to assume that the charitable contribution could have been made out of either salary or the taxable portion of the capital gain income, or the exempt portion of the capital gain income, and for that reason should be divided proportionately between them. Present law does not reach this result, however. Instead, the entire $9,000 of charitable expenses is offset only against income subject to tax. In other words, one-half of capital gains is not taxed, and at the same time the share of the expenses that is proportionate to that exempt income is used to reduce taxable income, so that tax is paid on only $26,000.

This misallocation aspect of personal expense deductions (if a taxpayer has excluded income) exists at all income levels and among high and low effective tax rate people. But the misallocation problem is most serious among certain high-income, low effective tax rate people. The magnitude of the interrelationship between the deduction of personal expenses and excluded income is brought out sharply in a study of high-income returns in 1964 with low effective tax rates.

Table 1 broadly indicates that personal deductions account for 28 percent of amended adjusted gross income[1] on 1964 returns with adjusted gross income over $200,000 and effective tax rates of 22 percent or less. But out of total amended adjusted gross income ($658 million) for these returns, almost 40 percent of such income (or $256 million[2]) was protected from tax because it was covered by net farm losses[3] or excess percentage depletion, or represented the excluded one-half of capital gains.

The personal deductions were used entirely against the taxable 60 percent of amended AGI.

TABLE 1.—*Characteristics of the estimated 1,100 tax returns in 1964 with AGI over $200,000 and effective tax rates[1] of 22 percent or less[2]*

[Amount in millions]

Amended adjusted gross income[3]		$658
Including dividends		134
Including wages and salaries		50
Less ½ of capital gains excluded from AGI	182	
Excess percentage depletion[4]	59	
Net farm losses over gains	15	
		−256
Adjusted gross income (income subject to tax before deductions)		402
Less ½ of capital gains included in AGI (taxed at 50 percent rate)		−182
Ordinary income		220
Less contribution deduction[5]	73	
Other deductions	111	
Plus unused deductions	8	
		−192

See footnotes at end of table.

[1] Amended adjusted gross income is adjusted gross income plus excluded income.
[2] Includes $182 million of capital gains, $59 million of excess percentage depletion, and $15 million of net farm losses.
[3] These farm losses are the subject of another proposal in the reform package.

TABLE 1.—*Characteristics of the estimated 1,100 tax returns in 1964 with AGI over $200,000 and effective tax rates[1] of 22 percent or less[2]*—Continued

Taxable ordinary income	$28
Plus taxable capital gains (taxed at 50 percent rate)	+182
Total taxable income	210
Tax before credits	102
Less credits	−4
Tax after credits	98
Effective rate on amended AGI (percent)	15
Effective rate on AGI (percent)	21

[1] The effective rate used for selection was the tax over amended AGI.
[2] Based on a 1 in 15 sample.
[3] Amended gross income is AGI plus the excluded part of net long-term capital gains, the exclusion due to excess percentage depletion, and for the group as a whole the excess of farm losses over farm gains.
[4] Although the figure shown in the table is total depletion claimed, it approximates the amount of excess percentage depletion since nearly all claimed depletion is in excess of the recovery of basis.
[5] The sampling process involves a fairly large sampling error on items that are a small portion of the universe. It is clear that this contribution deduction is low because the sample included only 3 unlimited contribution cases while the expected number in a 1 in 15 sample should have been 6.

Thus, 40 percent of total income—$258 million—was taxed at a zero rate (income covered by net farm losses, excess percentage depletion, and personal deductions), and most of the remainder of total income representing capital gains—$364 million—was taxed at the preferential 25 percent rate. This use of *all personal deductions as an offset against ordinary income* explains why the effective tax rate on these returns was 15 percent (based on amended AGI) or 21 percent (based on AGI).

Cases 1, 2, and 3 are all actual taxpayers with large amounts of exempt income plus large itemized deductions. In each case they are able to take advantage of using deductions against the included part of their income so as to reduce their effective tax rate on income subject to tax (AGI). This double benefit is carried to an extreme in Case 3 where about 90 percent of the taxpayer's income came from capital gain, and his total personal deductions were about one-half of the income. He virtually wiped out his tax, reducing it to three one-hundredths of 1 percent of total income. In Case 3 the deductions were primarily interest deductions which were the cost of carrying assets on which capital gains were realized. Even though he is allowed to exclude half of his capital gains, he is also allowed to use the interest deduction to wipe out the included half of capital gains and other ordinary income.

CASE 1.—*Taxpayer with income over $5,000,000 and over $4,000,000 in capital gains with large itemized deductions*

Adjusted gross income	$3,281,693
Amended adjusted gross income[1]	5,335,968
Wages and salaries	21,418
Dividends	224,597
Interest	27,782
Capital gains (100 percent)	4,108,551
Other income (net)	953,621
Total deductions	1,193,872
Contributions	748,177
Interest	52,605
Taxes	276,287
Medical	5,346
Other	111,457

CASE 1.—*Taxpayer with income over $5,000,000 and over, $4,000,000 in capital gains with large itemized deductions*—Continued

Taxable income	$2,085,421
Tax after credits	1,031,218
Tax as a percent of amended adjusted gross income	19.3
Income level at which a single individual pays 19.3 percent of his income in tax	12,600

[1] Adjusted gross income plus excluded net long-term capital gains.

CASE 2.—*Taxpayer with high capital gains and large itemized deductions*

Adjusted gross income	$650,873
Amended adjusted gross income [1]	935,781
Wages and salaries	17,708
Dividends	258,089
Interest	69,394
Capital gains (100 percent)	561,995
Other income (net)	28,595
Total deductions	396,108
Contributions	120,330
Interest	247,809
Taxes	14,629
Medical	0
Other	13,340
Taxable income	261,365
Tax after credits	137,854
Tax as a percent of amended adjusted gross income	14.7
Income level at which a single individual pays 14.7 percent of his income in tax	$6,300

[1] Adjusted gross income plus the excluded part of net long-term capital gains and losses.

CASE 3.—*Taxpayer with high capital gains and large itemized deductions*

Adjusted gross income	$679,405
Amended adjusted gross income [1]	1,284,718
Wages and salaries	20,000
Dividends	76,368
Interest	207
Capital gains (100 percent)	1,210,426
Other income (net) [2]	22,283
Total deductions	676,419
Contributions	463
Interest	587,693
Taxes	85,401
Medical	2,500
Other	362
Taxable income	2,386
Tax after credits	383
Tax as a percent of amended adjusted gross income	.03
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus excluded net long-term capital gains.
[2] Rental loss.

THE PROPOSAL

To eliminate this double benefit, an individual would be required to divide his nonbusiness deductible expenses between his taxable income and the more common sources of exempt income. The portion allocable to the exempt income would not be allowed as a tax deduction.

The deductions which would be affected.—The nonbusiness expense deductions which would be allocated under the proposal are: interest and tax payments, casualty losses (since replacement cost is considered the expense), charitable contributions (within the normal percentage limitations), medical expenses, and cooperative housing expenses. In each of these cases, it is reasonable to assume that a portion of such expenses is met out of tax-exempt income and, therefore, such portion should not be deductible in computing taxable income. On the other hand, business expenses will not be subject to allocation, and therefore will be allowed in full since they normally are related to fully taxable income. Likewise, alimony and child care deductions will be allowed in full, since alimony is fully taxable to the wife and payments for child care are made so that the parent can work and earn salary which is taxed.

Tax-exempt income which would cause expenses to be allocated.—The proposal requires that the taxpayer allocate his nonbusiness deductions between taxable income and the following four items of tax-exempt income which represent the principal sources of the double benefit described above:

(1) Tax-exempt interest on State and local bonds;

(2) The one-half of net long-term capital gains that may be deducted in arriving at taxable income;

(3) The amount of percentage depletion claimed after the cost of the property has been recovered; and

(4) The amount of unrealized—and thus untaxed—appreciation on property contributed to charity to the extent taken as a deduction under the normal limitations. This untaxed appreciation is an appropriate item of exempt income since it represents an amount of untaxed income which has been donated to charity and deducted against taxable income. In conjunction with this proposal, the base against which the percentage limitations on this deduction are applied would be expanded to include the exempt income items to which deductions are to be allocated.

Exception.—The allocation requirement would apply to an individual only if his exempt income exceeds $5,000. This $5,000 exclusion will confine the application of the allocation proposal to those cases in which the present abuse is substantial, and, by so doing, will limit the application of this provision to less than 5 percent of those taxpayers having some exempt income.

The allocation formula.—A simple percentage formula will be applied for computing the portion of the deductions to be allowed. To compute allowable deductions, the individual will multiply the entire amount of allocable deductions by a fraction, the numerator of which is adjusted gross income (that is, income subject to tax minus business deductions, which do not have to be allocated) and the denominator of which is the same adjusted gross income plus the amount of tax-exempt income above $5,000.

Example.—The allocation computation can be illustrated by returning to the previous example in which the taxpayer had a salary of $20,000, long-term capital gain of $30,000, and made a charitable contribution of $9,000. Of this taxpayer's $9,000 of charitable contributions, he will be allowed to deduct $7,000, computed as follows:

$9,000 (deductions subject to allocation) × [$35,000 (income subject to tax: $20,000 net salary, plus the $15,000 taxable half of capital gains) / $45,000 (numerator plus $10,000, which is the exempt half of capital gains less the $5,000 basic exclusion)] = $7,000

Corporations not affected.—The proposal would not apply to corporations. The corporations whose income would include the four tax-exempt items to any significant degree are found mainly in only a few industries. Since the impact would be so selective, the question of whether the tax structure for these specific industries should be altered requires an analysis of their particular economic and competitive positions. On the other hand, with respect to individuals the impact is much more general and relates directly to the basic structure of the progressive individual income tax.

EFFECT OF THE PROPOSAL

Table 2 indicates that the allocation proposal would affect approximately 400,000 taxpayers. It can be seen that allocation would be an infrequent event for returns with less than $50,000 of AGI. On returns over $100,000 AGI, allocation would affect more than two-thirds of the returns, with the percentage reaching 90 percent for returns with AGI of over $1 million.

Allocation would make taxable a substantial number of high-income returns that are now nontaxable because of the double benefit related to personal deductions and excluded income. Allocation in the lower AGI brackets would only arise if excludable income is a substantial portion of total income (because of the $5,000 exemption in the proposal).

The revenue gain from the proposal would be $405 million. The income distribution of the tax increase is shown in table 2.

TABLE 2.—EFFECT OF ALLOCATION OF DEDUCTIONS AFTER STANDARD DEDUCTION CHANGES AND DISALLOWANCES, 1969 LEVELS

AGI (in thousands of dollars)	Total tax increase (in millions of dollars)	Percentage tax increase[1]	Average tax increase[2]	Returns with a tax increase: Number of returns (in thousands)	Returns with a tax increase: Percent of all returns	Number of nontaxable made taxable	Percent of nontaxable made taxable	Tax increase for nontaxable made taxable: Total (in thousands of dollars)	Tax increase for nontaxable made taxable: Average
0 to 10	$2	(3)	$136	18	(3)	4,500	(3)	$1,500	$330
10 to 15	3	(3)	116	30	(3)	850	3	170	200
15 to 20	5	0.1	143	35	1.0	1,600	25	675	430
20 to 50	50	.4	358	140	6.0	750	17	300	400
50 to 100	90	1.4	750	120	36.0	250	33	650	2,600
100 to 500	160	3.3	3,075	52	70.0	100	35	1,590	15,900
500 to 1,000	35	5.3	17,500	2	85.0	11	42	617	57,100
1,000 and over	60	6.5	64,400	1	90.0	13	45	6,125	471,100
Total	405	0.5	1,025	395	0.5	8,074	(3)	11,625	1,440

[1] Percent of tax liability after standard deduction changes and disallowances.
[2] For those with an increase.
[3] Less than ½ of 1 percent.

Note: Details may not add to totals because of rounding. Averages computed from unrounded data.

V-C. ALLOCATION OF DEDUCTIONS

TECHNICAL EXPLANATION

DETAILED DESCRIPTION OF THE PROPOSAL

General calculation rule.—Under the proposal, an individual will be subject to allocation if two conditions obtain: First, if he has the type of deductions subject to allocation (i.e., "allocable expenses"); and second, if he has exempt income items in excess of $5,000 (i.e., "excluded items").

When these two conditions are met, the total amount allowable as a deduction with respect to the allocable expenses is a figure which is obtained by use of the following formula:

$$\frac{\text{A.G.I. (as modified)}}{\text{A.G.I. (as modified) plus Excluded Items minus \$5,000}} \times \text{Total Allocable Expenses} = \text{Allocable Expenses Allowable as Deductions.}$$

For the purpose of the allocation formula, the definition of adjusted gross income would be modified so that adjusted gross income would be reduced (but not below zero) by the itemized deductions which are not subject to allocation (e.g., trade or business expenses, child care expenses, alimony, etc.). This aspect of the proposal is explained in more detail later in this memorandum.

As a result of the allocation formula, some taxpayers having otherwise allowable deductions in excess of their standard deduction may find that the amount allowable is now less than the standard deduction. In such case, the standard deduction would be available to the taxpayer in full.

Definition of "allocable expenses."—The deductible expenses which are subject to allocation under the proposal (called allocable expenses) are:

(1) *Interest payments deductible under section 163.*—Although it may be possible to trace the proceeds of a loan to the purchase of particular investment property and, thus, relate the interest expense to a particular item of income, the general allocation formula would nevertheless apply, as it is generally a completely arbitrary decision as to which expenses or purchases are to be paid from borrowed funds and which with funds on hand. Accordingly, the present rule of section 265 which completely disallows any interest deduction for indebtedness used to purchase or carry wholly tax-exempt obligations will no longer apply; instead such interest deduction will be treated under the general allocation formula.[1]

(2) *Taxpayments deductible under section 164.*—The allocation provision would apply to a particular taxpayment even though it may technically be related to a specific item of taxable income. This rule is

---

[1] There is, however, an exception to the general rule that the entire deduction for interest expense is subject to allocation rather than complete disallowance. Under the proposal sec. 265(2) would be amended to disallow completely interest expense directly traceable to the first $5,000 of exempt interest income. This rule adopts the theory that the $5,000 exempted from "excluded items" consists first of exempt interest income and that a person with less than $5,000 of exempt interest income who is entitled to no deduction under present law because of sec. 265(2) should be in no better position under the allocation of deductions proposal. If exempt interest income is more than $5,000, the proportionate amount of interest expense traceable to such excess will be placed into the general allocation pool.

provided because of the difficulty and complexity of applying a direct tracing rule and because of the uneven results that would otherwise occur depending on each State's taxing pattern.

(3) *Personal theft and casualty losses deductible under section 165(c)(3).*—While a casualty loss does not represent an out-of-pocket expense, its deduction is grounded on the theory that the taxpayer must use his income to replace the property. Thus, to the extent that exempt funds are available for this purpose, it is logical to apply the allocation provision. Only casualty and theft losses under section 165(c)(3) are subject to allocation. The allocation proposal does not cover losses incurred in a trade or business deductible under section 165 (c)(1) since such losses are related to fully taxable income; nor does it cover losses deductible under section 165(c)(2) (relating to losses incurred in a transaction entered into for profit, though not connected with a trade or business) since such losses will, for the most part, merely offset capital gains, except for the limited deduction of $1,000 against ordinary income.

(4) *Charitable contributions deductible under section 170.*—The amount of charitable contributions subject to allocation would be limited to that amount which is deductible under the normal limits of section 170. The treatment of the additional deductions allowed under the unlimited charitable contribution provision is the subject of a separate proposal.

In order to prevent the distortion which would result from measuring the percentage limitation for the maximum charitable contribution deduction by reference to adjusted gross income while at the same time disallowing part of that deduction on the basis of excluded items which are not part of adjusted gross income, it is proposed to expand the income base against which the maximum percentage limitation is applied to include the excluded income items used in the allocation formula to the extent they exceed $5,000. The exclusion of $5,000 from the limitation base is consistent with the fact that there is no allocation against the first $5,000 of exempt income. Thus, if an individual's income consists of $100,000 salary and $60,000 of long-term capital gain, his maximum charitable contribution deduction would be computed by applying the appropriate percentage to $155,000 (instead of $130,000 as under present law). However, his actual contribution would be subject to the allocation provision, as a part of it is related to the excluded $30,000 of capital gain income.

Any carryover resulting from a charitable contribution in excess of the percentage limitation applied to the expanded income base will be subject to allocation in the year to which it is carried as though it were made in that year.

(5) *Net operating loss deductible under section 172.*—A net operating loss carryover or carryback to a particular year is not generally subject to the allocation rules, since the loss usually represents a business loss. However, one personal item—theft and casualty losses—may create or add to a net operating loss. This part of the loss would be subject to allocation as is the basic casualty loss deduction itself.[2]

---

[2] Where the casualty loss exceeds total income, the amount disallowed would be limited to the amount of exempt income. Otherwise it would be possible for more of the losses to be disallowed than there is exempt income.

(6) *Medical, dental, etc. expenses deductible under section 213.*

(7) *Cooperative housing expenses deductible under section 216.*—Section 216 allows a stockholder-tenant a deduction for his allocable share of expenses incurred by the cooperative housing corporation for real estate taxes and interest which would otherwise be deducted by the corporation itself. Allocation of this deduction is consistent with the fact that the underlying items—taxes and interest—are subject to allocation when paid directly by a homeowner.

On the other hand, trade or business expenses are not required to be allocated. Thus, for example, taxes or interest which are attributable to a trade or business expense would not be subject to allocation, whereas taxes or interest which are attributable to a personal or investment expense would be subject to allocation.[3]

Definition of "excluded items."—The items of exempt income (called excluded items) which are to be taken into account are:

(1) *Tax-exempt interest.*—Interest (including original issue discount) received from any obligations described in section 103(a) (as limited by sec. 103(b)) is considered to be an excluded item under the proposal. Thus, allocable deductions will be disallowed to the extent that they are proportionately allocable to the interest on State and municipal bonds.[4] When tax-exempt bonds sell at a premium, the net yield realized on them may be subtsantially less than the stated interest. Hence, it is appropriate to reduce such exempt interest by a proportionate amount of the bond premium in determining the amount of excluded items.

(2) *Depletion.*—Once the tax basis of mineral property has been recouped, the proposal treats all percentage depletion claimed as a deduction as an excluded item.

(3) *Long term capital gains.*—The one-half of net long term capital gains deductible under section 1202 is considered an excluded item.

Two special rules are provided to prevent distortions that might otherwise occur in the interoperation of this proposal and the proposal to tax appreciation on property transferred during life by gift or at death. First, no amount need be taken into account as an excluded item with respect to capital gain income arising on account of the gift of appreciated property. Second, no allocation will be required for the taxable year ending with the death of the taxpayer. The capital gain income arising as a result of a gift or on death will generally have no relation to the taxpayer's normal spending level. Moreover, the expenses just prior to death may be abnormal in relation to that year's income.

(4) *Charitable contributions of appreciated property.*—Another of the excluded items of income against which the deductions described above must be allocated is the appreciation in the value of property donated to charity for which a tax deduction is taken. The untaxed appreciation represents income that has accrued during the period the property was held; and the transfer of the property by the tax-

---

[3] In addition, the deductions for child care under sec. 214 and alimony under sec. 215 are not subject to allocation under the proposal. Child care expenses are nonallocable because they are in essence an expense of earning taxable salary; deductible alimony represents, in effect, an assignment of income which is fully taxable to the wife.

[4] Furthermore, any tax-exempt interest that is currently being paid on U.S. bonds or on obligations of certain corporations organized under an act of Congress will be included as an "excluded item" to the extent that to do so would not interfere with a contractual obligation guaranteed by the Constitution.

payer is the event which properly triggers recognition of such income as an untaxed, excluded item against which deductions should be allocated, since at the time of transfer it becomes evident that the donor will pay no tax on such appreciation. Moreover, the donation to charity of such income gives rise to the charitable deduction.

The amount of appreciation to be included as an "excluded item" is limited to that for which a tax deduction is obtained under the normal percentage limitations of section 170.[5] When the value of the donated property plus other contributions exceeds the applicable deduction ceiling, only so much of the appreciation element shall be considered as an excluded item as is equal to the difference between (*a*) the deduction limitation, and (*b*) the sum of the cash and the basis of the property contributed. In other words, if a taxpayer's section 170(b) limitation is $40,000, as computed on the proposed expanded base, and he has contributed to charity cash of $10,000 and property with a tax basis of $13,000 having a fair market value of $50,000, only $17,000 would be considered an excluded item in the taxable year in which the contribution is made.[6] The $20,000 in excess of the deduction limit which may be carried over and deducted in a subsequent year would be treated as an excluded item in the year to which it is carried.

Modified definition of adjusted gross income.—The formula for establishing the ratio of expenses to be disallowed uses the concept of "modified adjusted gross income." That is, the amount of allocable expenses allowable as a deduction is that amount which bears the same ratio to the total allocable expenses, as modified adjusted gross income bears to modified adjusted gross income plus excluded items. "Modified adjusted gross income" is gross income less all allowable deductions other than those subject to allocation (e.g., less all trade or business expenses, alimony, child care, and those section 212 expenses allowable under section 265). In other words, only that amount of taxable income in excess of those deductions fully allowable against that income is taken into account in the allocation formula.

Effect of allocation on net operating losses.—Adjustments must be made in computing a net operating loss in light of the effects of allocation on the basic deductions which give rise to the net operating loss. Special rules are provided for such adjustments.

Treatment of investment expenses.—Under present law, investment expenses are fully deductible except to the extent allocable to wholly exempt income, as provided in section 265(1). Under this proposal, the category of exempt income against which investment expenses would be proportionally disallowed would be expanded to include the four items of tax-exempt income which constitute the "excluded items" for purposes of the general allocation provisions. Thus, the deduction for investment expenses would be allowed to the extent it is related to taxable investment income and disallowed to the extent related to exempt investment income. The effect of this treatment is that investment expenses are allocable only in relation to the income to which they give rise and not in relation to other types of income. This reflects the fact that investment expenses are deductible because they result from producing investment income; whereas the medical

[5] The treatment of the additional deductions allowed under the unlimited charitable contribution provision is the subject of a separate proposal.

[6] This computation is made without regard to the 3-percent floor on charitable deductions, which is the subject of another proposal.

expense deduction, for example, is granted because of the nature of the expense.

If an investment expense is disallowed under section 265, an adjustment would be made in computing "modified adjusted gross income" and the "excluded items" for purposes of allocating the other deductions under the general allocation provisions. Such an adjustment is necessary because once income has been used to offset a particular investment expense item, the same income should not again be applied for the purpose of allocating other deductions as well. Accordingly, taxable investment income is included in modified adjusted gross income only to the extent that it exceeds investment expenses which are allowable as deductions under section 212 and section 265; and exempt investment income is considered an excluded item only to the extent that it exceeds investment expenses which are disallowed by section 265.

Adaptation to the return form.—The handling of the proposal on the return form would not be a difficult matter. The application of the allocation provision would proceed as follows:

1. Total the excluded items. If not in excess of $5,000, nothing more need be done. If the total is more than $5,000, the total should be reduced by $5,000.
2. Compute the amount of allocable expenses.
3. Compute modified adjusted gross income. It is adjusted gross income less all deductions other than personal exemptions and allocable expenses. This is the numerator of the *allowance* formula. (Net investment income, i.e., taxable investment income reduced by deductible investment expenses, is included.)
4. Total the amount of modified adjusted gross income and the amount of excluded items. This is the denominator of the allowance formula. (The net amount of tax-exempt investment income, i.e., tax-exempt investment income reduced by the amount of section 212 expenses which have been disallowed by section 265(1), is included.)
5. The resulting percentage (i.e., item 3 over item 4) is applied to the total of allocable expenses.
6. The resulting figure is the amount of allocable expenses allowable as a deduction to reach taxable income.

Effective date.—The proposal would become effective with respect to taxable years beginning in 1970.

V-D. CORRECTION OF ABUSES OF FARM TAX RULES BY NONFARMERS

General Explanation

BACKGROUND

Methods of Accounting.—There are two principal methods of accounting used in reporting business income for tax purposes. In general, those businesses which do not involve the production or sale of merchandise may use the cash method. Under it, income is reported when received in cash or its equivalent, and expenses are deducted when paid in cash or its equivalent.

On the other hand, in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only if the costs of the merchandise are deducted in the accounting period in which the income from its sale is realized. This is accomplished by recording costs when incurred and sales when made, and including in inventory those costs attributable to unsold goods on hand at year's end. Deduction of the costs included in inventory must be deferred until the goods to which they relate are sold, and deduction is not permitted when the costs are incurred. Thus, under this method of accounting, income from sales of inventory and the costs of producing or purchasing such inventory are matched in the same accounting period, thereby properly reflecting income.

Farmers, however, have been excepted from these general rules. Even in those cases where inventories are a material factor, they have historically been permitted to use the cash accounting method and ignore their yearend inventories of crops, cattle, et cetera. This results in an inaccurate reflection of annual income in situations when expenditures are fully deducted in the year incurred, but the assets produced by those expenditures (inventories) are not sold, and the income not reported, until a later year.

Capitalization of Costs.—Farmers are also permitted another liberal tax accounting rule. In most businesses, the cost of constructing an asset (including maintenance of the asset prior to its being used in the business) is a capital expenditure which may not be deducted as incurred but may be recovered only by depreciation over the useful life of the asset. In this manner, the cost of the asset is matched with the income earned by the asset. Farmers, however, have been permitted to deduct some admittedly capital costs as they are incurred. For example, a citrus grove may not bear a commercial crop until 6 or 7 years after it has been planted. Yet, the farmer may elect to deduct as incurred all costs of raising the grove to a producing state even though such expenditures are capital in nature. Similarly, the capital nature of expenditures associated with the raising of livestock held for breeding may be ignored, and the expenditures may be deducted currently.

The Problem.—These liberal deviations from good accounting practices were permitted for farm operations in order to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting.

However, some high-bracket taxpayers whose primary economic activity is other than farming, carry on limited farming activities such as citrus farming or cattle raising. By electing the special farm accounting rules which allow premature deductions, many of these high-bracket taxpayers show farm losses which are not true economic losses. These "tax losses" are then deducted from their high bracket nonfarm income, resulting in large tax savings. Moreover, these "tax losses" which arise from deductions taken because of capital costs or inventory costs usually thus represent an investment in farm assets rather than funds actually lost. This investment quite often will ultimately be sold and taxed only at low capital gains rates. Thus, deductions are set off against ordinary income while the sale price of the resulting assets represents capital gain. The gain is usually the entire sales price since the full cost of creating the asset has previously been deducted against ordinary income.

The existing "hobby loss" provision of the Internal Revenue Code is ineffectual in dealing with this problem. While that provision disallows deductions for continuing heavy losses in a trade or business over a period of at least 5 consecutive years, the fact of a loss and its extent are measured by comparing the expenses of the business with the total income from the business including the full amount of capital gain income although only one-half of that income is subject to tax. Thus, to escape the hobby loss provision, it is merely necessary that the taxpayer realize capital gain farm income at least once every 5 years. If the capital gain income just equals the farm expenses for a year, the hobby loss provision is inapplicable for 5 years even though the taxpayer will show a tax loss for that year equal to one-half his farm expenses.

Examples.—Under the present rules, if the taxpayer has chosen not to capitalize raising costs and also does not use an inventory method of accounting, he may deduct as incurred all the expenses of raising a breeding herd. These include costs of feed and other expenses attributable to the growth of the herd. During the development of the herd, there is relatively little income realized to offset these expenses with the result that "tax losses" are created which may be used to offset the taxpayer's nonfarm income. When the herd has reached its optimum size, a taxpayer seeking the maximum tax savings will sell the entire herd. If he does, he may report the entire proceeds of the sale as capital gain.

The dollars and cents value of this tax treatment can readily be seen through a simple example. Assume that the expenses of raising the herd are $200,000. If the taxpayer is in the top 70-percent tax bracket, the current deduction of these expenses will produce a tax savings of $140,000. On the sale of the herd, however, the entire sales price, including the $200,000 representing the recovery of these expenses, will be taxable only at the 25-percent capital gains rate. The capital gains tax on $200,000 is $50,000; or less than one-half the tax savings realized in the earlier years. Thus, the taxpayer in this situation would realize a $90,000 tax profit from a transaction which economically is merely a breakeven.[1]

In the typical situation, the taxpayer will then begin the entire cycle again by starting a new breeding herd which produces more "losses" and which is later sold at capital gains rates.

Similar advantages are available to one who develops citrus groves, fruit orchards, vineyards, and similar ventures. These assets require several years to mature; however, the development costs, such as the costs of water, fertilizer, cultivation, pruning, and spraying may be deducted as incurred and before the venture produces any income. When the operation has reached the stage where it is ready to begin producing on a profitable basis, the orchard, grove, or vineyard is frequently sold in a transaction which qualifies for the lower capital gains tax rates. Meanwhile, the expenses incurred in the years prior to the sale have been used to create "tax losses" which have been offset against high-bracket ordinary income from other occupations.

Effect of tax benefits on farm economy.—When a taxpayer purchases and operates a farm for its tax benefits, the transaction leads to a distortion of the farm economy. The tax benefits allow an individual to operate a farm at an economic breakeven or even a loss and

---

[1] This computation does not take account of the temporary surcharge.

still realize an overall profit. For example, for a top-bracket taxpayer, where a deduction is associated with eventual capital gains income, each $1 of deduction means an immediate tax savings of 70 cents to be offset in the future by only 25 cents of tax. This cannot help but result in a distortion of the farm economy, and is harmful to the ordinary farmer who depends on his farm to produce the income needed to support him and his family.

This distortion may be evidenced in various ways: For one, the attractive farm tax benefits available to wealthy persons have caused them to bid up the price of farmland beyond that which would prevail in a normal farm economy. Furthermore, because of the present tax rules, the ordinary farmer must compete in the marketplace with these wealthy farmowners who may consider a farm profit—in the economic sense— unnecessary for their purposes.

Statistical evidence of the problem.—In addition to expecting that high-income taxpayers would be drawn to farm "tax loss" situations, there is considerable evidence showing that they have in fact gone into farm investment to enjoy deductions on dollars that are really spent to acquire capital assets.

One piece of evidence is a growing body of investment advisers who advertise that they will arrange just this sort of deal.

Another piece of evidence is provided by an impressive body of statistics showing an amazing predominance of farm losses over farm gains among high-bracket taxpayers.

The second category of data supports the contention that this trend toward losses in the higher brackets is peculiar to the farm industry. Table 1 compares, at various adjusted gross income levels, the profit and loss experience shown on tax returns with income from individually owned businesses or professions (other than farms) with the experience shown on returns with income from individually owned farms.

In contrast to farms, the experience in nonfarm businesses shows that net profits outweigh net losses through all income levels up to $1 million.[2]

Among the returns showing farm income, however, the pattern is dramatically different. The indication is that as people have more adjusted gross income they have a remarkable propensity to run their farm operations at a loss. In the aggregate, returns with AGI from $50,000 to $100,000 showed farm profits of $68 million and farm losses of $67 million, virtually a breakeven. Nonfarm business returns in this income bracket showed business profit of $1,559 million compared to business losses of $42 million; a ratio of about 37 to 1 in favor of profits.

In the adjusted gross income class from $100,000 to $1 million, the same pattern appears but in more striking fashion. Returns with incomes from nonfarm businesses showed net profits of over $300 million and net losses of only about $60 million; a ratio of profits to losses of about 5 to 1. The result on returns with farm incomes is just the opposite; losses exceed profits by almost 3 to 1.

It is hard to believe that people in these high-income brackets persistently go into farm businesses and lose money due to mismanage-

---

[2] A small net loss is shown on the returns over $1 million. In the nonfarm business area the excess business losses do tend to occur in particular industry groups, including mining, real estate, and entertainment.

ment or due to bad investment decisions. When one observes the extensive literature which explains how wealthy people can save after-tax dollars through showing "tax losses" on farm operations which involve actual net investment in the farm, it is obvious that this propensity to show farm losses among high-income returns is evidence of extensive use of a tax abuse.

This implication of a tax abuse is reinforced by table 2, which compares a sample of field crop farms and livestock farms on the basis of the frequency of large losses (i.e., over $25,000). In the aggregate, farms on which livestock is the primary product outnumber farms on which field crops are primary in the ratio of about 3 to 2. However, livestock farms are six times more likely to show large losses than field crop farms. The literature on how to save taxes on nonfarm income through farm losses heavily emphasizes livestock farming.

Table 3 classifies returns showing farm income by their nonfarm adjusted gross income. This classification tends to put full-time farmers, that is, farmers without much nonfarm income, into the low brackets and tends to isolate in the upper brackets people who are not in farming for a living. On this basis it turns out that even in the bracket of $5,000 to $10,000 of nonfarm income, farm operations are more likely to show a loss than a profit, and as the nonfarm income goes higher, the prospective loss as compared to the prospective profit steadily and dramatically increases. In the nonfarm income bracket of $100,000 to $1 million, only about one out of seven returns with farm income shows a net profit. Moreover, aggregate losses exceed aggregate profits by more than 30 to 1 in this income bracket. These data are particularly striking evidence that people with appreciable nonfarm incomes arrange their affairs to show net "losses" on farm operations. Since these people can be assumed to have some financial acumen, the preponderance of "losses" make it clear that they are "tax losses" which arise from the generous accounting rules which permit current tax deductions for increases in inventory and for capital improvements in land.

Conclusion.—These data clearly demonstrate the scope and seriousness of the problem. The fact is that our tax laws have spawned artificial "tax losses" and have distorted the farm economy.

THE PROPOSAL

The essence of the proposal is to deny high-bracket, part-time farmers the ability to use the generous farm accounting rules to reduce taxes on their nonfarm income. They would, in effect, be treated as if their farm operations were carried on apart from their other activities and, thus, they would have the same tax treatment with regard to their farms as farmers without substantial nonfarm income.

On the other hand, in order not to treat real economic losses from farming less favorably than losses sustained in nonfarming businesses, these limitations would not apply if the taxpayer elects to forgo the special farm accounting rules described above. Instead, the following accounting rules, which are applicable to business generally—and indeed to farm accounting itself apart from taxation—would be applicable to insure that tax losses are real and not simply the result of accounting distortions. To fall under this alternative, a taxpayer (whether individual or corporate) must elect to—

(*a*) Compute gross income from farming by use of an inventory method of accounting where inventories are a significant factor in reflecting income, and

(*b*) Capitalize all capital expenditures including development costs incurred prior to the time when the productive stage is reached in farm operations.

If a taxpayer does not make such an election, then, under the proposal, he may not deduct in any one year more than $15,000 of a farm loss against income from sources other than farming. The first $15,000 of loss is allowed in order to exclude from the proposal bona fide farmers who may have to supplement their income with part-time employment or with employment during the off season. If a taxpayer has more than $15,000 of nonfarm income, his primary source of livelihood is not likely to be his farming efforts, and, thus, he is not the type of farmer for whom the special accounting rules were devised.

Congress has in the past recognized that the special accounting rules should not be available to produce unlimited tax benefits. The provisions which now allow a farmer to deduct currently certain soil and water conservation expenses and certain expenses for clearing land, although they are capital expenditures, limit the deduction in each case to a specified percentage of farm income. This proposal would not permit these and the other special benefits to be pyramided to provide excessive deductions.

A farm loss would be defined generally as the difference between the total of a taxpayer's farm expenses and his farm income. Farm income would include only the one-half of farm capital gains that is included in adjusted gross income. If the difference between expenses and income exceeds $15,000, only the first $15,000 of the loss would be deductible in the current year. The disallowed portion would first be reduced by the excluded one-half of farm capital gains. Thereafter, any balance could be carried forward or backward as a deduction against net farm income of other years to avoid imposing hardships where the taxpayer incurs a large isolated loss in one year.

Certain deductible items may be disregarded in computing a farm loss and thereby allowed without regard to whether they produce a loss which exceeds the $15,000 limit. The first category includes taxes and interest which are generally deductible whether or not they are attributable to the carrying on of a trade or business. However, an unlimited deduction of these items would be in place of, and not in addition to, the $15,000 general limitation.

The second category of deductible items that may be disregarded includes casualty and abandonment losses and expenses and losses arising from drought. These items may be deducted in addition to the basic $15,000 limitation, as they are not in the taxpayer's control, and disallowance of them might create an undue hardship to the taxpayer. These same expenses and losses are excluded from the operation of present section 270 which disallows losses incurred in connection with a hobby operation. The third category is losses incurred on the sale or other disposition of assets used on the farm. These losses generally represent real economic losses and not artificial "tax losses" created by the special farm tax accounting rules.

In cases where a farming activity is carried on by a partnership or a corporation which has elected to be taxed in a manner similar to a partnership, the farm nature of the income and expense would be carried over to the individual partners or shareholders who must aggregate them with all of their other farm operations. The $15,000 limitation would then apply to any loss computed on this aggregate basis unless each of the entities from which the individual derives farm income or deductions has made the election described above.

The proposal would not affect the present treatment of preparatory costs such as clearing brush and land, planting trees and vines, drilling wells and installing irrigation and drainage ditches, which now must be capitalized.

EFFECT OF PROPOSAL

It is expected that this proposal will affect less than 14,000 individual tax returns. Present estimates are that it would raise $145 million from these individuals. About $55 million of this total would be from taxpayers having nonfarm income of more than $15,000 and less than $100,000. The balance, about $90 million, would be from 2,400 individuals all of whom showed nonfarm income of more than $100,000.

Farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect thereto are not available.

TABLE 1.—PROFIT AND LOSS BY AGI CLASS FOR FARM AND NONFARM BUSINESSES, 1964

[Amounts are in millions of dollars]

AGI class	Business and profession				Farm			
	Net profit		Net loss		Net profit		Net loss	
	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount
Under $5,000	2,103,742	$4,028	474,223	$1,156	1,368,436	$1,917	655,116	$1,220
$5,000 to $10,000	1,608,911	6,104	289,627	277	460,739	1,513	325,741	375
$10,000 to $20,000	821,696	6,409	108,384	138	134,986	805	89,540	173
$20,000 to $50,000	313,310	6,386	26,092	125	31,400	376	29,701	165
$50,000 to $100,000	37,053	1,559	4,866	42	3,807	68	6,927	67
$100,000 to $500,000	4,658	296	2,103	52	846	21	2,576	56
$500,000 to $1,000,000	90	11	133	9	22	1	149	6
Over $1,000,000	30	9	69	10	11	(1)	80	5
Total	4,889,491	24,802	903,499	1,809	2,000,249	4,703	1,109,829	2,067

[1] Less than $0.5 million.
Source: Statistics of Income, Individual Income Tax Returns, 1964.

TABLE 2.—SAMPLE OF INDIVIDUAL RETURNS WITH FARM NET LOSS GREATER THAN $25,000,[1] 1964

[In thousands of dollars]

Nonfarm AGI	Field crop farms—Size of loss			Livestock farms—Size of loss		
	$25 to $50	$50 to $100	$100 and over	$25 to $50	$50 to $100	$100 and over
0 under $25,000	0	0	0	0	0	0
$25,000 to $50,000	3	0	0	25	0	0
$50,000 to $100,000	11	2	0	70	16	0
$100,000 to $250,000	36	10	4	181	95	19
$250,000 to $500,000	8	11	4	63	53	33
$500,000 to $1,000,000	9	1	1	22	12	21
$1,000,000 and over	1	1	0	6	14	4
Sum	68	25	9	367	190	77
Grand total			102			634

[1] In 1964 field crop farming was the primary activity on 1,154,913 schedules F and livestock farming the primary activity on 1,587,786 schedules F.

TABLE 3.—FARM PROFIT AND LOSS ON INDIVIDUAL RETURNS WITH POSITIVE AGI, BY NONFARM ADJUSTED GROSS INCOME, 1964

Nonfarm AGI (in thousands of dollars)	Number of returns with farm profit or loss	Excess of farm profit over loss		Number of returns with farm net profit	Farm net profit		Number of farms with farm net loss	Farm net loss	
		Aggregate (thousands)	Average		Aggregate (thousands)	Average		Aggregate (thousands)	Average
0 to 5	1,775,037	$2,664,166	$1,501	1,271,508	$3,111,816	$2,447	503,529	$447,650	$889
5 to 10	626,128	−265,160	−423	213,952	335,461	1,568	412,176	600,621	1,457
10 to 25	210,458	−303,274	−1,441	61,858	161,774	2,615	148,600	465,048	3,130
25 to 50	33,020	−79,849	−2,418	8,586	37,662	4,386	24,434	177,511	4,809
50 to 100	12,363	−151,963	−12,292	2,327	13,505	5,804	10,036	165,468	16,487
100 to 1,000	4,835	−190,993	−39,502	631	6,210	9,842	4,204	197,203	46,908
Over 1,000	96	−6,492	−67,625	11	442	40,182	85	6,934	81,576
Sum	2,661,937	1,666,435	626	1,558,873	3,666,870	2,352	1,103,064	2,060,435	1,868

V-D. CORRECTION OF ABUSES OF FARM TAX RULES BY NONFARMERS

Technical Explanation

The essence of the proposal is to deny high-bracket part-time farmers the ability to use without limit the special farm accounting rules to reduce taxes on their nonfarm income.

1. TO WHOM APPLICABLE

The farm tax loss abuse giving rise to this proposal occurs because of the special tax accounting rules available only to farm operations. Under these rules, even in those cases where inventories are a material factor, farmers are permitted to use the cash accounting method and ignore their yearend inventories of crops, cattle, etc. This has resulted in an inaccurate reflection of their annual income since expenditures are fully deducted in the year incurred, notwithstanding the fact that the assets produced by those expenditures (inventories) are not sold, and the income not reported, until a later year. Moreover, farmers are permitted to deduct some admittedly capital costs as they are incurred rather than to recoup them over the useful life of the asset or on its sale. This again results in a mismatching of the timing and the tax effect of the income and expenses.

The proposal would apply only to those taxpayers who actually use these special tax accounting rules. It would not, on the other hand, apply to a taxpayer who—

(*a*) Computes gross income from farming by means of an inventory method of accounting, and

(*b*) Elects to capitalize all expenses of farming as to which the taxpayer presently has an option, whether conferred by statute or regulations, to deduct or to capitalize.[1]

An election to adopt these accounting rules would be made on the tax return for the first year for which the election is to apply. The election would not affect expenses for prior taxable years. For example, when an inventory is established at the end of the first year for which the election is effective, it will include only the expenses for that year attributable to the inventory on hand at year's end even though there may have been costs attributable to such inventory which were deducted in prior years. Thus, there will be no need for special transition rules.

2. THE GENERAL RULE

Under the general rule of the proposal, for a taxpayer who continues to use the special farm accounting rules, the amount of "expenses of farming" which may be deducted in a taxable year would generally be limited to an amount equal to (A) the "income from farming" for that

---

[1] There are many expenses as to which a taxpayer now has such an option, e.g., soil and water conservation expenditures, expenditures for fertilizer, expenditures for clearing land (secs. 175, 180, and 182 of the Internal Revenue Code, respectively) and costs associated with the raising of assets for use on the farm such as the cost of feed and other costs incurred in raising a breeding herd (if not inventoried) or such as the cost of irrigation, fertilizer, spraying, pruning, and cultivation associated with orchards, groves, and vineyards before they produce income.

year, plus (B) $15,000.[2] The effect of this rule is, thus, to limit to $15,000 the amount of farm loss that may be deducted in any one year against income from sources other than farming. However, as explained in more detail later, certain deductions would be allowed even if the effect is to allow a deductible loss of more than $15,000.

The limitation on the deductibility of farm losses would be applied no matter what the organizational form of the farming activity. Thus it would apply to individual as well as corporate taxpayers.

3. INCOME FROM FARMING

"Income from farming" is defined to include all gross income from farming activities except that, if the taxpayer has gain from the sale or farm assets which is treated as long-term capital gain under section 1231 of the code, only one-half of the gain is treated as income from farming because only one-half of such gain is subject to tax.

4. EXPENSES OF FARMING

The term "expenses of farming" is defined generally as all items allowable as deductions in connection with the carrying on of the trade of business of farming. Three categories of expenses are excluded, however, from the definition of "expenses of farming" so as to allow them without regard to whether they produce a loss which exceeds the $15,000 limit.

The first category includes taxes and interest which are generally deductible whether or not they are attributable to the carrying on of a trade or business. However, an unlimited deduction of these items would be in place of, and not in addition to, the $15,000 general limitation.

The second category of deductible items that may be disregarded includes casualty and abandonment losses and expenses and losses arising from drought. These items may be deducted in addition to the basic $15,000 limitation, as they are not in the taxpayer's control, and disallowance of them might create an undue hardship to the taxpayer. These same expenses and losses are excluded from the operation of present section 270 which disallows losses incurred in connection with a hobby operation. The third category is losses incurred on the sale or other disposition of assets used on the farm. These losses generally represent real economic losses and not artificial tax losses created by the special farm tax accounting rules.

5. PARTNERSHIPS AND SUBCHAPTER S CORPORATIONS

Partnerships and subchapter S corporations (i.e., corporations which have elected to be taxed similarly to a partnership) would be treated as conduits and the farm income and expenses of each would be attributed to the partners and shareholders for purposes of applying the farm loss provisions. In the case of a subchapter S corporation, each shareholder during the year would be required to take into account his pro rata share of the corporation's farm income

[2] In the case of a married couple filing separate returns, each spouse would have a separate limit of $7,500.

and expenses, computed in accord with the principles already established in section 1374 for computing pro rata shares of net operating losses for subchapter S corporations. Thus, a 10-percent shareholder who owned his stock for 180 days out of a 365-day calendar year would take into account 10 percent of each item of farm income or expense multiplied by the fraction of which 180 is the numerator and 365 is the denominator.

An individual must, in applying the $15,000 limit, aggregate all his farm income and expenses, including those attributed to him as a partner or a stockholder in a subchapter S corporation. The $15,000 limitation will then apply to any loss computed on this aggregate basis unless he and each of the partnerships or subchapter S corporations from which he derives farm income or deductions has elected to forego the special farm accounting rules.

6. CARRYBACK AND CARRYOVER OF UNUSED DEDUCTIONS

Farm deductions disallowed by reason of this proposal may be carried back 3 years and forward 5 years and deducted against any net farm income for those years.

The amount which may be carried to other years must be reduced, however, by an amount equal to the one-half of net long-term capital gains from farming which has been deducted for the taxable year under section 1202 of the Internal Revenue Code. This provision is patterned after the normal loss carryover provision of section 172 which requires that, in computing the loss carryover or carryback, the net operating loss for a year must be reduced by the section 1202 deduction for that year.

7. EXAMPLE

The operation of this proposal may be illustrated by a taxpayer who utilizes the cash basis method of accounting and does not inventory or capitalize the expenses of raising a breeding herd. His income from the sale of farm products is $100,000. He also realizes a $300,000 long-term capital gain from the sale of breeding cattle. His farm expenses total $400,000 and include local property taxes of $30,000 and interest charges of $50,000. Thus, his farm operations for the year have broken even from an economic standpoint. Under present law, his taxable income from farming would be computed as follows assuming that he has a substantial amount of nonfarm income:

	Long-term capital gain income	Ordinary income
Sale of farm products		$100,000
Sale of cattle	$300,000	
Total income	300,000	100,000
Deductions attributable to the farming operation	0	400,000
Total	300,000	(300,000)
Less deduction for ½ capital gains	150,000	0
Income or loss from farm operation	150,000	(300,000)

At present, the ordinary loss ($300,000) could be deducted against the ordinary income realized from other activities, while the capital gain ($150,000) would result in a tax of no more than $75,000.

Under the proposal, the $300,000 ordinary loss would not be fully deductible. Rather, the deductible "expenses of farming" (the farm deductions shown above less taxes and interest) could not exceed "income from farming" plus the amount of taxes and interest (since they exceed the general $15,000 limitation). Thus, the first step in determining the amount of deductible "farm loss" is to ascertain "income from farming." It is:

Income from sale of farm products	$100,000
Plus one-half of net farm capital gain	[1] 150,000
Income from farming	250,000

"Expenses of farming" are:

Deductions attributable to the farming operation	$400,000
Less taxes	30,000
Less interest	50,000
"Expenses of farming"	320,000

[1] In cases where casualty losses are partially compensated by insurance so that they fall under sec. 1231 and offset farm capital gains, appropriate adjustments will be made to assure that the full amount of the casualty will be deductible.

While the "expenses of farming" are $320,000, they are allowable only to the extent of "income from farming" of $250,000. In addition, the $80,000 of taxes and interest is allowable.

Thus, under the proposal, the taxpayer would report:

	Capital gains income	Ordinary income
Sale of farm products		$100,000
Sale of cattle	$300,000	
Total income	300,000	100,000
Less allowable "expenses of farming"		250,000
Less taxes		30,000
Less interest		50,000
Total	300,000	(230,000)
Less deduction for ½ of capital gains	150,000	
Income or loss from farming operation	150,000	(230,000)

The amount of unused farm expense deductions which could be carried back or over and deducted against net farm income of other years (if any) is computed as follows:

"Expenses of farming" as computed above	$320,000
Less allowable "expenses of farming"	250,000
Unused "expenses of farming"	70,000
Less excluded one-half of farm capital gain	150,000
Amount to be carried to other years	0

8. EFFECTIVE DATE

The proposal would apply to taxable years commencing after December 31, 1969.

V-E. TAXATION OF MULTIPLE TRUSTS AND ACCUMULATED INCOME IN TRUSTS

General Explanation

I. PRESENT LAW

One premise of our present tax system is a progressive rate scale. This progressive system is abused when taxpayers create additional entities for the purpose of spreading income among several taxpayers, thereby lowering the overall tax rate. One marked abuse is the creation of trusts to accumulate income at low rates to distribute that income with little or no additional tax even where the beneficiary is in a high tax bracket.

This abuse comes about because under present law if a person creates a trust and does not retain certain controls over the trust property, he is not taxed on the income of the trust. Rather, the trust itself is taxed unless the income is currently distributed or required to be distributed to the trust's beneficiaries. Thus, the tax on income accumulated by the trust is paid by the trust, a separate taxpayer with its own exemptions, deductions, and rate of tax. If the income is distributed to the beneficiaries, they are taxed, but the amount of taxable income may not exceed distributable net income of the trust.[1]

Example A

X creates a trust and contributes $50,000 to it. Under the terms of the trust instrument, the income of the trust is to be distributed each year to X's son Y. Assume that the $50,000 is invested in 7 percent corporate bonds which return $3,500 in interest income annually. The trust incurs expenses of $100 per year allocable to the production of the income. When the net income of the trust ($3,400) is distributed to Y, Y pays tax on that amount at his particular rate. If Y's taxable income is $10,000 for the year without regard to the $3,400, he will have to pay a tax of $1,144 on the distribtuion of the trust's net income to him (assuming Y files a separate return).[2]

Now assume that instead of current distributions to Y, under the terms of the trust instrument, the income is to be accumulated for 5 years and then distributed to Y. Assume, as above, that the trust earns $3,500 income annually and has $100 of expenses allocable to the production of income. Since the income is accumulated and not distributed currently to Y, the tax is paid by the trust. In addition to a deduction for the $100 of expenses, the trust is also allowed a personal exemption of $100. The tax due from the trust on the $3,300 annually would be $557—$587 less than the tax due if the income had been distributed currently to Y (and presumably even a still lesser amount than if X had paid tax on the income himself). Thus, by the use of the trust to accumulate income, the tax has been reduced to approximately 50 percent of that which would have been due if the income had been distributed currently to Y.

---

[1] Basically, distributable net income is the taxable income of the trust, excluding capital gains (and losses) to the extent that the capital gains are allocated to the corpus of the trust and are not paid, credited, or required to be distributed currently to the beneficiaries.

[2] Does not include 10 percent surcharge.

At the end of the 5 years, the trust will have accumulated $14,215 (annual net income of $3,400 less taxes of $557 per year leaving $2,843 times 5 years) which will be distributed to Y. Failure to tax Y on this distribution of the prior accumulations would invite tax avoidance of the worst sort; if the beneficiary were in a higher bracket than the trust, the lower marginal tax rate of the trust could be substituted for the higher marginal tax rate of the beneficiary simply by accumulating the income for a year before distributing it. On the other hand, taxing the entire amount to Y in the year of distribution could result in a very high tax because several years' income would fall into a single year and bear a higher rate than if it had been distributed annually.

Present law attempts to solve the problem with a special rule known as the "throwback rule." In substance, the throwback rule provides that the excess of an "accumulation distribution" over distributable net income for the current year is taken back through the 5 preceding years and treated as a distribution of the preceding years to the extent of the trust's undistributed net income, that is, its "unused" distributable net income for those preceding years. The character of the items making up the distribution is determined by the composition of the distributable net income for the year to which attributed. Thus, to the extent that the distributions would have been included in the beneficiary's income for each preceding year had they been distributed in the preceding years, they are included in the beneficiary's income of the current year. In addition, the beneficiary is regarded as having received the tax paid by the trust, and the beneficiary is given credit for taxes paid by the trust on the accumulated distributions. The beneficiary's tax for the year of receipt, however, is not to exceed what the beneficiary would have paid had the amounts been distributed when earned. This throwback process is limited, however, to the 5 years preceding the year of distribution. Thus, any part of the distribution attributed to years earlier than the fifth preceding year is received tax free by the beneficiary.

There are several significant exceptions to the throwback rule. Where the rule does not apply because of one of the exceptions, the beneficiary receives the accumulation distribution without paying tax. The exceptions are—

(1) A distribution of income which was accumulated prior to the beneficiary's attaining the age of 21;

(2) A distribution of accumulated income to a beneficiary to meet his "emergency needs";

(3) A distribution of accumulated income which is a final distribution and which is made more than 9 years after the last transfer to the trust;

(4) A distribution of accumulated income not in excess of $2,000;

(5) Certain gifts of specific sums of properties paid in not more than three installments; and

(6) Certain periodic mandatory distributions under trusts created prior to 1954.

The 5-year limitation on the throwback rule and the numerous exceptions seriously erode the basic principle that a beneficiary who receives income from property should pay tax on that income at the same rate as he pays on his other income. A few examples will show how trusts can be used today to avoid this taxation.

Example (1)

X creates a trust in 1966 and contributes $50,000 to the trust which is invested in 7-percent corporate bonds returning $3,500 in interest annually. As we saw in example A above, if the income were distributed currently to a beneficiary with $10,000 of other income, the beneficiary would pay tax of $1,144 annually, assuming he files a separate return.

Assume, however, that X directs the trust to accumulate the income for 10 years to distribute all of the accumulated income to Y and then to terminate and return the bonds to X. As we saw in example A above, the trust would pay a tax of $557 on the $3,500 of income each year. At the end of year 10, when the income is distributed to Y, the trust will have paid $5,013 in tax on the accumulations. When Y receives the funds, he need pay no further tax on the accumulated income since the distribution is a final distribution made more than 9 years after the last transfer in trust. Assuming Y still has other income of $10,000 a year, he will pay tax of $1,144 on the current distribution of the last year's income. The total taxes paid, therefore, if the income is accumulated and distributed after 10 years is $6,157 compared to $11,440 if the income had been distributed currently—a saving of $5,283 despite the fact that the ultimate beneficiary is the same in both cases.[2] The problem is aggravated if the beneficiary is X's wife. Assuming that X and his wife file joint returns and that X's other income is $52,000 annually, the tax saving resulting from accumulation rather than current distribution will approach $12,000 despite the fact that the income is returned to the family unit of which X, presumably, is the head. Furthermore, since it was assumed that X and Y filed joint returns, the income would have been taxed directly to the donor X under the joint return upon its current distribution to Y.

Example (2)

A trust has $2,000 of income in 1966; the trust accumulates the $2,000. In 1967, the trust has $4,000 of income. It then distributes $6,000, that is, its $4,000 income for 1967 and the $2,000 accumulation. The beneficiary will pay tax on the current distribution of $4,000 but will pay no tax at all on the accumulation distribution since it was not in excess of $2,000. Assuming the trust had expenses of $100 attributable to the accumulation, it will have paid taxes of $276 on the accumulation. Assuming the beneficiary filed a separate return and had $28,000 of other income, he would have paid taxes of $1,007 if the income that was accumulated had been currently distributed. In other words, the taxes paid if the 1966 income is accumulated are less than 30 percent of the taxes paid if the income is currently distributed. Furthermore, the accumulation distribution may be made on the first day of the trust's taxable year following the year of accumulation with the result that the beneficiary need not wait a full extra year to achieve this large tax saving.

Accumulation distributions to a beneficiary who has not attained the age of 21 or to a beneficiary for "emergency needs" and gifts of specific

---

[2] The computations assume that income tax rates will remain constant. Furthermore, any reinvestment of earned income is disregarded.

property paid in not more than three installments likewise result in unwarranted tax savings. The beneficiaries pay no tax on such distributions, again with the result that the lower marginal tax rate of the trust is substituted for the higher marginal tax rate of the beneficiary.

These abuses are seriously compounded by the use of multiple trusts due to the multiplication of exceptions to the throwback rule. The creation of multiple entities will also serve to increase the number of $100 exemptions allowed to each trust and to reduce the marginal tax rate paid by the trust on the trust income. The abuses are further compounded by multiple trusts for the same beneficiary (assuming that the multiple trusts are so structured as to be considered as separate trusts and not parts of a single trust).

Another particularly egregious example of the use of a trust for purposes of decreasing taxes is the trust created by one spouse for the benefit of the other spouse. It was seen in Example (1) above how such a trust compounded the abuse in the case of the "final distribution" exception to the throwback rule. The capacity for abuse exists, however, apart from any exception to the throwback rule. For example, a husband creates a trust with his wife being entitled to the income from the trust. If the trust has annual income of $5,000 which is accumulated, and expenses of $400, the trust will pay tax of $800 annually. If the income were not accumulated and the husband and wife had income of $76,000 and filed joint returns, they would pay tax of $2,668 annually on the trust income—more than three times the tax paid if the income were accumulated in the trust. Even if the throwback rule operates to tax the wife upon receipt of the accumulations, the family will have had the benefit of accumulation at low rates and consequent savings from the postponement of tax. And, as has been seen, the numerous exceptions to the throwback rule and its restriction to the past 5 years create the distinct possibility that the wife will pay little or no tax on the receipt of the distributions.

II. PROPOSAL

As previously explained, the tax system should not permit the creation of additional taxpayers in order to avoid the impact of the progressive rate structure. Recent cases and reports from the Internal Revenue Service indicate that individual taxpayers have set up over 100 substantially identical trusts for the sole purpose of avoiding income taxes. Although such devices are of doubtful validity under present law, any uncertainty should be removed by specifically denying the sought-after benefits to this flagrant abuse. The guiding principle of trust taxation, therefore, should be to tax a beneficiary who receives income from trust property at the same rate as he pays on his other income. The proposal is designed to effectuate this principle.

Under the proposal, the 5-year throwback would be converted to an unlimited throwback and the exceptions eliminated. To avoid burdensome record keeping and to provide simplification the proposal provides for the computation of the unlimited throwbacks by a new, short method. Basically, this is done by an averaging device, the mechanics of which are as follows:

(1) An average annual income is computed by dividing the total accumulated income distributed by the number of preceding taxable years of the trust from which the distribution was deemed to have been made.

(2) An average annual tax increase is then computed by adding the average annual income (as computed in step (1)) to the beneficiary's income for the present taxable year and the 2 preceding taxable years; recomputing the beneficiary's tax for those years taking into account the added income; adding the increases in tax for those years together; and dividing by three.

(3) This average annual increase in tax is then multiplied by the number of preceding taxable years of the trust from which the distribution was deemed to have been made. This amount is the limitation of the beneficiary's tax liability; that is, the beneficiary must pay tax on the total distribution in the present taxable year but in not more than the amount determined by this averaging device. The limitation is before the application of any allowable credit for taxes paid by the trust. Special rules would cover the situation where the number of years from which the distribution has been made is fewer than three, where the beneficiary is not alive on the last day of the taxable year, and where the beneficiary has no preceding taxable year.

The proposal also provides a solution to the problem of the trust created by one spouse for the benefit of the other spouse. In such a case, all the income of the trust which may be used for the benefit of the beneficiary spouse is taxed to the spouse who created the trust as the income is earned. Special rules will be provided to determine when and to what extent a trust is created for the benefit of a spouse. This proposal effectuates the concept that a husband and wife should be treated as one economic unit.

The rules for husband-wife trusts reach the problem of accumulation at low rates directly since the income of the trust is taxed currently even if not distributed. Insofar as it deals with trusts between parties other than husband and wife, the proposal does not specifically prevent using a number of trusts to accumulate income at low rates. Abuses in this area will have to be corrected by judicial determination. For example, numerous substantially identical trusts may be held to be one trust for tax purposes thereby limiting the trusts to one $100 exemption and presumably increasing the marginal rate of tax. The proposal will insure, however, that when the accumulated income is distributed to the beneficiary, whether the several trusts are considered as multiple trusts or parts of one trust, the accumulated income will be taxed substantially as it would have been if distributed currently to the beneficiary.

The proposal will apply to all trusts, whenever created, but only with respect to distributions made after the date of enactment of the proposal.

III. REVENUE EFFECT

It is estimated that this proposal will increase annual revenues by $70 million.

V–E. TAXATION OF MULTIPLE TRUSTS AND ACCUMULATED INCOME IN TRUSTS

TECHNICAL EXPLANATION

I. GENERAL BACKGROUND

Our present tax system is premised on a progressive rate scale which increases the percentage of income paid in taxes as income increases. When taxpayers create additional entities for the purpose of spreading income among several taxpayers thereby lowering the overall tax rate, this progressive system is abused. One marked abuse is the creation of trusts to accumulate income at relatively low rates and to distribute that income with little or no additional tax even when the beneficiary is in a high tax bracket.

This abuse comes about because under present law, if a person creates a trust and does not retain certain controls over the trust property, he is not taxed on the income of the trust. Rather, the trust itself is taxed unless the income is currently distributed or required to be distributed to the trust's beneficiaries. Thus, the tax on income accumulated by the trust is paid by the trust, a separate taxpayer with its own exemptions, deductions, and rate of tax. If the income is distributed to the beneficiaries, they are taxed, but the amount of taxable income may not exceed the distributable net income of the trust.

Present law attempts to solve the problem with a special rule known as the throwback rule. In substance, the throwback rule provides that the excess of an "accumulation distribution" over distributable net income for the current year (generally taxable income less capital gains not required to be paid out or not paid out to beneficiaries) is taken back through the 5 preceding years and treated as a distribution of the preceding years to the extent of the trust's undistributed net income; that is, its "unused" distributable net income for those preceding years. The character of the items making up the distribution is determined by the composition of the distributable net income for the year to which attributed. Thus, to the extent that the distributions would have been included in the beneficiary's income for each preceding year had they been distributed in the preceding years, they are included in the beneficiary's income of the current year. In addition, the beneficiary is regarded as having received and paid to the Federal Government the taxes paid by the trust on the accumulated distributions. The beneficiary's tax for the year of receipt, however, is not to exceed what the beneficiary would have paid had the amounts been distributed when earned. This throwback process is limited, however, to the 5 years preceding the year of distribution. Thus, any part of the distribution attributed to years early than the fifth preceding year is received tax free by the beneficiary.

In addition to the time limitation, there are several exceptions to the throwback rule. If the accumulation distribution falls within one of the exceptions, the beneficiary receives it tax free, and the general purpose of the rule is frustrated. The exceptions are—

(1) a distribution of income which was accumulated prior to the beneficiary's attaining the age of 21;

(2) a distribution of accumulated income to a beneficiary to meet his "emergency needs";

(3) a distribution of accumulated income which is a final distribution and which is made more than 9 years after the last transfer to the trust;

(4) a distribution of accumulated income not in excess of $2,000;

(5) certain gifts of specific sums of properties paid in not more than three installments; and

(6) certain periodic mandatory distributions under trusts created prior to 1954.

II. THE PROPOSAL

The proposal would apply to any trust which has accumulated income. Such trusts would, however, fall into one of two categories, namely, (1) trusts created by one spouse for the benefit of the other spouse, and (2) all other trusts which accumulate income.

(a) *The trust for a spouse*

In a case where a spouse creates a trust for the benefit of the other spouse, all the income of the trust which may be used for the benefit of the beneficiary spouse is taxed to the spouse who created the trust as the income is earned. Special rules will be provided to determine when and to what extent a trust is created for the benefit of a spouse. This proposal effectuates the concept that a husband and wife should be treated as one economic unit.

Example.—A husband creates a trust and contributes $50,000 in 7-percent bonds to the trust. The income is to be accumulated for 3 years and then distributed to his wife. The interest income of $3,500 will be added to husband's other income and taxed at the husband's marginal tax rate.

(b) *Other trusts accumulating income*

For other trusts, the proposal does two things. It would eliminate the exceptions to the present throwback rule. It would also convert the 5-year throwback to an unlimited throwback. To avoid burdensome recordkeeping and to provide simplification, the proposal provides for the computation of the unlimited throwback by a new, short method. Basically, this is done by an averaging device, the mechanics of which are as follows:

(1) An average annual income is computed by dividing the total accumulated income distributed by the number of preceding taxable years of the trust from which the distribution was deemed to have been made.

(2) An average annual tax increase is then computed by adding the average annual income (as computed in step (1)) to the beneficiary's income for the present taxable year and the two preceding taxable years; recomputing the beneficiary's tax for those years taking into account the added income; adding the increases in tax for those years together; and dividing by 3.

(3) This average annual increase in tax is then multiplied by the number of preceding taxable years of the trust from which the distribution was deemed to have been made. This amount is the limitation of the beneficiary's tax liability, i.e., the beneficiary must pay tax on the total distribution in the present taxable year but in not more than the amount determined by this averaging device. The limitation is

before the application of any allowable credit for taxes paid by the trust. Special rules would cover the situation where the number of years from which the distribution has been made is fewer than 3, where the beneficiary is not alive on the last day of the taxable year, and where the beneficiary has no preceding taxable year.

Example.—X creates a trust which is to accumulate its income and pay the income to Y when Y reaches 30; Y is now 19. Over the 11 years of the trust, the trust earned $1,200 of income annually and had expenses each year of $100 allocable to the production of income. The trust paid tax of $1,450 on the accumulated income. When Y reaches 30, the $9,550 of accumulated income after taxes and the $1,100 of current net income is distributed to Y. Y is treated as having received an accumulation distribution of $11,000 (the taxes paid by the trust are deemed to have been distributed to Y). The income of the current year is taxed directly to Y. The computation would be as follows: $11,000 (accumulation distribution) divided by 10 (number of years out of which distribution was made) equals $1,100. The $1,100 is added to the present year's and preceding 2 years' taxable income and the increases in tax due to the additional $1,100 in each year are computed. Assume the $1,100 produces increases as follows:

Present year	$350
Last year	300
2 years ago	250
Total	900

$900 (total additional tax) divided by 3 equals $300 (average annual increase in tax).

$300 (average annual increase in tax) times 10 equals $3,000.

Three thousand dollars is the limit of tax which Y must pay on the accumulation distribution. Y is also entitled to a credit for taxes paid by the trust with respect to the accumulation distribution, i.e., $1,450. The amount of tax currently to be paid cannot therefore exceed $1,550.

Where multiple trusts have been created for the same taxpayer, distributions from each trust would simply be put through the procedure just outlined. Thus, if in the example above, there had been two trusts, each having the characteristics of the trust above, the additional income added to the current and each of the two proceding years would have been $2,200. Assume that this $2,200 produced the following increases:

Present year	$800
Last year	700
2 years ago	600
Total	2,100

This $2,100 tax increase would be divided by 3 to give an annual average increase of $700. The limit on taxes for the 10-year period would be $7,000. Since Y's credit for taxes paid by the trusts would be $2,900, the amount of current tax cannot exceed $4,100.

III. EFFECTIVE DATE

The proposal will apply to all trusts, whenever created, but only with respect to distributions made after the date of enactment of the proposal.

V-F. MAXIMUM INDIVIDUAL INCOME TAX

General Explanation

BACKGROUND

As part of a program for achieving tax fairness among higher income individuals, it is appropriate to consider not only those who pay too little tax in relation to others, but also those who pay too much tax. The former group consists of individuals whose income includes substantial amounts of exempt income. A minimum tax has been proposed for them under a rate schedule that could raise their effective rate of tax on true income up to nearly 35 percent.

The latter group consists of individuals who enjoy few, if any, tax preferences.

For example, of those with adjusted gross income of $500,000 or more, about 29 percent will pay—after the other reforms included in the program—more than 50 percent of their true incomes in tax.[1] This tax burden is high in relation to what others in their income class pay or are being asked to pay under the reform program.

PROPOSAL

As a component of an overall program to improve the equity of the income tax at the higher brackets, it is proposed that no individual be required to pay more than one-half of his total income (including presently taxable income plus the major sources of exempt income) in income tax to the Federal Government. This would be accomplished through the introduction of an optional, alternative maximum tax.

"Total income," for this purpose, would include the items of exempt income which would be included in the minimum tax base; that is, tax-exempt interest, the excluded portion of capital gains, the amount of percentage depletion claimed after the cost of the property has been recovered, and the appreciation of property contributed to charity and claimed as a tax deduction. In addition, the maximum tax base would include the value of any stock options exercised during the year (i.e., the difference between the value of the stock at the time the option is exercised and the option price). Stock options represent a major component of executive compensation which—although eventually taxable when the stock is sold—should nevertheless be included in the year in which exercised to obtain a realistic measure of the relationship between an individual's total income and his tax payments and thereby the appropriateness of applying the maximum ceiling.

The appropriateness of the maximum tax proposal is directly related to the proposal to include in the income tax base the appreciation in assets transferred at death or by gift. The adoption of a maximum tax provision without this other important reform would result in tax reductions for individuals who in reality have substantial exempt income represented by the untaxed appreciation in their investment and other assets.

[1] See table 2 accompanying the general explanation of the minimum tax.

Effective date

It would be appropriate to implement the maximum tax only when the current temporary need for higher taxes has expired. Thus, it is proposed that the maximum tax not go into effect until the expiration of the 10-percent tax surcharge.

Effect of maximum tax

The maximum tax would provide tax reductions for approximately 12,000 taxpayers at an estimated annual revenue cost of $205 million based on 1969 income levels. The details of the effect of the maximum tax are set forth in table 1.

Moreover, the combination of the minimum and maximum taxes would substantially reduce the disparity in effective tax rates for those in the higher income brackets. For example, under the full program including the minimum and maximum tax, the true effective tax rates for over 9 out of 10 of those individuals with adjusted gross incomes over $500,000 will fall within the range of 30 to 50 percent. Without the minimum and maximum taxes, it would be necessary to extend the range to cover effective tax rates from 25 percent to almost 70 percent before nine out of 10 of the individuals in the over $500,000 income bracket would be included.[3]

TABLE 1.—EFFECT OF MAXIMUM TAX

AGI class (in thousands of dollars)	Tax decrease (in millions)	Percentage tax decrease [1]	Number of returns with tax decrease (in thousands)	Percent of returns with tax decrease	Average tax decrease
Under 10					
10 to 15					
15 to 20					
20 to 50					
50 to 100	$2	(2)	1.5	0.4	$1,325
100 to 500	93	2.0	9.1	12.1	10,208
500 to 1,000	40	6.2	.7	28.9	59,700
1,000 and over	70	7.9	.3	29.0	233,300
Total	205	.3	11.6	(2)	17,685

[1] Percentage tax decrease for those with a decrease.
[2] Less than 1/10 of 1 percent.

Note: Averages computed from unrounded data.

V-F. MAXIMUM INDIVIDUAL INCOME TAX

TECHNICAL EXPLANATION

(*a*) *General outline of the maximum tax.*—This proposal would establish a maximum limitation on the total tax which an individual would be required to pay with respect to his income for any one year. Under the maximum tax structure, an individual could elect to pay a tax equal to 50 percent of his income (computed on an expanded base) if this tax is smaller than his regular tax.

(*b*) *Maximum tax base.*—The 50 percent maximum tax effective rate would be applied to a tax base computed in the same manner as the proposed *minimum tax taxable income* with two modifications.

[3] See table 2 accompanying the general explanation of the minimum tax.

The special $10,000 minimum tax standard deduction would not be available, and the value of any qualified stock options exercised during the year (i.e., the difference between the value of the stock received and the option price) would be added to the tax base.

(c) *Credits against maximum tax.*—The same type of credits would be allowed against the maximum tax as are allowed against the regular tax, and usually in the same amount. However, the limitation upon the investment credit would be computed on the basis of the maximum tax liability rather than the amount of the regular tax liability. Moreover, the limitation upon the foreign tax credit would be computed by multiplying (1) the amount of the maximum tax by (2) the ratio of the maximum tax base which is from sources without the United States to the total maximum tax base. Thus, the amount of the foreign tax credit could not exceed 50 percent of the maximum tax base which is from sources without the United States.

(d) *Nonresident aliens.*—In determining the maximum tax, a nonresident alien's income which is not effectively connected with the conduct of a U.S. trade or business (and thus taxed at a flat 30 percent, or lower treaty, rate) would be excluded from the tax. Correspondingly, the tax on such income would be treated separately. Thus, an individual's eligibility for the maximum tax and his ultimate tax liability on his effectively connected income will not vary according to the amount of, or the applicability of any preferential treaty rate to his noneffectively connected income.

(e) *Effective date.*—The maximum tax would be applicable after the expiration of the surcharge but no earlier than for taxable years beginning after December 31, 1969.

V-G. LIBERALIZATION OF THE STANDARD DEDUCTION

General Explanation

BACKGROUND

Under existing law taxable income is computed by subtracting a taxpayer's allowable deductions for personal expenses and his personal exemptions from adjusted gross income. As an alternative to itemizing his allowable deductions separately, a taxpayer may elect to claim a standard deduction equal to 10 percent of his adjusted gross income up to a maximum of $1,000 ($500 for married persons filing separately). A minimum standard deduction is also provided.

PROPOSAL

It is recommended (in addition to liberalization of the minimum standard deduction explained in V–A) that the 10 percent standard deduction be increased to 14 percent and the $1,000 ceiling on the standard deduction be increased to $1,800.

The standard deduction is one of the most important and desirable features of our tax system combining tax simplification with tax equity. Under present law it will be used to compute tax liability by 57 percent of those filing returns in 1969. For these individuals the standard deduction vastly simplifies the problems of maintaining records and computing a number of separate deduction items. Tax liability is, therefore, easily computed. By the same token, the simplicity of the standard deduction reduces the auditing problems of the Government, and in doing so, makes an important contribution to the orderly and uniform operation of the taxing system.

In 1944, shortly after the Congress extended the income tax to the broad mass of the population (early in World War II), the deliberate decision was made to reduce the complexity of the income tax system by adopting a standard deduction which would apply to over 80 percent of taxpayers. Two aspects of this decision are noteworthy. First, it meant that for the great mass of taxpayers the recordkeeping and general complexity of itemized deductions would be avoided. Second, since the limits of the standard deduction were fixed at about the level of typical incomes and typical personal deductions in 1944, it meant that variations in such personal expenses between otherwise similar taxpayers would not create different tax burdens. Only personal deductions over the average would change the tax.

Two things have happened since 1944. In the first place, average deductions have risen with higher State and local taxes and greater homeownership. Further, incomes have risen while the standard deduction has continued to apply only to the first $10,000 of income of a married couple. The result has been a progressive decline in the relative use of the standard deduction, as shown in table 1.

TABLE 1.—PROPORTION OF INDIVIDUAL TAX RETURNS WITH STANDARD DEDUCTIONS, SELECTED YEARS SINCE 1944 AND ESTIMATED 1969 PRESENT LAW

Year	Total number of returns (millions)	Percent with itemized deductions	Percent with standard deductions
1944	47.1	17.8	82.2
1951	55.4	20.9	79.1
1955	58.3	29.0	71.0
1960	61.0	39.5	60.5
1963	63.9	43.9	56.1
1965	67.6	[1] 41.2	58.8
1969 (estimated)	78.0	43.0	57.0

[1] It should be noted that the lower percent of the itemizers in 1965 was due to the introduction of the minimum standard deduction in 1964.

EFFECT OF THE PROPOSAL

The proposed increases in the standard deduction will greatly contribute to the simplification of the tax system. Under present law approximately 43 percent of the returns filed in 1969 will itemize their deductions which requires extensive recordkeeping. Under the proposal more than half of the itemized returns would switch to the standard deduction or minimum standard deduction and thus avoid much recordkeeping. In all, adoption of the proposal would result in 80 percent of all returns filed using the standard or minimum standard deduction, roughly the utilization rate of 1944 when the standard deduction was introduced.

Under present law there will be 65 million taxable returns filed in 1969. The proposed changes in the standard deduction would provide tax savings to approximately one-third of these taxpayers.

Liberalization of the maximum limits of the standard deduction would provide more than $1.4 billion of tax relief to taxpayers mainly in the income range of $5,000 to $20,000. See tables 2 and 3. About $1.2 billion of tax savings would result from raising the $1,000 ceiling to $1,800. This would be particularly helpful to those with incomes between $10,000 and $20,000. They would get 70 percent of the benefits from the new ceiling.

About 14.6 million taxpayers would benefit from the $1,800 ceiling, of which more than 13 million are in the $7,000 to $15,000 income group.

TABLE 2.—EFFECT OF INCREASING THE STANDARD DEDUCTION FROM 10 PERCENT TO 14 PERCENT WITH A $1,00 CEILING AFTER INCREASING THE MINIMUM STANDARD DEDUCTION TO $600 PLUS $100 WITH A $1,000 CEILING

[Dollar amounts in millions and number of returns in thousands]

AGI (in thousands of dollars)	Present law tax	Tax decrease	Tax decrease as percent of present law tax	Number of returns with tax decrease	Number of returns made nontaxable	Number of returns shifting to standard deduction
0 to 3	$1,159					
3 to 5	3,177					
5 to 7	5,439	$70	1.3	3,390		220
7 to 10	13,925	145	1.0	5,230		460
10 to 15	18,916					
15 to 20	7,550					
20 to 50	12,795					
50 to 100	6,326					
100 and over	6,202					
Total	75,490	215	.3	8,620		680

Note: Details may not add to totals because of rounding.

TABLE 3.—EFFECT OF INCREASING THE CEILING ON THE STANDARD DEDUCTION FROM $1,000 TO $1,800 AFTER INCREASING THE STANDARD DEDUCTION FROM 10 TO 14 PERCENT AND INCREASING THE MINIMUM STANDARD DEDUCTION TO $600 PLUS $100 [1]

[Dollar amounts in millions and number of returns in thousands]

AGI (in thousands of dollars)	Present law tax	Tax decrease	Tax decrease as percent of present law tax	Number of returns with tax decrease	Number of returns made nontaxable	Number of returns shifting to standard deduction
0 to 3	$1,159					
3 to 5	3,177					
5 to 7	5,439					
7 to 10	13,925	$265	1.9	6,250	(2)	1,255
10 to 15	18,916	695	3.7	6,900	5	3,035
15 to 20	7,550	145	1.9	1,070		585
20 to 50	12,795	80	0.6	400		195
50 to 100	6,326	5	0.1	20		10
100 and over	6,202	1	(2)	2		1
Total	75,490	1,190	1.6	14,642	5	5,080

[1] The ceiling on the minimum standard deduction remains at $1,000.
[2] Less than one-tenth of 1 percent or less than 500 returns.

Note: Details may not add to totals because of rounding.

More than $200 million of tax relief from raising the 10 percent limitation to 14 percent would flow entirely to 8.6 million taxpayers in the $5,000 to $10,000 income group.

The extension of the maximum limits of the standard deduction would also result in substantial tax simplification. Almost 6 million individuals would shift to the simple standard deduction from the tedious task of keeping personal expenditure records and itemizing deductions. Most of this would be attributable to the higher dollar ceiling. See tables 2 and 3.

Tables 4 and 5 show for single persons and married persons (two children) respectively the tax relief accorded at selected income levels by the liberalization of the standard deduction and the minimum standard deduction.

TABLE 4.—TAX DECREASE FROM $600 PLUS $100 MINIMUM STANDARD DEDUCTION ($1,000 CEILING) AND 14 PERCENT STANDARD DEDUCTION ($1,800 CEILING), SINGLE INDIVIDUAL, WITH STANDARD DEDUCTION

Wage income	Present tax	Tax decrease	New tax	Percentage tax decrease	Tax decrease as a percent of income
$2,000	$161	$61	[1] $100	38	3.0
$3,000	329	70	[1] 259	21	2.3
$5,000	671	38	[2] 633	6	.8
$7,500	1,168	70	[3] 1,098	6	.9
$10,000	1,742	112	[3] 1,630	6	1.1
$12,500	2,478	240	[3] 2,238	10	1.9
$15,000	3,334	288	[3] 3,046	9	1.9
$20,000	5,350	348	[3] 5,002	7	1.7
$25,000	7,730	400	[3] 7,330	5	1.6
$35,000	12,980	440	[3] 12,540	3	1.3
$50,000	21,630	480	[3] 21,150	2	1.0

[1] Taxpayer elects the minimum standard deduction rather than the standard deduction.
[2] Taxpayer pays the same amount of tax with either the minimum standard or the standard deduction.
[3] Taxpayer elects the standard deduction rather than the minimum standard deduction.

TABLE 5.—TAX DECREASE FROM $600 PLUS $100 MINIMUM STANDARD DEDUCTION ($1,000 CEILING) AND 14 PERCENT STANDARD DEDUCTION ($1,800 CEILING), MARRIED COUPLE, 2 DEPENDENTS, WITH STANDARD DEDUCTION

Wage income	Present tax	Tax decrease (2)–(4)	New tax	Percentage tax decrease	Tax decrease as a percent of income
(1)	(2)	(3)	(4)	(5)	(6)
$2,000	0				
$3,000	0				
$5,000	$290	$60	$230	21	1.2
$7,500	686	56	630	8	.7
$10,000	1,114	76	1,038	7	.8
$12,500	1,622	165	1,457	10	1.3
$15,000	2,172	176	1,996	8	1.2
$20,000	3,428	218	3,210	6	1.1
$25,000	4,892	256	4,636	5	1.0
$35,000	8,504	312	8,192	4	.9
$50,000	15,360	400	14,960	3	.8

V–G. PROPOSED LIBERALIZATION OF THE STANDARD DEDUCTION

TECHNICAL EXPLANATION

Present law

Under present law section 63 of the Internal Revenue Code permits an individual taxpayer, as an alternative to itemizing his deductions, to elect to claim a standard deduction. This standard deduction, as defined in section 141 of the code, is equal to 10 percent of the taxpayer's adjusted gross income, subject to a $1,000 ceiling (or $500 for married individuals filing separate returns).

The proposal

Under this proposal section 141 of the code would be amended so that the standard deduction would be increased from 10 to 14 percent of the taxpayer's adjusted gross income. Section 141 would also be amended to increase the ceiling on the standard deduction from $1,000 to $1,800 (or $900 in the case of a married couple filing separate returns). Thus, the standard deduction for an individual would equal the lesser of 14 percent of his adjusted gross income or $1,800 (or $900 if he is married and filing separately).

Effective date

These changes in the standard deduction would become effective for taxable years beginning after December 31, 1969.

V-H-1. CHARITABLE CONTRIBUTION DEDUCTION—DEFECTS AND ABUSES

General Explanation

A. REPEAL OF TWO-YEAR CHARITABLE TRUST RULE

Present law

Under existing law a person may establish a trust to pay the income from his property to a charity for 2 years. The trust income thereby becomes excludable from his own tax base. The effect of this provision has been to permit wealthy individuals with substantial incomes from property to avoid the general provisions limiting the deductibility of charitable contributions to 30 percent of income. For example, the maximum deductible contribution that could be made each year by an individual who did not qualify for the unlimited deduction and who has $100,000 of dividend income (and no other income) would be $30,000. However, by transferring 60 percent of his stock to a trust with directions to pay the annual income ($60,000) to charity for 2 years and then return the property to him, the taxpayer excludes the $60,000 from his own income each year. This provision conflicts directly with the percentage limitations governing the deductibility of contributions applicable to the vast majority of taxpayers; moreover, taxpayers presently using this device would benefit from the proposed increases in deduction limits from 30 to 50 percent.

Proposal

To eliminate this avenue for avoidance of the general provisions limiting the deductibility of charitable contributions, it is recommended that the special 2-year charitable trust rule be repealed. As a result the grantor will be taxed in all cases on the trust income from the property in which a reversionary interest will or may be expected to take effect within 10 years.

B. CHARITABLE DEDUCTION FOR INCOME GIFTS WITH NON-CHARITABLE REMAINDER

Present law

Under existing law a grantor in a high tax bracket desiring to make a substantial gift to a friend or a member of his family may first transfer property to a trust to pay the income to a charity for a term of years, remainder to the intended ultimate beneficiary. Under existing law he would claim an income tax deduction for the value of the charitable interest and would also exclude from his gross income the income earned by the trust with the result that he would have used the occasion of a gift to improve his own after tax position.

For example, assume a taxpayer in the 70 percent bracket transferred property worth $100,000 currently earning interest at the rate of 5 percent to a trust for 2 years specifying that $5,000 be paid the charity each year, remainder to A. If he had retained the property for 2 years he would have received $10,000 in interest taxable at 70 percent for an after tax return of $3,000. On the other hand, by transferring the property to a trust he received a charitable deduction of $9.498.50 (the present value of the charitable interest.) The $10,000 received by the charity is not included in income and the deduction claimed reduces his tax on other income by $6,648.95. Thus, by postponing a planned noncharitable gift, taxpayer has both made a charitable contribution and increased his after tax cash position, receiving a "double benefit" for a single gift.

Proposal

To eliminate this unwarranted tax advantage it is recommended that the grantor be denied an income tax deduction for the value of a charitable income interest transferred in trust in circumstances where the income from the trust payable to charity is not taxed to the grantor.

However, under present law in all cases where a grantor retains a substantial reversionary interest he is denied a charitable deduction for his contribution. Accordingly, in order to achieve equality of treatment it is recommended that, in circumstances where the income from the trusts is taxed to the grantor, the taxpayer be permitted a charitable deduction notwithstanding the fact that he retains a substantial reversionary interest.

C. GIFTS OF ORDINARY INCOME PROPERTY

Present law

When property, the gain on which would be taxed at ordinary income rather than capital gain rates, is donated to a charity a severe distortion of tax liability may result. This is because under present law the ordinary income earned with respect to the property is not taxed if the property is given to charity. In some cases an individual can realize more after-tax income by donating ordinary income or short-term capital gain property (which is taxed at ordinary income rates) to charity than would be the case if the property had been sold for a profit.

For example, a married taxpayer filing a joint return with $95,000 of income, after allowing for deductions and personal exemptions, is in the 60 percent marginal tax bracket and would have an after-tax net income of $52,820. If this individual sells an asset worth $15,000 which would produce $12,000 of income taxable at ordinary income rates, his taxable income would be increased to $107,000 and, after payment of his tax, he would be left with $60,480 of after-tax income. On the other hand, by donating the asset to charity he pays no tax on the $12,000 income and also deducts the full $15,000 value of the gift from his other income thereby reducing his taxable income to $80,000. After payment of Federal income tax he would be left with $61,660. Thus, by donating the asset to charity rather than selling the asset the taxpayer made $1,180, the amount by which he improved his after-tax position. In effect the gift cost the taxpayer nothing and the Government paid him $1,180 for making the gift.

Proposal

To prevent this unwarranted tax benefit it is recommended that, in cases of this type, the amount of ordinary income or short-term capital gain which would have resulted if the property had been sold at fair market value be included in taxable income subject to a charitable contribution deduction equal to the fair market value of the property.

D. GIFTS OF THE USE OF PROPERTY

Present law

An individual may receive what is in effect a double benefit by granting to a charity the right to use property for a specified period. The donor excludes from income the amounts that would have been included in income had the property been rented to a non-charitable party and, in addition, the donor claims a charitable deduction for the fair rental value of the property.

For example, an individual owning a 10-story office building which is currently netting $1 million annually may donate use of one floor for a year to charity. His economic gift is, of course, only $100,000, the fair rental value of the space. However, for tax purposes he reports only $900,000 in income for the year and also claims the right to deduct the $100,000 rental value from his $900,000 of income. A deduction is claimed although the fair rental value of the property attributable thereto has not been included in income. Thus, the taxpayer is receiving a double benefit for a single gift.

Proposal

To correct this inequitable tax benefit it is proposed that no deduction be allowed for the contribution of the right to use property to a charity.

E. REPLACEMENT OF APPRECIATED SECURITIES

Present law

Under existing law even if an individual does not desire to dispose of certain appreciated properties it may still be advantageous to contribute such property to a charity and secure the same securities in the open market. This would permit the individual an income tax deduction for the value of the contributed property while permanently excluding the appreciation from his taxable income as well as acquiring a stepped-up basis in the newly purchased securities.

For example, assume a taxpayer in the 70 percent bracket holds $11,000 worth of stock which cost him $1,000. If he retains the stock until its market value is $15,000, upon its sale he realizes $14,000 income with a capital gains tax of $3,500. On the other hand, by transferring it to a charity he receives a charitable deduction of $11,000 while also excluding $10,000 of appreciation. This amounts to a present tax saving of $7,700 ($11,000 × 70 percent) to which the individual adds $3,300 in cash and purchases an equivalent amount of stock. He now has a basis for his stock of $11,000 rather than $1,000; when he later sells the stock for $15,000, his capital gain tax would be $1,000 instead of $3,500. The taxpayer reduces his tax liability to the extent of $10,200. Thus, by donating the asset to charity and simultaneously repurchasing it the taxpayer is able to make a contribution to charity at a nominal cost to himself, but which results in a substantial loss of taxes to the Government.

Proposal

It is therefore proposed that where a taxpayer contributes appreciated property to a charity and acquires substantially similar property within 90 days prior to or subsequent to the date of contribution, the basis of the property in the hands of the donor shall be the same as it was immediately prior to the contribution.

F. BARGAIN SALES

Present law

Under existing law a donor may unduly magnify the tax advantages already inherent in giving appreciated property to charity by selling the property to a charity for less than its fair value.

For example, an individual in the 50 percent tax bracket owning $125,000 worth of stock which cost him $25,000 may wish to make a $100,000 gift to charity. If he donates $100,000 of stock to charity he is entitled to a $100,000 deduction against other income and the net cost of his gift is $50,000 (50 percent of $100,000). He simply ignores the fact that a portion of the value of donated stock ($80,000) represents gain which has never been included in income. On the other hand, were he to follow the bargain sale method, he would sell $125,000 of stock to the charity for the cost basis of that amount of stock, $25,000. Under the present law the $25,000 sales proceeds would first be allocated to a return of his cost, or tax basis, and, since that basis is $25,000, there would be no tax. His gift to the charity would remain a $100,000 gift, and his deduction would remain a $100,000 deduction. However, by following this procedure, instead of being left with $25,000 of stock with a cost basis of $5,000 (which if he later sold would cost him $5,000 in tax thus leaving him $20,000 in cash) he has $25,000 in cash. Thus, his $100,000 gift to charity has permitted him to recover his investment in the property while at the same time securing a deduction for the appreciation in value without imposition of tax.

The rule permitting the nontaxable donation of appreciated property clearly should not be permitted to shield from tax what is essentially a functionally unrelated sale of an additional amount of stock. The taxpayer intends to benefit the charity only by the net amount of the gift. He should not be allowed to enlist the charity as a buyer of his stock to save him a tax liability.

Proposal

In such cases it is recommended that a contributor be required to allocate the basis of the property between the gift element and sale element on the basis of the fair market value of each part. If this rule were applied to the example above, since one-fifth of the total value of the stock is being sold, one-fifth of the taxpayer's basis in the stock would be allocated to the sale element of the transaction. Thus, he would be deemed to have a $5,000 basis in the stock sold to the charity for $25,000, and would be subject to tax on the resulting $20,000 gain. Under the proposal the individual would therefore be in precisely the same position he would have been in had he donated $100,000 worth of stock to charity and simultaneously sold $25,000 more on the open market.

G. CONTRIBUTION OF STOCK RIGHTS

Present law

Under existing law an individual can, in certain circumstances, obtain a double deduction for a single gift of stock rights to charity. Once, as a charitable deduction when the rights are donated, and again as a loss deduction when the stock which was purchased at a price that took into account the value of the rights is sold separate from the rights at a reduced price.

For example, a company listed on the New York Stock Exchange may have announced on January 1, that it will distribute stock rights on January 30, to shareholders of record as of January 15. An individual in the 60-percent marginal tax bracket purchases 100 shares of stock at $200 per share, or a total of $20,000, prior to January 15, knowing that after the rights are distributed the market will discount the shares so that each share will be worth $190 and each right worth $10. Between January 15 and January 30 (i.e., after the stock has gone ex-rights) the individual sells the stock for $190 per share and claims a short-term capital loss of $1,000. After January 30, when he receives the tax-free distribution of rights which have no cost basis he donates the rights to charity and claims a $1,000 charitable deduction. After taking into account the tax effects the individual actually makes an after-tax profit. Because he is in the 60-percent tax bracket the $1,000 deduction and the $1,000 loss produced a tax savings of $1,200, so his apparent $1,000 economic gift actually increased his after-tax income by $200 as a result of the double deduction he realized for his single economic gift.

Proposal

In these circumstances it is recommended that no deduction be allowed for the gift of stock rights unless the donor elects to allocate an appropriate portion of the basis of the underlying stock to the contributed stock rights.

H. SPLIT-INTEREST TRUSTS

Present law

An individual making a charitable contribution may either make a direct gift to the charity or may transfer property to a trust and require that either the income be paid to a charity for a period of years with the remainder or principal to go to private persons thereafter, or that the income be paid to private persons and the remainder to a charity. When property is transferred to a trust in which the charity has either an income or remainder interest, the contributor often claims current income tax deductions whose magnitude has little relation to the value of the benefit which the charity ultimately realizes. The problem arises because of the need to value the charity's interest at the time the trust is created. The interest is valued for these purposes by determining present values using actuarial life expectancy tables and an assumed interest rate. The amount so determined is currently deductible even though the charity may not receive the property until a later date and the amount it could ultimately receive may be subject to various contingencies including the possibility of manipulation by the donor or others to enhance the noncharitable interest.

For example, under existing law and regulations an income interest is valued on the basis of an assumed 3½-percent return on trust property. However, a donor transferring property to a trust to pay the income to charity for a period of years with the remainder to members of the donor's family may have the trustee invest the property in a manner designed to yield maximum capital appreciation without an annual income or income considerably less than 3½ percent. As a result, the trust property is being invested for the benefit of the donor's family and the charity may actually receive no income or income substantially less than the value that was assumed for purposes of computing the donor's deduction in the year the trust was created.

The same principle applies when the charity's interest is a remainder, rather than a right to present income; the trust corpus may be invested in high income, high-risk assets, to the detriment of the interest which finally passes to the charity, or it may be subject to other contingencies that will reduce the charity's ultimate interest.

Proposal

It is therefore recommended that a deduction for gifts in this form be limited to cases in which the donor complies with certain specific requirements which will insure that the charity will actually receive that portion of the property for which a deduction is allowed. These requirements would generally restrict the deduction to cases where the donor either specifies in dollar terms the annual payments to the party entitled to the income interest, or requires annual payments based on a stated percentage of the total value of the trust property each year. By restricting the deductions to gifts in this form, and denying a deduction where payment of the charitable interest is subject to a contingency, the proposal will tend to insure that there is a direct relationship between the deduction claimed and the charitable benefit involved.

1. *The annuity or unitrust format.*—No deduction would be allowed in connection with the charitable interest in the case of split-interest gifts unless the intervening interest (irrespective of whether it is the charitable or noncharitable interest) takes the form of a guaranteed annuity or the trust instrument adopts the so-called unitrust format and specifies that the intervening interest receive each year a fixed percentage of the current fair market value of the trust property (determined annually).

If the annuity format is used—irrespective of whether the charity has the annuity or remainder interest—the trustee would have no incentive to manipulate trust investments or misallocate deductions or receipts. In all events either income, or to the extent necessary, principal would be used to pay the annuity and sound business judgment would dictate that the trustee invest the property in the most profitable manner possible since neither interest could benefit from a different investment policy. However, while the annuity format provides the greatest assurance that the amount allowed as a charitable deduction would actually go to the charity, it may not be sufficiently flexible to achieve the objectives of all donors. For example, a donor retaining a life estate and donating the remainder to charity seeks a form of life interest that is not fixed in amount and could increase in the event of inflation or investment success. In such circumstances, the so-called unitrust format would appear to provide the desired flexibility while at the same time insuring that the charitable and noncharitable interest shared equally in the fortunes of the trust.

Under this provision a donor would be entitled to a present charitable deduction if the trust provided that the trust property was to be valued annually and a fixed percentage of the fair market value of the property held by the trust on each valuation date was to be distributed to the "income" beneficiary. In effect all income as received by the trust would be combined with principal in a single fund and, for purposes of determining the payout to the holder of the "income" interest, no distinction would be made between income and principal. The prime beneficiary would receive payments each year equal to a specified percentage of the market value of the fund as constituted on the valuation date. Thus, the amount the prime beneficiaries would receive from year to year would directly reflect the way the fund prospered. In this situation all incentive for the trustee to invest the property for the benefit of either the income or the remaindermen to the detriment of whichever was the noncharitable interest would be removed. Such a trust would make it possible for the trustee to pursue either a growth-oriented investment policy or an income-oriented investment policy or some combination of both with the assurance that neither investment policy could benefit one party to the detriment of the other.

2. *Charitable interests subject to contingencies.*—No deduction would be allowed if—

(*a*) The charity has only a contingent remainder interest in the trust (for example, a $5,000 annuity to A for life, remainder to his children or else to the charity if A has no children).

(*b*) The charity has a remainder interest and the trust permits invasion of the charitable share for the benefit of a noncharitable intervening interest which is incapable of reasonably certain actuarial valuation. (For example, a $5,000 annuity to A for life, remainder to a charity, but the trust provides that the trustee may pay A amounts in excess of $5,000 in order to maintain his standard of living.)

(*c*) The charity has an intervening income interest measured by the life of an individual. (For example, a $5,000 annuity to charity for the life of A, who has a terminal illness, remainder to B.)

In both case (*a*) and (*b*), the donor has indicated that the charitable interest is not his primary concern. In case (*a*), the charitable interest may be defeated completely. In case (*b*), the amount the charity will ultimately receive is rendered uncertain by the desire of the donor that the trustee use funds nominally committed to charity to pay the intervening interest unascertainable amounts thereby making the charitable interest incapable of evaluation. On the other hand, case (*c*) would appear to be a gimmick form of gift since the donor can render any actuarial form of valuation meaningless by consciously selecting a measuring life that is likely to be substantially shorter than actuarial tables would indicate.

3. *Maximum limitation of a deduction for charitable intervening interests.*—No deduction would be allowed in the case of annuity or unitrust gifts where the charity has the intervening interest in excess of 60 percent of the fair market value of the contributed property.

This limitation would prevent the "gamblers' trust" type of gift by insuring that there was an adequate financial cushion protecting the value of the charitable interest. For example, unless such a rule was imposed the donor could specify an annuity to the charity, remainder to the donor's family, and limit his contribution to the trust to the discounted amount necessary to fund the charity's interest only. Thus, the donor would be claiming a deduction for the entire amount transferred to the trust since actuarially this was the amount needed to fund the charity's interest. The actuarial value of the remainder interest would be zero. Such a donor would presumably be planning to invest in highly speculative property on the theory that, if the gamble was successful, the family would benefit; if it failed, the charity would lose but he would nevertheless have received a deduction for the full value of the "gambling stake." Accordingly, denying the deduction in such cases would tend to protect the charitable interest by providing a deterrent to such arrangements.

Effect of recommended changes

The changes recommended involve generally available abuse situations and it is impossible accurately to calculate the extent of their use. It is unlikely that the correction of these abuses will have a significant revenue effect. By the same token, the elimination of these "gimmick" type gifts will not adversely affect either the taxpaying public in general or the charitable organizations involved. However, the recommended changes will substantially improve the fairness of our tax system.

V-H-1. CHARITABLE CONTRIBUTION DEDUCTION—DEFECTS AND ABUSES

Technical Explanation

I. Charitable Income Trusts

A. THE TWO-YEAR CHARITABLE TRUST

Present law

Under section 673 of the Code a person creating a trust the income from which is payable to others is treated as the owner of the trust and taxable with respect to trust income if either the principal or the income may revert to him within 10 years after the transfer of property to the trust. A special exception contained in section 673 makes this rule inapplicable if the income is payable to a charity for a 2-year period. This provision conflicts directly with the percentage limitations governing the deductibility of contributions applicable to the vast majority of taxpayers.

For example, the maximum deductible contribution that could be made each year by an individual who did not qualify for the unlimited deduction and who has $100,000 of dividend income (and no other income) would be $30,000. However, by transferring 60 percent of his stock to a trust with directions to pay the annual income ($60,000) to charity for 2 years and then return the property to him, the taxpayer may presently exclude the $60,000 from his own income each year and thus circumvent the general provisions limiting deductible charitable contributions to 30 percent of adjusted gross income.

Proposal

It is proposed that the special 2-year charitable trust rule contained in section 673(b) be repealed.

B. CHARITABLE DEDUCTION FOR INCOME GIFTS WITH NON-CHARITABLE REMAINDERS

Present Law

Under existing law a grantor in a high tax bracket desiring to make a substantial gift to a friend or a member of his family may first transfer property to a trust to pay the income to a charity for a term of years, remainder to the intended ultimate beneficiary. Under existing law he would claim an income tax deduction for the value of the charitable interest and would also exclude from his gross income the income earned by the trust.

For example, assume a taxpayer in the 70 percent bracket transferred property worth $100,000 currently earning interest at the rate of 5 percent to a trust for 2 years specifying that $5,000 be paid the charity each year, remainder to *A*. If he had retained the property for 2 years he would have received $10,000 in interest taxable at 70 percent for an after-tax return of $3,000. On the other hand, by transferring the property to a trust he received a charitable deduction of $9,498.50 (the present value of the charitable interest). The $10,000 received by the charity is not included in income and the deduction claimed reduces his tax on income by $6,648.95.

Proposal

It is therefore proposed that the grantor be denied an income tax deduction for the value of charitable income interest transferred in trust in circumstances where the income from the trust payable to charity is not taxed to the garantor; i.e.,

(1) the grantor does not retain a reversionary interest; or

(2) the grantor retains a reversionary interest which will or may reasonably be expected to take effect in possession or enjoyment commencing after the expiration of 10 years from the date of the transfer.

However, in circumstances where the income from the trusts is taxed to the grantor, it is proposed that the taxpayer be permitted a charitable deduction notwithstanding the fact that he retains a subsantial reversionary interest. In this respect it should be noted that under present law a grantor that creates a trust to pay income to a charity is not permitted to deduct an amount representing the value of the charitable interest if he has a substantial reversion in the property. It is therefore recommended that this rule be amended in order to permit a deduction for the value of the charitable income interest transferred in trust, the interest of which will be or may be reasonably expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

Effective date

The repeal of the 2-year charitable trust exception and the denial of a deduction for charitable income trust gifts where the income has not been taxed to the grantor shall be applicable in cases of trusts created in taxable years beginning after December 31, 1969.

II. Gifts of Ordinary Income Property

Present law

Under present law, when property, which if retained or sold would have produced ordinary income (or short term capital gain), is given to a charity, there is no tax on the ordinary income earned with respect thereto; in addition, a charitable contribution deduction is allowed for the fair market value of the property.

For example, a married taxpayer filing a joint return with $95,000 of income after allowing for deductions and personal exemptions, is in the 60 percent marginal tax bracket and would have an after-tax net income of $52,820. If this individual sells an asset valued at $15,000 which would produce $12,000 of income taxable at ordinary income rate, his taxable income would be increased to $107,000 and, after payment of his tax, he would be left with $60,480 of after-tax income. On the other hand, by donating the asset to charity he pays no tax on the $12,000 income and also deducts the full $15,000 value of the gift from his other income thereby reducing his taxable income to $80,000. After payment of Federal income tax he would be left with $61,660. Thus, under present law by donating the asset to charity rather than selling the asset, the taxpayer makes $1,180, the amount by which he improved his after-tax position.

Proposal

It is proposed that section 170 be amended to provide that, in the case of a gift of property which, if retained or sold would have produced ordinary income or short term capital gain, the amount of ordinary income or short-term gain involved be included in taxable income subject to a deduction equal to the fair market value of the property. Under this proposal, the taxpayer in the example would include the $12,000 in income subject to a charitable contribution deduction of $15,000.

Effective date

The ordinary income proposals would apply to gifts made in the taxable year beginning after December 31, 1969.

III. Gifts of the Use of Property

Present law

Under existing law a taxpayer, by granting to a charity the right to use property for a specified period, may exclude from income the amounts that would have been included in income had the property been rented to a noncharitable party; in addition, the donor claims a charitable deduction for the fair rental value of the property.

For example, an individual owning a 10 story office building which is currently netting $1 million annually may donate use of one floor for a year to a charity. His economic gift is, of course, $100,000, the fair rental value of the space. However, for tax purposes he reports only

$900,000 in income for the year and also claims the right to deduct the $100,000 rental value from his $900,000 of income. A deduction is claimed although the fair rental value of the property attributable thereto has not been included in income.

Proposal

It is proposed that no deduction be allowed for the contribution of the right to use property to a charity.

Effective date

The use of property proposal would apply to gifts made in any taxable year beginning after December 31, 1969.

IV. Replacement of Appreciated Securities

Present law

Under existing law even if an individual does not desire to dispose of certain appreciated properties it may still be advantageous to contribute such property to a charity and secure the same securities in the open market. This would permit the individual an income tax deduction for the value of the contributed property while permanently excluding the appreciation from his taxable income as well as acquiring a stepped-up basis in the newly purchased securities.

For example, assume a taxpayer in the 70 percent bracket holds $11,000 worth of stock which cost him $1,000. If he retained the stock until its market value was $15,000, upon its sale he would have realized $14,000 income with capital gains tax of $3,500. On the other hand, by transferring it to a charity he receives a charitable deduction of $11,000 while also excluding $10,000 of appreciation. This amounts to a present tax saving of $7,700 ($11,000 x 70%) to which the individual adds $3,300 in cash and purchases an equivalent amount of stock. He now has a basis for his stock of $11,000 rather than $1,000; when he later sells the stock for $15,000, his capital gain tax would be $1,000 instead of $3,500. The taxpayer reduces his tax liability to the extent of $10,200.

Proposal

It is therefore proposed that where a taxpayer contributes appreciated property to a charity and acquires substantially similar property within 90 days prior to or subsequent to the date of contribution, the basis of the property in the hands of the donor shall be the same as it was immediately prior to the contribution.

Effective date

The replacement of appreciated securities proposal would apply to sales made after December 31, 1969.

V. Bargain Sales

Present law

Under existing law it may be advantageous for a donor, rather than simply giving property to a charity, to sell the property to charity for less than its fair market value. Independent of tax considerations, the result is the same since the taxpayer intends to benefit the charity only by the net amount of the gift.

For example, an individual in the 50-percent tax bracket owning $125,000 worth of stock which cost him $25,000 may wish to make a $100,000 gift to charity. If he donates $100,000 of stock to charity he is entitled to a $100,000 deduction against other income and the net cost of his gift is $50,000 (50 percent of $100,000). He simply ignores the fact that a portion of the value of donated stock ($80,000) represents gain which has never been included in income. On the other hand, were he to follow the bargain sale method, he would sell $125,000 of stock to the charity for the cost basis of that amount of stock, $25,000. Under the present law, the $25,000 sales proceeds would first be allocated to a return of his cost basis, and, since that basis is $25,000, there would be no tax. His gift to the charity would remain a $100,000 gift, and his deduction would remain a $100,000 deduction. However, by following this procedure, instead of being left with $25,000 of stock with a cost basis of $5,000 (which if he later sold would cost him $5,000 in tax, thus leaving him $20,000 in cash) he has $25,000 in cash.

Proposal

It is therefore proposed that section 1001 of the code (dealing with the determination of gain or loss) be amended to provide that in any case where property is sold for less than its fair market value that gain from the transaction is to be determined by allocating the basis of the property between the gift element and sale element in accordance with the fair market value of each part. If this rule were applied to the example above, since one-fifth of the total value of the stock is being sold, one-fifth of the taxpayers' basis in the stock would be allocated to the sale element of the transaction. Thus, he would be deemed to have a $5,000 basis in the stock sold to the charity for $25,000 and would be subject to tax on the resulting $20,000 gain. Under the proposal, the individual would therefore be in precisely the same position he would have been in had he donated $100,000 worth of stock to charity and simultaneously sold $25,000 more on the open market.

Effective date

The bargain sale proposal would apply to sales made after December 31, 1969.

VI. Contribution of Stock Rights

Present law

Under existing law, an individual can, in certain circumstances, obtain a double deduction for a single gift of stock rights to charity. Once, as a charitable deduction when the rights are donated, and again as a loss deduction when the stock which was purchased at a price that took into account the value of the rights is sold separate from the rights at a reduced price.

For example, a company listed on the New York Stock Exchange may have announced on January 1 that it will distribute stock rights on January 30 to shareholders of record as of January 15. An individual in the 60-percent marginal tax bracket purchases 100 shares of stock at $200 per share, or a total of $20,000, prior to January 15, knowing that after the rights are distributed the market will discount the shares to reflect dilution in the equity interest of each share so that each share will be worth $190 and each right worth $10. Between

January 15 and January 30 (i.e., after the stock has gone ex-rights) the individual sells the stock for $190 per share and claims a short-term capital loss of $1,000. After January 30, when he receives the tax-free distribution of rights which have no cost basis he donates the rights to charity and claims a $1,000 charitable deduction. Before taking into account the tax effects the individual would appear to be out of pocket $1,000. However, after taking into account the tax effects the individual actually makes an after-tax profit. Because he is in the 60-percent tax bracket, the $1,000 deduction and the $1,000 loss produced a tax savings of $1,200, so his apparent $1,000 economic gift actually increased his after-tax income by $200 as a result of the double deduction he realized for his single economic gift.

Proposal

In these circumstances it is proposed that section 170 be amended to provide that no deduction be allowed for the gift of stock rights unless the donor elects to allocate an appropriate portion of the basis of the underlying stock to the contributed stock rights.

Effective date

The allocation proposal in connection with a gift of stock rights would apply to gifts made after December 31, 1969.

VII. Gifts in Trust Involving Charitable and Noncharitable Interests

Present law

Under existing law, a donor contributing property to a trust in which a charitable organization has either an income interest or a remainder interest may, in certain circumstances, be entitled to an income tax deduction equal to the present value of the charitable interest.

For example, a donor may contribute property to a trust requiring the payment of income to a charity for 10 years and the remainder to the donor's family. Under present law, the amount of the allowable deduction would be determined on the assumption that the trust will earn 3½ percent a year which will be paid to charity and that the present value of such periodic payments may be determined by discounting the anticipated payments at 3½ percent. In fact, however, the trustee may invest the property in the common stock of corporations pursuing a policy of retaining earnings rather than distributing dividends so that the periodic payments to the charity are far less than the 3½-percent return assumed. Furthermore, the charitable interest may be subject to various contingencies that may result in the charity receiving substantially less than the amount estimated or, in some cases, nothing at all.

Proposals

It is recommended that the rules governing the income, estate and gift tax deductions for such split interest gifts be revised so as to deny deductions in cases presenting a substantial potential for favoring the noncharitable interest to the detriment of the charitable interest. In addition, it is recommended that no deduction be allowed in any case in which the charitable interest is subject to a contingency that is incapable of reasonably certain actuarial valuation.

1. THE ALLOWANCE OF A DEDUCTION TO THE DONOR

(*a*) *The annuity or unitrust format.*—No deduction would be allowed in connection with the charitable interest in the case of split interest gifts unless the intervening interest (irrespective of whether it is the charitable or noncharitable interest) takes the form of a guaranteed annuity or the trust instrument adopts the so-called unitrust format and specifies that the intervening interest receive each year a fixed percentage of the current fair market value of the trust property (determined annually).

Under this provision, a donor would be entitled to a present charitable deduction if the trust provided that the trust property was to be valued annually and a fixed percentage of the fair market value of the property held by the trust on each valuation date was to be distributed to the "income" beneficiary. In effect, all income as received by the trust would be combined with principal in a single fund and, for purposes of determining the payout to the holder of the "income" interest, no distinction would be made between income and principal. The prime beneficiary would receive payments each year equal to a specified percentage of the market value of the fund as constituted on the valuation date. Thus, the amount the prime beneficiaries would receive from year to year would directly reflect the way the fund prospered. Such a trust would make it possible for the trustee to pursue either a growth-oriented investment policy or an income-oriented investment policy or some combination of both with the assurance that neither investment policy could benefit one party to the detriment of the other.

(*b*) *Charitable interests subject to contingencies.*—No deduction would be allowed if—

(1) the charity has only a contingent remainder interest in the trust (for example, a $5,000 annuity to A for life, remainder to his children or else to the charity if A has no children).

(2) the charity has a remainder interest and the trust permits invasion of the charitable share for the benefit of a noncharitable intervening interest which is incapable of reasonably certain actuarial valuation. (For example, a $5,000 annuity to A for life, remainder to a charity, but the trust provides that the trustee may pay A amounts in excess of $5,000 in order to maintain his standard of living.)

(3) the charity has an intervening income interest measured by the life of an individual. (For example, a $5,000 annuity to charity for the life of A, who has a terminal illness, remainder to B.)

(*c*) *Maximum limitation of a deduction for charitable intervening interests.*—No deduction would be allowed in the case of annuity or unitrust gifts, where the charity has the intervening interest, in excess of 60 percent of the fair market value of the contributed property.

This limitation would insure that there was an adequate financial cushion protecting the value of the charitable interest. Under present law, the donor can specify an annuity to the charity, remainder to the donor's family, and limit his contribution to the trust to the discounted amount necessary to fund the charity's interest only. Thus, the donor may claim a deduction for the entire amount transferred to the trust since actuarially this was the amount needed to fund the charity's interest. The actuarial value of the remainder interest would be zero. Such a donor would presumably invest in highly speculative property on the theory that, if the gamble was successful, the family would benefit; if it failed the charity would lose but he would nevertheless have received a charitable deduction for the full amount of the contribution. Accordingly, denying the deduction in cases where the charity has an intervening interest in excess of 60 percent of the amount transferred to the trust would tend to protect the charitable interest.

2. THE VALUATION OF THE DONOR'S CHARITABLE GIFT

The amount of the donor's charitable contribution deduction is determed by allocating the contribution between the charitable and noncharitable interests. The fact that in addition to producing income the trust principal may appreciate or depreciate in value is irrelevant. Both the annuity format and the unitrust format may be discounted according to standard assumptions in determining the portion of the property transferred that represents the present value of the charitable interest.

For example, a donor makes a completed gift of $100,000 to the trust; with a 3½-percent discount rate, a $5,000 annuity for life, remainder to charity would be valued by determining A's life expectancy and discounting the annual $5,000 payments by 3½ percent. This amount, when subtracted from the total value of property transferred would indicate the present value of the charitable remainder. If, on the other hand, the trust utilized the unitrust format specifying a payout of 5 percent of the fair market value of the trust property each year, A's interest would be determined (as was the value of A's annuity) on the assumption that each year the trust will earn 3½ percent on the existing fund and will therefore be distributing principal to the extent of 1½ percent each year (a declining balance calculation). The fact that under the unitrust format A may actually receive more or less than $5,000 each year depending on the success of the investment is irrelevant in determining his relative interest in the given amount ($100,000) that must be allocated between A's interest and the charitable interest.

3. THE TAX TREATMENT OF THE NONCHARITABLE INTERVENING INTEREST

Under the annuity and unitrust concept the amount paid the noncharitable beneficiary would retain the character it had in the hands of the trust; except that each payment would be treated as having been made, first out of ordinary income to the extent thereof, then out of capital gain and then out of principal. Thus, for example, assume A has a 5 percent interest in a trust of $100,000 created on January 1, and that during the first year the trust receives $5,000 in dividends which are reinvested and as of the end of the year the total value of the trust property is $125,000. The amount due A is $6,250. In order to pay A, the amount due to the trustee sells a block of stock for $5,000 that had a cost basis of $5,000 and a second block of stock for $1,250 that has a cost basis of $1,000 thus producing a gain of $250. Accordingly, of the $6,250 received, $5,000 would be treated as having been paid out of ordinary income taxable at ordinary income rates, $250 would be taxed at capital-gain rates, and the remaining $1,000 would be treated as a nontaxable capital distribution.

For future years in determining the extent of ordinary income and capital gain the trust would be required to carry over all ordinary income and capital gain realized but not treated as having been distributed to A. For example, in year 2 the value of the trust on January 1 was $118,750 ($125,000 less than $6,250 distributed). Assume that during the year the trust received $7,000 in dividends which were reinvested and as of the end of the year the total value of the trust was $130,000. A's payment would be $6,500. In order to make the payment the trustee sells a block of stock for $6,500 with a cost basis of $5,000. The entire payment to A would be treated as ordinary income. In addition, the trust would carry over $500 of undistributed ordinary income ($7,000 less $6,500) and $1,500 of undistributed capital gain. Initial value in year 3 would be $123,000. If we assume that the trust received no dividends in year 3 and the trust property did not appreciate in value, A's payment would be $5,175 (5 percent of $123,000). If the trustee sold stock worth $5,175 with a cost basis of $5,175 to make the payment, A would be taxed as having received $500 of ordinary income, $1,500 of capital gain, and $3,175 would be a nontaxable capital distribution.

Capital losses realized by the trust would be used to offset distributable capital gain income, including any capital gain being carried forward. Ordinary losses would reduce the amount of distributable ordinary income including any amount carried forward.

4. THE TAX TREATMENT OF THE TRUST

In the case of a charitable remainder unitrust the trust would not be taxed. Undistributed ordinary income and capital gain would be considered allocated to the charitable remainder subject to the unlimited carryforward of such income characteristics for determining the status of distributions in a noncharitable beneficiary's hands.

In the case of a charitable intervening interest undistributed ordinary income would be taxed subject to an unlimited carryback adjustment permitting the tax paid to be recouped to the extent that previously undistributed income and capital gain is subsequently treated as having been distributed to the charity under the allocation and carryforward rules.

5. THE ANNUAL VALUATION OF THE TRUST ASSETS

In the case of assets with no objective ascertainable market value such as real estate, or stock in a closely held corporation, it is proposed that the contribution deduction be denied unless an independent trustee is the sole party responsible for making the annual determination of value.

Effective date.—In order to permit adequate adjustment to the new rules it is recommended that the proposal apply to *inter vivos* transfers made in taxable years beginning after the enactment, and, in the case of testamentary trusts, to transfers made in taxable years beginning after the third year following enactment.

V-H-2. PROPOSED STRUCTURAL REVISION OF THE CHARITABLE CONTRIBUTION DEDUCTION

General Explanation

PRESENT LAW

Under existing law taxable income is computed by subtracting a taxpayer's allowable deductions and personal exemptions from adjusted gross income. As an alternative to itemizing his deductions separately, a taxpayer may elect to use the standard deduction. The standard deduction permits a taxpayer to deduct a specified percentage of his income (or a minimum dollar amount) subject to a maximum dollar limitation without separately listing each deductible item. A taxpayer who finds it advantageous to use the standard deduction may not separately deduct his charitable contributions. A taxpayer who itemizes his deductions may deduct all charitable gifts subject to a general limitation that the allowable deduction may not exceed 30 percent of adjusted gross income, (20 percent in the case of gifts to certain types of charitable institutions).

PROPOSAL

Under the proposal all taxpayers—even those who elect to claim the increased standard deduction that is recommended in a separate proposal—would be entitled to separately deduct their charitable contributions. However, as a necessary corollary to increasing the standard deduction and making charitable contributions deductible independent of the standard deduction, the charitable deduction would be restricted to the amount by which contributions exceed 3 percent of taxpayer's adjusted gross income. In addition, the 30-percent limitation on deductible contributions would be increased to 50 percent of an amount equal to his adjusted gross income plus the exempt income items (in excess of $5,000) which are taken into account under the allocation of deductions and minimum tax proposals.

REASONS FOR THE PROPOSAL

The vital role that charitable organizations fulfill in our society is recognized by the provisions of existing law which exempt such organizations from Federal income tax. The provisions allowing private persons to deduct contributions to certain tax-exempt organizations also reflect the Federal Government's commitment to private charity and are principally justified as an incentive for charitable giving.

Under existing law persons who find it advantageous to use the standard deduction may not deduct their charitable contributions. The standard deduction is one of the most important and desirable features of our tax system combining both tax simplification and tax equity. Most taxpayers now use the standard deduction. (In the absence of any tax reform proposals approximately 57 percent of the total returns to be filed in 1969 will claim the standard deduction.) Since persons in this category are not entitled to separately deduct charitable contributions, the charitable deduction provisions of existing law do not function as an incentive for charitable giving for this group. In addition, because of the importance of the standard deduction to our tax system, a substantial increase in the standard deduction has been proposed. It is estimated that as a consequence of this and other reform proposals approximately 80 percent of all persons filing tax returns in 1969 will use the standard deduction. Accordingly, in order to preserve and strengthen the charitable contribution deduction as an incentive for donations among a broadly based segment of taxpayers, it is recommended that the charitable contribution deduction be allowed independently of the standard deduction.

In order to achieve the objectives of the proposals relating to the increased standard deduction and the charitable contribution deduction outside of the standard deduction (COSD), the charitable contribution deduction must be made inapplicable to routine gifts. Only in this manner can the simplification and tax equity objectives of the increased standard deduction be harmonized with the preservation of the charitable contribution deduction as an incentive for charitable giving. Moreover, since persons making only routine contributions each year are generally uninfluenced by tax considerations, the recommendation that the charitable contribution deduction be limited to amounts in excess of 3 percent of a taxpayer's adjusted gross income is unlikely to have any significant effect on the total flow of contributions to charitable organizations. In addition, if such a limitation were not imposed, the revenue loss that would result from allowing the deduction of routine contributions would make it impractical to permit charitable deductions independent of the increased standard deduction.

The increased standard deduction proposal in conjunction with the proposal allowing all taxpayers to deduct charitable contributions subject to a 3-percent threshold would vastly simplify our tax system. The need for maintaining detailed records to substantiate deductions for routine contributions would be eliminated. The 3-percent threshold also is necessary to avoid the intolerable administrative burden that would otherwise be imposed upon the Internal Revenue Service if all charitable contributions were deductible, regardless of amount, and subject to examination.

Allowing all persons to deduct contributions subject to a general 3-percent threshold will also do much to alleviate the structural inequities in the charitable contribution area which presently prevent the deduction from functioning efficiently as an incentive for charitable giving. Present law provides no incentive for above average gifts in the case of persons who have few noncharitable deductions and, therefore, use the standard deduction; and, of course, this will become more marked when the recommended increases in the standard deduction become effective. At the same time, present law permits persons who have large noncharitable deductions to deduct nominal gifts which would have been made under any circumstances. The proposal would correct this situation by limiting the tax benefit to persons making routine gifts and providing an incentive that does not presently exist for persons using the standard deduction—including those persons who will use the proposed increased standard deduction—to make above average contributions.

The remaining structural proposal would increase the ceiling on deductible contributions from 30 percent of adjusted gross income to 50 percent of an amount equal to adjusted gross income plus excluded items (in excess of $5,000) which are taken into account in the allocation of deductions and minimum tax proposals. This will permit larger deductions for contributions by taxpayers in the upper income ranges where the incentive effect of the charitable deduction is strongest.

EFFECT OF THE PROPOSAL

In the absence of these reform proposals, approximately 57 percent of all persons filing returns use the standard deduction and could not separately deduct their charitable contributions. Under this program it is estimated that 80 percent of all persons filing returns will use the new, increased standard deduction, as follows:

(1) Taxpayers who presently use the standard deduction, but nevertheless contribute more than routine amounts to charity. The effect of allowing charitable deductions in excess of 3 percent in addition to the standard deduction will constitute a benefit. This group will involve about 11 million returns which will receive a tax saving of about $118 million.

(2) Taxpayers who presently itemize their deductions but (including charitable deductions in excess of 3 percent of AGI) will shift to the standard deduction as a result of the recommended increase in the rate and ceiling of the standard deduction. This group will involve about 6 million taxpayers who will have a tax saving of $206 million.

(3) Taxpayers with large charitable contributions and modest noncharitable deductions who will switch to the standard deduction because the increased standard deduction is greater than their noncharitable deduction. This group which will be composed of 2 million taxpayers who will save $116 million since the effect of a 3-percent threshold will be partially or totally offset by their ability to use the proposed new standard deduction.

Table 1 indicates the revenue effects of both the 3 percent threshold and the COSD proposal by income level, after taking into account the proposed changes in the standard deduction, the minimum standard deduction, and after the disallowance of the gasoline tax deduction. The former provision increases revenue about $1.5 billion; the latter produces a loss in revenue of about $440 million. The effect of increasing the ceiling to 50 percent of the expanded income base is a revenue loss of approximately $20 million. Thus, the combined effect of all three provisions is a revenue increase of about $1 billion.

NUMBER OF RETURNS WITH CHARITABLE DEDUCTIONS

Under the overall reform program the number of returns claiming itemized deductions would be cut approximately in half (from 34 million to 16 million). Accordingly, of the present law itemizers taking the contribution deduction, about one-fourth would continue to itemize and to deduct contributions over the 3 percent threshold. Another fourth will continue to deduct contributions over 3 percent of AGI, but will no longer itemize other deductions. In addition, 11 million claiming the standard deduction under present law will also deduct charitable contributions in excess of the 3 percent floor under the program. Thus, the overall number of returns with a contribution deduction would not materially change; in 1969 it would be close to 26 million returns—including 18 million returns under COSD—compared to about 32 million estimated for that year under present law.

THE 3-PERCENT DEDUCTION THRESHOLD

Among 27 million persons who claimed itemized deductions including a charitable deduction in 1966, 78 percent of the total contributions were made by approximately 13 million people whose contributions were over 3 percent of their AGI. It is important to recognize that for these contributors the marginal contribution will be as valuable in terms of tax savings as it is now, despite the threshold provision. If a taxpayer has already contributed 3 percent of his AGI, the tax savings involved in an additional $100 contribution is unchanged whether or not the first part of his contribution is deductible. In other words, the price of giving at the margin (which is relevant to taxpayers' decisions to increase or decrease contributions) is unaffected by the imposition of a deduction threshold. Table 2 provides some detail material on the patterns of contributions in relation to AGI.

THE EFFECT OF THE PROGRAM ON CHARITABLE CONTRIBUTIONS

THE 50-PERCENT DEDUCTION LIMIT

The increase in the upper limitation on the charitable contribution deduction from 30 percent of adjusted gross income to 50 percent of the expanded income base will benefit those who presently donate substantial portions of their income to charity. These are principally upper-middle and upper income taxpayers for whom the deduction incentive is strong.

The history of special benefits in the income tax law has been dominated by considerations of the sort: "This incentive may do some good; we don't know for sure. Let's put it in the law anyway." A provision of this sort is thereafter strongly defended on the grounds that taking it out may eliminate the hypothetical benefit.

A serious effort to improve the tax law requires a hard look at evidence to reach some judgment on just what the effect is and whether it is worth the burden that this imposes on the rest of society.

This discussion undertakes to provide some analysis of how much difference might be made in contributions to charity as a result of the reform program. It will be convenient here to put the various parts together in one place by including a discussion of the effects of other provisions besides the 3 percent threshold, COSD, and the 50 percent upper limit. Table 3 provides some summary estimates of the possible impact of the complete program on charitable contributions.

A preliminary explanation is called for: A particular tax provision can affect the contributions of an individual in two ways.

1. *Income effect.*—If a tax provision increases or decreases income after tax, the provision should bring about a corresponding change in the individual's various uses of disposal income, including charitable contributions. What we need to know to estimate this effect is the portion of after-tax income which is allocated to contributions. In general, we can estimate this to average 4 percent for all itemizers, 3 percent for nonitemizers, and 7 percent for all high incomes. Further, we can estimate that these relationships tend to remain constant for moderate changes in after-tax income.

2. *Price effect.*—Some tax changes affect not only the after-tax income of an individual but also the cost to him of putting a dollar at the disposal of charity. The individual may respond to this in various ways. He could incur more cost and give the charity just as much; he could decide to incur the same cost as he did before and let the charity get along with a smaller contribution; or he could assume some compromise position between these two extremes. Several economists who have addressed this problem have found little evidence that changing the tax value of contributions has a noticeable effect on contributions. Fund raisers, on the other hand, persist in giving considerable emphasis to deductibility in their fund appeals.

For the present discussion we can suggest a range of possible effects. At the one end it seems too extreme to assert that when the tax advantage of a contribution is reduced contributors will maintain the same net cost of the contribution. Logically this is equivalent to asserting that every dollar of tax saving from the contribution deduction goes to increasing the contribution, and this is not consistent with the evidence.

NONECONOMIC INFLUENCES ON CHARITABLE GIVING

In addition to the economic motivations for charitable giving, the American Association of Fund-Raising Counsel recognizes many noneconomic incentives for giving. These include responses to social awareness, generosity, social pressure, pity, and habit. To the extent that the noneconomic factors influence charitable giving patterns, changes in the tax treatment of charitable donations have little repercussion on the level of contributions.

Since these noneconomic motivations are largely nonquantifiable, the importance of the economic incentive is difficult to distinguish from that of the noneconomic incentive. There is reason to believe, however, that noneconomic motivations have considerable influence on the level of giving. This is substantiated by the fact that studies relating variations in charitable contributions to changes in both the tax treatment and the incomes of contributors have been successful in explaining scarcely half of the observed variation in contributions.

The estimated $20 million income effect shown on table 3 is relatively small because in the aggregate the program is balanced and will leave income after tax unchanged. Some small net effect is possible because there is some shift in burden from low incomes to high incomes.

It is likely that the price effect will appear principally among people who now contribute less than 3 percent because, for larger contributors, the price of putting an additional dollar at the disposal of charity is not changed. About 40 percent of the revenue comes from this former group, and if they reduce their contribution by half of the increased tax their contributions would fall by $300 million. In this income area, contributions are most often associated with noneconomic incentives, for example, social pressures of community chest campaigns at the place of work, so this rate of decline would appear unrealistically high. The high estimate figure is only plausible if some price effect is attributed to people whose contributions are now a little over 3 percent.

Under the allocation of deductions proposal, about 40 percent of the allocated deductions will be contributions. Half of the contribution share of the revenue effect of allocation would be $80 million, which is increased in the high estimate to take account of the fact that some contributions of appreciated property will have the effect of causing more loss of deduction through allocation.

The price effect on foundations is a calculation of the additional contributions that some foundations would have to make to comply with the minimum distribution rule.

The COSD effect is related to the deduction allowed present standard deductors. (The remainder of the COSD offsets the effect of the increased standard deduction.)

The increase in the contributions limit from 30 percent of adjusted gross income to 50 percent of an expanded income base has an effect on giving of about the same magnitude as does the removal of the unlimited contribution deduction. They roughly balance each other.

The other effects will be small. The minimum tax will tend to provide a stimulus to contributions, especially for taxpayers who presently pay only the alternative capital gains tax and, thus, have no advantage from charitable contributions at this time. There will be some deterrent working through the contribution of appreciated property. The maximum tax should slightly increase the net cost of contributions by lowering the marginal tax rates for some taxpayers.

This implication of table 3 is that the program could on balance reduce contributions by an amount ranging between $100 and $300 million. To put this in context, it is important to recognize that the aggregate of contributions is in the neighborhood of $15 billion, and increasing from growth in the income of contributors by about $1 billion a year. The tax reform program might reduce this annual rate of growth in 1 year from about 6 to 5⅓ or to 4 percent. (By comparison, this growth rate would be affected more drastically by 1 year of recession.) After the year in which the tax law was changed, the normal growth should resume.

TABLE 1.—REVENUE EFFECT OF 3 PERCENT THRESHOLD IN CONTRIBUTIONS DEDUCTION AND COSD

	Revenue change			
	3 percent floor		COSD	
AGI class (in thousands of dollars)	Dollar in millions	Percent of total tax	Dollar in millions	Percent of total tax
0 to 3	2	0.2	−15	−1.3
3 to 5	15	0.5	−35	−1.1
5 to 7	65	1.2	−55	−1.0
7 to 10	205	1.5	−105	−0.8
10 to 15	270	1.9	−135	−0.7
15 to 20	155	2.1	−50	−0.7
20 to 50	370	2.9	−40	−0.3
50 to 100	205	3.2	−5	−0.1
100 to 500	142	3.0	(1)	(1)
500 to 1,000	20	3.1	(1)	(1)
1,000 and over	23	2.6	(1)	(1)
Total	+1,470	+1.9	−440	−0.

TABLE 2.—CHARITABLE CONTRIBUTION DEDUCTIONS (BASED ON STATISTICS OF INCOME FOR 1966)

AGI class (in thousands of dollars)	Returns with contribution deductions	Returns with contributions in relation to AGI			
		0 to 1 percent	1 to 2 percent	2 to 3 percent	Over 3 percent
Total	27,005,815	2,251,425	6,086,863	5,822,502	12,845,025
Below 5	5,000,953	224,396	691,586	747,446	3,337,525
5 to 10	12,047,691	1,089,259	2,772,195	2,629,404	5,556,833
10 to 20	8,238,297	770,687	2,145,664	2,046,664	3,275,282
20 to 50	1,458,717	133,523	404,542	349,269	571,383
50 to 100	208,511	25,000	60,682	42,458	80,371
100 to 500	49,468	7,978	11,915	7,131	22,444
500 to 1,000	1,550	398	210	105	837
1,000 and up	628	184	69	25	350

AGI class (in thousands of dollars)	Amount of contribution deductions	Contributions on returns with contributions as percent of AGI (in thousands)				Contributions over 3 percent as percent of all contributions
		0 to 1 percent	1 to 2 percent	2 to 3 percent	Over 3 percent	
Total	$9,122,491	$75,033	$700,521	$1,260,398	$7,086,539	77.7
Below 5	861,497	2,371	25,519	54,988	778,619	90.4
5 to 10	2,835,668	23,206	212,622	399,993	2,199,847	77.6
10 to 20	2,947,265	29,167	285,544	533,528	2,099,026	71.2
20 to 50	1,195,977	11,112	117,706	194,422	872,737	73.0
50 to 100	473,411	4,653	39,255	54,352	375,151	79.2
100 to 500	489,646	3,438	17,357	20,767	448,084	91.5
500 to 1,000	106,955	524	1,278	1,363	103,790	97.0
1,000 and up	212,074	562	1,240	985	209,287	98.7

TABLE 3.—ESTIMATES OF THE EFFECT OF THE PROGRAM ON CONTRIBUTIONS

[Millions of dollars]

	High estimate	Low estimate
1. Income effects	−20	−20
2. Price effects:		
3 percent threshold	−300	−100
COSD	+60	+20
Minimum tax	−20	−20
Maximum tax	−15	−10
Allocation of deductions	−100	−40
30 percent limit increase to 50 percent and repeal of ULCD	0	0
Foundations	+100	+100
3. Total (rounded)	−300	−100

V-H-2. PROPOSED STRUCTURAL REVISION OF THE CHARITABLE CONTRIBUTION DEDUCTION

TECHNICAL EXPLANATION

I. DEDUCTION OF CHARITABLE CONTRIBUTIONS INDEPENDENT OF THE STANDARD DEDUCTION AND THE 3-PERCENT THRESHOLD

Present law

Under existing law taxable income is computed by subtracting a taxpayer's allowable deductions and personal exemptions from adjusted gross income. As an alternative to itemizing his deductions separately, a taxpayer may elect to use the standard deduction. A taxpayer who elects to use the standard deduction may not separately deduct charitable contributions, medical expenses, interest, taxes, and other similar items that are allowable as deductions from adjusted gross income.

Proposal

It is proposed that the charitable contribution deduction be allowed independent of the standard deduction. Thus, all taxpayers, including those claiming the standard deduction will be able to separately deduct their charitable contributions. A necessary corollary of this proposal is that the contribution deduction be limited to the amount by which qualifying charitable contributions for the taxable year exceed 3 percent of the taxpayer's adjusted gross income. Accordingly, no deduction would be allowed for taxpayers making only routine gifts.

Under the proposal an individual using the standard deduction would compute taxable income by deducting from adjusted gross income the allowable (1) personal exemptions, (2) standard deduction or minimum standard deduction, and (3) charitable contributions in excess of 3 percent of adjusted gross income.

An individual electing to itemize his deductions would compute taxable income by deducting from adjusted gross income (1) the allowable personal exemptions and (2) all allowable deductions including a deduction, if any, equal to the amount by which charitable contributions exceed 3 percent of adjusted gross income for the taxable year.

Implementation of the charitable deduction proposals requires conforming changes in section 170 (dealing with charitable contribution deductions) as well as section 63 (the definition of taxable income), section 144 (involving the election of the standard deduction) and section 161 (concerning the allowance of deductions).

Effective date.—The proposals involving the allowance of a deduction for charitable contributions independent of the standard deduction, and the 3-percent threshold will be effective with respect to taxable years beginning after December 31, 1969.

II. INCREASE IN LIMITATION FROM 30 PERCENT TO 50 PERCENT

Present law

Section 170 of the Internal Revenue Code provides for the deduction of charitable contributions. Section 170(b) limits the deductibility of contributions to 20 percent of adjusted gross income but also provides for additional deductions equal to 10 percent of adjusted gross income for a total limit of 30 percent provided any contributions claimed in excess of the 20-percent limit are made to organizations defined generally as follows: (1) churches, (2) educational organizations, (3) hospitals and certain medical research organizations, (4) governmental units and (5) other specified organizations which receive a substantial part of their support from the general public.

Proposal

Under the proposal the additional 10-percent allowance—which in most cases makes the effective limit on deductible contributions 30 percent of adjusted gross income—would be increased from 10 to 30 percent, thereby making the effective limit on the deductibility of contributions 50 percent of an amount equal to adjusted gross income plus the excluded items (in excess of $5,000) which are taken into account under the allocation of deductions and minimum tax proposals. One of these excluded items is the appreciation in the value of property donated to charity to the extent taken as a deduction in the taxable year.[1] Under the proposal, taxpayers confining their contributions to the five types of organizations generally described above would be entitled to deduct all contributions provided the total deduction claimed did not exceed the 50-percent limit. On the other hand, a taxpayer who does not confine his contributions to the type of publicly supported institutions listed above, for example, a taxpayer who made contributions to a private charitable trust that did not receive substantial support from the general public, will not be entitled to deduct contributions in excess of an amount equal to 20 percent of the same expanded income base on which the 50-percent limit is figured. Of course, that taxpayer could, in addition to the amount contributed to such a trust, deduct contributions to organizations of the type listed above provided total contributions to both types of organizations did not exceed the 50-percent limit.

The limitations operate independently of the proposal limiting deductible contributions to amounts contributed in excess of 3 percent of a taxpayer's adjusted gross income.[2] For example, a taxpayer has $100,000 of adjusted gross income. In addition, he has $6,000 of excluded items includible in the minimum tax base. He contributes $55,000 to an educational institution during the taxable year. His maximum allowable charitable contribution deduction is computed as follows:

---

[1] When the value of the property contributed exceeds the applicable deduction ceiling, only so much of the appreciation element shall be considered as an excluded item as is equal to the difference between (a) the generally applicable ceiling, and (b) the sum of the cash and the basis of the property contributed.

[2] In order to avoid additional complexity, however, it was decided not to recompute the base against which the proposed charitable deduction threshold will be measured. Thus, the proposed 3 percent threshold on charitable deductions will be determined by reference to adjusted gross income rather than by reference to the expanded income base. However, contributions disallowed as falling under the threshold will, for purposes of the allocation of deductions and minimum tax proposals, consist first of unrealized appreciation, which would not be included as an "excluded item" and secondly, of cash and basis of property contributed.

Eligible contributions:	
Total contributions	$55,000
Less 3 percent of adjusted gross income ($100,000)	3,000
Eligible contributions prior to application of maximum limitation	52,000
Maximum limitation:	
Adjusted gross income	100,000
Net excluded items ($6,000—5,000)	1,000
Total	101,000
Maximum limitation (50 percent × $101,000)	50,500
Maximum allowable limitation:	
(Lesser of eligible contributions or maximum limitation)	50,500

In this respect it should be noted that under section 170(b)(5) the amount by which eligible contributions exceed the 50-percent limit ($1,500 in the above example) may be carried forward for up to 5 years subsequent to the year of contribution. To reflect properly the 3-percent limit and the 50-percent limit it is proposed that the carryover provisions be amended to provide that any excess in contributions over the 50-percent limit in the year of contribution will be treated as having been contributed in the year following such contribution irrespective of whether a deduction is actually allowable in the latter year, except such amount as is not allowable by reason of the 50-percent limit (but not the 3-percent limit) may be further carried forward for up to 4 additional years. Thus, if the taxpayer's gross income in the following year was $100,000 and his actual contributions in that year were $10,000 his deduction would be $8,500 computed as follows:

Actual contributions	$10,000
Contributions carried forward	1,500
Total contribution treated as having been made	11,500
Less: 3 percent of adjusted gross income	3,000
Allowable deduction	8,500

No further carryforward would be available since it has all been used. Similarly, if instead of contributing $10,000 in the above example taxpayer made no contributions in the second year the $1,500 carryforward would be treated as having been made in that year but no deduction would be allowable since the total of actual contributions ($0) and carryforward contributions ($1,500) did not exceed 3 percent of adjusted gross income. No further carryforward would be allowable.

Effective date.—The increase in the limit on the deductibility of contributions from 30 to 50 percent of an amount equal to the adjusted gross income plus the excluded items (in excess of $5,000) which are taken into account under the allocation of deductions and minimum tax proposals shall be applicable to taxable years beginning after December 31, 1969.

V-I. REPEAL OF THE UNLIMITED CHARITABLE CONTRIBUTION DEDUCTION

GENERAL EXPLANATION

Present law

Under existing law individuals are permitted to claim a charitable contribution deduction only to the extent of 30 percent of adjusted gross income (or 20 percent if the donation is made to certain classes of charities). The general purpose of this limitation is to prevent people from discharging their entire tax liability to the Government by making donations to selected charities equal to the amount of their otherwise taxable income. In this manner, persons are encouraged to support charitable organizations but at the same time also contribute to the costs of running their Government. However, a special provision permits individuals, under certain conditions, to deduct all their contributions notwithstanding the general 20 and 30 percent limitations. This special provision is used by about 100 of our wealthiest taxpayers.

An individual can qualify for the unlimited charitable deduction if in the taxable year, and in 8 out of the 10 preceding taxable years, the total of his charitable contributions and income taxes paid exceed 90 percent of his taxable income.[1] In the great majority of cases using the unlimited deduction, the bulk of such contributions consists of appreciated property, primarily securities. Because no tax is imposed upon this appreciation and because the individual is able to deduct the full value of the contributed property from income, the approximately 100 unlimited charitable givers usually pay little or no tax on their current income.[2]

The proposal

In keeping with the basic principles underlying the structural revision of the charitable contribution deduction—that all individuals should pay their fair share of taxes in order to support the Federal Government—this provision of the reform program would repeal the unlimited charitable deduction. The repeal would become effective in 10 years. This 10-year grace period is provided in recognition of the fact that the individuals involved had to make some nondeductible contributions in previous years in order to qualify for the unlimited deduction. Hence, the repeal would not become effective until January 1, 1980. After this date, such individuals would be subject to the general limitation on charitable deductions which, under the reform program, would be increased to 50 percent of the taxpayer's expanded income base.[3]

Relation to the allocation of deductions and minimum tax proposals

One of the items of exempt income which is taken into account in computing the base for the allocation of deductions proposal and the base for the proposed minimum tax is the amount of appreciation

[1] For these purposes, taxable income is computed without regard to the charitable deduction, personal exemptions, and any net operating loss carryback.

[2] For example, in a recent year an individual who qualified for the unlimited charitable deduction had net income of $9.7 million. He did not contribute any of the components of this income to charity. Instead, he contributed securities which originally cost him $460,000 and which had greatly appreciated in value. As a result of the deduction generated by this donation, he paid no tax on his $9.7 million of income and no tax on the appreciation that was reflected in the present value of the donated securities.

[3] The expanded income base consists of adjusted gross income plus the items of exempt income over $5,000 that are used for the purpose of the allocation of deductions proposal.

in the value of property donated to charity. However, consistent with the reasons for granting the 10-year grace period described above, the full effect of the unlimited charitable deduction will be preserved during this period by providing that such deduction will not be subject to allocation and that the appreciation element therein will not constitute an item of exempt income against which other deductions are to be allocated. Moreover, the appreciation element in the unlimited charitable gift will not be included in the minimum tax base of taxpayers using the unlimited deduction.

Revenue effect of the proposal

It is estimated that the repeal of the unlimited charitable deduction will increase revenues in 1980 by approximately $25 million at 1969 levels of income. The individuals affected generally have income well in excess of $1 million, although most pay little or no tax under present law.

V-1. REPEAL OF THE UNLIMITED CHARITABLE CONTRIBUTION DEDUCTION

Technical Explanation

Under section 170 (b)(1)(C) and (g) of the Code and individual can deduct charitable contributions in excess of the general percentage limitation,[1] if in eight out of the 10 preceding taxable years his charitable contributions and income tax paid exceeded 90 percent of taxable income.[2]

This proposal would repeal the unlimited charitable contribution deduction, thereby making the general percentage limitation referred to above applicable to all individual taxpayers.

In recognition of the fact that individuals who qualify or are qualifying to use the unlimited deduction have, in the past, made certain nondeductible contributions, it is recommended that the repeal of these provisions become effective for taxable years beginning after December 31, 1979. This grace period would permit those presently qualified to continue to make unlimited contributions for a period of 10 years. It would also permit any individuals presently in the process of qualifying to determine whether they should continue their present program in order to gain the advantages of the unlimited deduction for the limited period that it will be usable following their qualification.

During the 10-year grace period described above, the unlimited charitable deduction will not be subject to allocation and the appreciation element therein will not constitute an item of exempt income against which other deductions are to be allocated. Moreover, the appreciation element in the unlimited charitable gift will not be included in the minimum tax base of taxpayers using the unlimited deduction.

---

[1] Under sec. 170(b)(1)(A) and (B) the present limitation is 30 percent of adjusted gross income (or, in the case of gifts to certain charitable organizations, 20 percent thereof). Under a separate part of the reform program, this limitation would be raised to 50 percent of the taxpayer's "expanded income base" (defined as adjusted gross income, plus the "excluded items" (as defined in the proposal for allocation of deductions) in excess of $5,000)

[2] For this purpose, taxable income is computed without regard to the charitable deduction, personal exemptions, and any net operating loss carryback.

V–J. REPEAL OF THE GASOLINE TAX DEDUCTION

General Explanation

Under existing law, State gasoline taxes, but not Federal gasoline taxes, are deductible in computing Federal income taxes. Repeal of the provision of existing law which allows the deduction of State gasoline taxes that are personal expenditures is recommended. The deductibility of State gasoline taxes that are business expenses would continue under the proposal.[1]

The tax is a user charge and personal expense.—The gasoline tax is essentially a user charge imposed on those who use the highways, and 95 percent of the funds collected are spent for the purpose of building and maintaining the highways. The use of the gasoline tax for highways is encouraged by Federal highway aid which prohibits to a large extent the diversion of State motor fuel taxes to nonhighway use.[2] As a general principle, user charges should not be tax deductible. Since there is a close link between the payment made and the benefit received, such taxes are basically the price paid for a consumer item and should be treated as a personal expense. The gasoline tax should have the same nondeductible status as other user charges

Table 1.—*States allocating motor fuel tax receipts to nonhighway uses, 1966*

State:	*Percent of net State motor-fuel tax receipts allocated to nonhighway uses*
Alabama	0.4
Arkansas	3.3
Connecticut	.2
Delaware[1]	.9
Florida	3.5
Hawaii	3.8
Illinois	1.4
Indiana	.7
Kansas	1.5
Minnesota	.2
Missouri	.2
New Jersey[1]	57.3
New Mexico	.1
New York[1]	11.4
North Dakota	.4
Oregon	4.9
Rhode Island[1]	35.5
South Carolina	3.8
Tennessee	4.3
Texas	24.9
Utah	.2
Washington	.2
Wisconsin	5.7
Total	4.6

[1] Motor fuel tax revenues are placed in the general fund.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 24, 1968. "Highway Statistics 1966," Department of Transportation, April 1968. Table MF–3.

---

[1] Less than 60 percent of total gas consumption is for a nonbusiness use. Passenger cars account for 71 percent of total gas consumption, and 83 percent of passenger car consumption is for nonbusiness use.

[2] Approximately 95 percent of motor fuel tax receipts are devoted to highway use, and only 23 States divert any portion of this revenue to nonhighway use. Only four States, New Jersey, New York, Rhode Island, and Texas devote more than 11 percent of these receipts to nonhighway use (table 1).

such as highway tolls, State park fees, hunting and fishing licenses, and auto registration fees and drivers' licenses. The fact that the gasoline tax and auto registration fees are called taxes rather than tolls is a matter of semantics rather than substance and should have no bearing on their deductibility.

It is noteworthy that a number of States do not allow the deduction of Federal and State gasoline taxes. Of the States which permit the deduction, 16 do so because they have adopted the Federal definition of taxable income. (See table 2.) Of the 18 States (and the District of Columbia) with definitions which do not conform to Federal practice, one-third have chosen to disallow the deduction of gasoline taxes (Georgia, Louisiana, Massachusetts, Mississippi, North Carolina, and Oregon). In addition, Indiana which uses Federal adjusted gross income as taxable income does not allow deduction of gasoline taxes. Virginia allows deduction of the State gasoline tax but does not allow deduction of Federal gasoline and other special excises.

Disallowance is consistent with the continued deductibility of general sales taxes, income taxes, and property taxes.—Disallowing the deduction of special taxes on gasoline and continuing the deduction of general sales, income taxes, and property taxes is consistent.

Under the reform program deductions will be continued for property taxes, income taxes, and general sales taxes. In general, States and localities rely on one or more of these three groups of taxes for the bulk of their general tax revenue. Gasoline tax receipts are almost universally segregated from the State's general revenues and devoted to highway construction and maintenance and considered a user charge. Furthermore, the proposal is consistent with the practice of some States which allow a deduction of general sales taxes and property taxes for purposes of computing their own State income tax but deny a deduction for the gasoline tax and other special excises.

TABLE 2.—DEDUCTIBILITY OF GASOLINE TAXES UNDER STATE INCOME TAXES

States permitting the nonbusiness deduction of motor fuel taxes		
Definition of taxable income conforms to Federal	Nonconforming	States not permitting the nonbusiness deduction of motor fuel taxes
Alaska	Alabama	Georgia [1]
Colorado	Arizona	Indiana [2]
Hawaii	Arkansas	Louisiana [1]
Idaho	California	Massachusetts
Iowa	Delaware	Mississippi
Kentucky	District of Columbia	North Carolina
Maryland	Kansas	Oregon
Michigan	Minnesota	
Montana	Missouri	
Nebraska	Oklahoma	
New Mexico	South Carolina	
New York	Utah	
North Dakota	Virginia [3]	
Vermont		
West Virginia		
Wisconsin		
Total, 16	Total, 12 (and District of Columbia)	Total, 7

[1] Allows general sales and property taxes but does not allow deduction of gasoline taxes.
[2] Uses Federal adjusted gross income as taxable income and therefore does not allow deduction of gasoline taxes.
[3] Allows deduction of State gasoline tax but does not allow deduction of Federal gasoline tax.

Disallowance will make tax burden more equitable.—Removing the deduction for nonbusiness gasoline taxes will make the tax burden more uniform among taxpayers. Present law gives greater deductions to those having vehicles which consume large quantities of gas either because they drive more or because of poor mileage per gallon. Table 3 shows how taxpayers of the same income class receive larger tax savings for heavier cars or for more driving, and the tax savings increase with income.

Disallowance would have only a slight impact on individual taxpayers.—Table 4 shows that the average tax increase is below $11 for the income classes under $7,000 and between $16 and $19 for the income classes between $10,000 and $20,000. This demonstrates that the deductibility is a minor item for most taxpayers and that to deny the deduction would have little effect on the consumption of gasoline or the ability of the States to derive revenue from this tax.

Revenue effect

The revenue gain from disallowance would be $310 million. It is estimated that State motor fuel tax receipts will be $5.9 billion in 1969, and $3.5 billion will be eligible for deduction by individuals as a nonbusiness expense. Assuming the recommended standard deduction changes have taken place, approximately 20¾ million itemizers, 90 percent of the remaining itemizers, will deduct an estimated $1.5 billion of State gasoline taxes, resulting in a revenue loss of $310 million. If the deduction were eliminated, the resulting tax increase for all itemizers would be less than 1 percent of present tax liability. (See table 4.)

TABLE 3.—TAX SAVINGS [1] FROM PERSONAL DEDUCTION OF STATE GASOLINE TAXES [2]

Taxable income bracket and annual mileage	Foreign economy car (average 27 miles per gallon)	American compact car (average 18.5 miles per gallon)	American medium weight car (average 15 miles per gallon)	American heavyweight car (average 14 miles per gallon)
$3 to $4,000:				
5,000	$2.20	$3.22	$3.96	$4.25
10,000	4.41	6.44	7.92	8.49
15,000	6.61	9.65	11.89	12.74
$12 to $16,000:				
5,000	3.21	4.73	5.83	6.25
10,000	6.41	9.47	11.66	12.50
15,000	9.62	14.20	17.49	18.75
$24 to $28,000:				
5,000	4.62	6.81	8.40	8.99
10,000	9.23	13.62	16.79	17.98
15,000	13.85	20.43	25.19	26.97
$36 to $40,000:				
5,000	5.77	8.51	10.49	11.24
10,000	11.54	17.02	20.99	22.48
15,000	17.32	25.54	31.48	33.72
$100 to 120,000:				
5,000	7.95	11.73	14.46	15.48
10,000	15.90	23.46	28.92	30.97
15,000	23.86	35.19	43.38	46.45
Over $200,000:				
5,000	8.98	13.23	16.32	17.48
10,000	17.96	26.47	32.65	34.96
15,000	26.93	39.70	48.98	52.44

[1] Applying current marginal rates for joint return brackets.
[2] Assumes State gasoline tax is 7 cents per gallon.

TABLE 4.—EFFECT OF DISALLOWING THE GASOLINE TAX DEDUCTION AFTER INCREASING THE MINIMUM STANDARD DEDUCTION TO $600 PLUS $100 AND THE STANDARD DEDUCTION TO 14 PERCENT WITH AN $1,800 CEILING, 1969 INCOME LEVELS

[Dollar amounts in millions; number of returns in thousands]

AGI (in thousands of dollars)	Present law tax	Tax increase	Tax increase as percent of present law tax	Number of returns with tax increase	Number of returns made taxable	Number of returns shifting to standard deduction
0 to 3	$1,159	$1	0.1	190	25	30
3 to 5	3,177	10	.3	1,060	25	140
5 to 7	5,439	30	.6	2,840	15	275
7 to 10	13,925	90	.6	7,060	10	550
10 to 15	18,916	95	.5	5,900	(1)	500
15 to 20	7,550	35	.5	1,850		85
20 to 50	12,795	35	.3	1,580		20
50 to 100	6,326	10	.2	230		(1)
100 and over	6,202	3	(1)	50		(1)
Total	75,490	310	.4	20,750	75	1,600

1 Less than one-tenth of 1 percent or less than 500 returns.

Note: Details may not add to totals because of rounding.

V-J. TO REPEAL THE GASOLINE TAX DEDUCTION

Technical Explanation

Under present law, section 164(a)(5) of the Internal Revenue Code permits an income tax deduction for State and local taxes levied on the sale of gasoline and other motor fuels. On the other hand, except as a business expense, present law does not grant a deduction for Federal gasoline taxes or for Federal, State, or local charges which have a direct relationship to services or facilities provided to the taxpayer, such as highway tolls, park fees, hunting and fishing license fees, and automobile registration fees and drivers' licenses.

This proposal would repeal section 164(a)(5) of the code, thereby making nonbusiness State and local gasoline tax payments a nondeductible expense. However, gasoline tax payments which would qualify for a deduction under section 162 of the code as a business expense would continue to be deductible and would be claimed under section 162. The repeal of section 164(a)(5) would also have no effect upon State and local property, income, and sales taxes which would continue to be deductible under section 164(a).

Under this proposal the repeal of the gasoline tax deduction would become effective for taxable years beginning after December 31, 1969.

V-K. CONSISTENCY OF CAPITAL GAIN AND LOSS RULES

General Explanation

BACKGROUND

Under the mechanics of present law, gains and losses from sales and exchanges of assets held for 6 months or longer (known as long-term capital gains and losses) are offset against each other and a *net* long-term capital gain or loss determined. Similarly, gains and losses from sales and exchanges of assets held for less than 6 months (short-term capital gains and losses) are offset against each other and a *net* short-term capital gain or loss determined. If a taxpayer has in the same year a combination of either net long-term capital gain and net short-term capital loss, or net long-term capital loss and net short-term capital gain, the larger amount is reduced by the smaller, the excess retains its original character, and the rules discussed below are applied.

Net losses, whether long term or short term, may be deducted, up to $1,000 a year, from ordinary taxable income. If the net loss exceeds the $1,000 limitation, the excess may be carried forward and treated as if it were a capital loss realized in the succeeding taxable year. If there is an excess in that year also, it may continue to be carried forward year by year until it is fully absorbed. There is no limitation on the number of years to which it may be carried forward. *Net short-term capital gain* is fully includible in taxable income. On the other hand, only 50 percent of *net long-term capital gain* is required to be included in income, subject to a maximum alternative tax equal to 25 percent of the total gain.

This framework, under which net long-term gain is included in taxable income only to the extent of 50 cents on the dollar while each dollar of net long-term loss may be used to offset a full dollar of taxable income (within the $1,000 limitation), is illogical and unjustifiable. Such a structure affords an undue advantage to those taxpayers with capital investments who are able to realize their gains and losses in alternate years. For example, if a taxpayer with an unrealized long-term capital gain of $1,000 in one property and unrealized long-term capital loss of $1,000 in another were to sell both properties in the same year, the realized loss would offset the realized gain and the taxpayer would break even on the two transactions, with no net tax effect. On the other hand, if he were to sell the properties in different years, only $500 of the realized gain would be subject to tax, while the entire $1,000 realized loss would be deductible against ordinary taxable income. In this situation, the tax laws can turn a break-even transaction into a profit for the taxpayer.

Present law governing capital losses also permits an unjustifiable advantage to be gained under certain circumstances by married couples who elect to file separate returns. When separate returns are filed, the $1,000 annual limitation on the current deduction of net capital losses is in effect doubled for the couple, since a separate $1,000 limit applies for each spouse. Each spouse must have his own losses in order to claim them on a separate return and receive this double limitation. This situation, however, is automatic in community property States where all capital gains and losses of community property are split between the spouses by operation of community property law. Moreover, in community property States the usual income-splitting advantage of a joint return is not lost when separate returns are filed, since the income is split by operation of community property law, regardless of which spouse earned it. Thus, the benefit of the double limitation is almost automatic in community property States.

Taxpayers in common-law States may also secure two $1,000 limitations by filing separate returns. They can attain this advantage if the assets sold are in joint names or each spouse sells assets owned in his own name. But couples in common-law States who file separate returns must be willing to give up the split-income rates applicable to joint returns, and the overwhelming number of such couples would not gain from so doing. Thus, while present law provides an artificial incentive for filing separate returns in all States, the opportunity and net advantage to be derived from so doing is substantially greater for couples in community property States than for couples in common-law States.

PROPOSALS

In order to eliminate the inconsistencies and inequities of present law described above, it is proposed that (1) the rules governing the deduction of long-term capital losses be made consistent with the rules governing taxation of long-term capital gains, and (2) in the case of a married couple, the annual deduction of capital losses be made subject to the same total dollar limitation regardless of whether the spouses file jointly or separately.

(1) *Annual limitation.*—Specifically, it is proposed that in the case of a noncorporate taxpayer, each $1 of net long-term capital loss be permitted to offset only 50 cents of ordinary taxable income, subject to the same overall $1,000 limitation on the amount deductible in any one year. For example, if net long-term loss for a year is less than $2,000, 50 percent of it will be deductible in that year and no carryover would be available. If the net long-term loss exceeds $2,000, a maximum deduction of $1,000 would be permitted for the current year, and the amount of the loss in excess of $2,000 may be carried over and treated as a long-term capital loss in the succeeding year.[1]

The proposed 50-percent limitation on deductions of net long-term capital losses would not affect corporate taxpayers, since corporations under present law are allowed no deduction of net capital losses against ordinary income.

Under existing rules when excess capital losses are carried over to the succeeding year, they retain the same character as in the original year. This would not be changed. By retaining their character as long-term or short-term capital losses, the carryover losses may be properly offset against long-term or short-term capital gains of the carryover year as if they had been incurred in that year. When a taxpayer has both a net long-term loss and a net short-term loss in the same year and the sum of these losses exceeds the $1,000 which may be deducted against ordinary income, present law provides that the $1,000 deduction absorbs the short-term loss first on a dollar-for-dollar basis. This rule would not be changed.

(2) *Married couples filing separate returns.*—It is proposed that the annual limitation on the deduction of net capital losses be lowered to $500 in the case of a married person who files a separate return. This change would eliminate the doubling of the annual limitation for those couples who file separate returns.

EFFECTIVE DATE

The amendments affecting capital losses would be effective beginning with the 1970 tax year, but they would not change the amount of capital losses carried forward from prior years.

[1] As under present law, the amount of the loss carried over would be treated in the succeeding year in the same manner as if it had been incurred in that year.

REVENUE EFFECT

The proposed changes relating to capital losses would result in an estimated revenue gain of $60 million for the first effective year. The annual gain would increase each year to an ultimate level of about $100 million within about 6 years. (See table 1.) The 6-year lag in reaching the ultimate anticipated level of revenue gain results from gradual absorption, under the new 50-percent rule, of long-term capital losses carried over from the years preceding the adoption of the proposal, when long-term capital losses were still allowed without the proposed limitation.

TABLE 1.—REVENUE EFFECT OF ALLOWING ONLY 50 PERCENT OF LONG-TERM CAPITAL LOSSES TO OFFSET ORDINARY INCOME, AND REDUCING MAXIMUM TO $500 FOR MARRIED PERSONS FILING SEPARATELY

Adjusted gross income class (in thousands of dollars)	Revenue increase (millions)		Number of returns with tax increase (thousands)	
	1969	Long run	1969	Long run
0 to 3	$6	$8	85	115
3 to 5	4	5	55	75
5 to 7	6	7	70	100
7 to 10	10	14	135	200
10 to 15	17	23	200	290
15 to 20	7	12	75	135
20 to 50	9	24	55	155
50 to 100	1	6	5	25
100 and over	(1)	1	(1)	5
Total	60	100	680	1,100

[1] Less than $500,000 or 500 returns.

V-K. CONSISTENCY OF CAPITAL GAIN AND LOSS RULES

TECHNICAL EXPLANATION

GENERAL DESCRIPTION OF PROBLEMS AND PROPOSALS

1. *Limitation on deduction of capital losses.*—Under present section 1211 of the Internal Revenue Code, all taxpayers may deduct capital losses at least to the extent of capital gains, and in the case of individuals, capital losses which exceed capital gains may be deducted against ordinary taxable income of the taxpayer up to $1,000 per year, with an unlimited right to carry any excess forward to future taxable years. The mechanics of present law are as follows: Long term capital gains and long term capital losses are offset against each other and a net long term capital gain or loss determined. Similarly, short term capital gains and short term capital losses are offset against each other and a net short term capital gain or loss determined. If the taxpayer has in the same year a combination of either net long term capital gain and net short term capital loss or net long term capital loss and net short term capital gain, the larger amount is reduced by the smaller, and the excess retains its original character. However, in computing the current deduction against taxable income no distinction is made between long term capital losses and short term capital losses; each is allowed dollar-for-dollar against ordinary taxable income, subject to the $1,000 limitation.

In the case of long term capital losses, this dollar-for-dollar offset is entirely inconsistent with the fact that only a maximum of one-half of long-term gains is subject to tax and that if the long term gains and losses were realized in the same year, they would offset each other in the tax computation. The following illustrates the incongruity of present law in this respect: Assume that an individual has two blocks of stock which he has held for more than 6 months; one block has appreciated in value by $1,000 and the other has decreased in value by $1,000. If he sold them both in the same year, the $1,000 loss would offset the $1,000 gain, with no net tax effect. However, if he were to sell the appreciated block in one year and the depreciated block in the next, he would have to report only one-half of his $1,000 gain, yet he could claim a full $1,000 deduction against ordinary income for his loss.

In order to make the treatment of capital losses parallel to the treatment of capital gains, the proposal would permit the deduction of only 50 percent of net long term capital losses against ordinary taxable income. Net short term capital losses would continue to be deductible in full as under present law, and the present overall $1,000 limit would continue as a ceiling on the combined total of allowable annual deductions for net long term and short term losses.

2. *Married couples filing separate returns.*—A further problem under present law has been the unjustifiable advantage which may be gained by married couples who file separate returns. When separate returns are filed, the $1,000 limit on the current deduction of net capital losses is in effect doubled for the couple since a separate $1,000 limit applies for each spouse. If both spouses have capital transactions and a joint return is filed, their gains and losses are pooled together and netted against each other as if there were only one taxpayer who had realized all of them. The married couple is treated as a single economic unit in this manner and can realize subtantial benefits over filing separate returns. For example, one spouse's long term capital loss can be used to offset the other spouse's short-term capital gain which would otherwise be taxable at ordinary income rates. It is inconsistent with this treatment to then let them be treated as two taxpayers when this proves more advantageous, as for example, if both have capital losses.

Of course, each spouse must have his own losses in order to claim them on a separate return. However, in community property States all capital gains and losses from community property are split between the spouses by operation of community property law. Taxpayers in common law States may also secure two $1,000 limitations by filing separate returns. However, they can attain this advantage only if the assets sold are in joint names or each spouse sells assets owned in his own name. Furthermore, couples in common law States who file separate returns must be willing to give up the split-income rates applicable to joint returns, and the overwhelming number of such couples would not gain from so doing. Thus, not only does present law provide an artificial incentive for filing separate returns, but the advantage to be derived from so doing is substantially greater for couples in community property States than for couples in common law States.

The proposal would eliminate this problem by applying the same rule for purposes of the capital loss limitation as is presently applied with respect to the $1,000 standard deduction limitation. That is, the limitation would be lowered to $500 for each spouse, instead of $1,000, in the case of a married person filing a separate return.

DETAILED DISCUSSION AND ILLUSTRATIONS OF PROPOSAL FOR LIMITATION ON DEDUCTION OF CAPITAL LOSSES

The present rules for offsetting capital gains and losses would be retained. In the case of noncorporate taxpayers, the additional deduction for capital losses, to the extent that they are not absorbed against capital gains, would operate as follows:

Net short-term capital losses are first offset against any net long-term capital gain (under the general rule as stated above) and any excess would be deductible (as under present law) against other taxable income, subject to the $1,000 limitation. Net long-term capital losses are first offset against any net short-term capital gain (under the general rule as stated above) and 50 percent of any excess (as compared to 100 percent under present law) would be deductible against ordinary taxable income to the extent that the $1,000 limitation was not absorbed by a deduction of net short-term capital loss.

Provision would be made for the carryover of net long-term capital loss to the extent that it exceeds twice the amount allowed as a deduction against taxable income as outlined above. This provision changes present law by requiring that the amount which may be carried over must be reduced by *double* the amount of long-term capital loss allowed as a deduction. This change is necessary to effect the new rule that only one-half of net long-term capital losses will be deductible against taxable income.

As under present law, carryover is permitted for the full amount of any net short-term capital loss which is not absorbed against ordinary taxable income under the $1,000 limitation.

EXAMPLES

The application of the proposal may be illustrated by the following examples:

Example A.—An individual has a long-term capital loss of $3,000 and no other capital gains or losses. He would be entitled to a current deduction limited to $1,000, and would be permitted to carry over to the following year a long-term capital loss of $1,000. If he had no capital gains or losses in the subsequent year, he could deduct $500.

Example B.—An individual has a long-term capital loss of $1,800 and a short-term capital loss of $600 in the same year. In a case such as this, where there is both a net long-term capital loss and a net short-term capital loss in the same year and the total of these losses exceeds the amount that may be deducted under the overall $1,000 deduction limitation, it is necessary to determine the character of the loss which is deducted currently so that the character of the loss carried forward may be established. Under present law, it is provided that the $1,000 limitation is first absorbed by the short-term losses. This rule would not be changed. Thus, in this example, the entire $600 of short-term loss would be deductible first; $400 of the long-term capital loss would then be deductible. Under the new 50 percent rule for long-term losses, this $400 deduction would represent $800 of the total long-term capital loss, thus leaving $1,000 of that loss to be carried over and treated as a long-term capital loss in the following year. If he had no capital gains or losses in the subsequent year he could deduct $500.

EFFECTIVE DATE

The proposal would apply to taxable years beginning after December 31, 1969. A transitional rule will be provided for the application of the proposed amendments. Thus, the extent to which net capital losses which occur in a taxable year prior to the first year in which the proposal becomes effective may be carried over into such first year will be governed by present law. Further carryover of such losses into succeeding years would be governed by the new provisions. For example, if an individual realized a $3,000 long-term capital loss in 1969, $1,000 of which was deductible in 1969, he could carry over $2,000 of that loss into 1970 (the first year in which the proposal is effective) and, if he has no other losses in 1970, claim a deduction for $1,000 with respect to that loss. He would have no carryover into 1971.

V-L. MOVING EXPENSES

General Explanation

As American industry has grown, individual companies have expanded their operations and opened new offices and plants throughout the country. Many large corporations have offices in virtually every major American city and plants in every section of the country. A natural result of this growth has been the necessity to transfer employees from one location to another. Furthermore, the competition for skilled employees has led to an increasing movement of new employees to locations where more attractive opportunities are available. The mobility of labor is a necessary part of a full employment economy, since it reduces unemployment and increases productive capacity. It has been estimated that there are about a half million employment-related family moves each year. Some major U.S. corporations, faced with the need for trained personnel in scattered areas, transfer as many as 1,000 employees in the period of a year. In addition, substantial numbers of Government employees, both civilian and military, are transferred each year.

Naturally, these business-related family relocations have a significant impact upon the families involved. The expenses involved are frequently substantial and in some cases impose a financial burden on the family involved. In other cases, the employer will alleviate the financial burden by reimbursing the employee for his moving expenses.

PRESENT LAW

Existing tax law provides that the unreimbursed expenses of transporting the employee, his family and belongings, incurred in a job-connected move, are deductible in computing Federal income tax. Employees who are transferred and who receive reimbursement from their employer for these expenses are not required to pay tax on the amount reimbursed. While these so-called direct transportation expenses which are given this tax treatment generally constitute the major portion of the total cost of a move, there are other "indirect" expenses which are typically involved. Such expenses include the cost of selling the old house (or breaking a lease), premove house-hunting trips, and expenses of temporary living quarters in the new location prior to occupying the new permanent residence. These expenses are not deductible under present law, and reimbursements of such expenses are subject to tax.

SUMMARY OF RECOMMENDATIONS

It is proposed that the tax treatment presently provided with respect to "direct" job-connected moving expenses be expanded to cover certain "indirect" expenses which are commonly incurred in connection with a move. Thus, deduction would be permitted for the costs of house-hunting trips, temporary living expenses, and certain real estate costs, whether or not reimbursement is received.[1] However, deductibility of these "indirect" expenses would be subject to an overall dollar limitation of $1,500.

This proposed $1,500 limitation would apply to the deductible indirect expenses only. Direct expenses, which are deductible under present law, would continue to be deductible without a dollar limitation. The $1,500 limitation on indirect expenses will provide the needed relief from the financial burden of moving for the great majority of employees; that is, employees with average earnings and average moving expenses. Total expenses for these indirect costs may exceed the limitation in cases of high-income employees. Their added costs are attributable to their higher standard of living which their increased earning power makes possible and should therefore properly be considered as personal rather than business related. For example, a corporate executive who is transferred is likely to have above-average temporary living expenses by staying in a more expensive hotel and above-average real estate costs from selling a more expensive home. The taxpaying public should not be required to defray, through reduced tax revenues, a part of the cost of these more-than-average expenses. In addition, the $1,500 limitation reduces the possibility of abuse, or extravagant expenditures, at the expense of the general public. Thus, the proposal represents a reasonable accommodation of the deduction of indirect moving expenses in the case of most taxpayers without providing unnecessary tax preferences for higher income executives and without undue revenue loss.

STRUCTURAL AND TECHNICAL CHANGES

Present law with respect to direct moving expenses gives the *reimbursed* transferred employee an unwarranted tax preference over new or unreimbursed employees. While the latter group may deduct their direct moving expenses, they may do so only if they satisfy certain qualification tests for the deduction; however, reimbursed transferred employees may simply exclude from income the reimbursement for these expenses and forego the deduction, and thereby receive the fav-

[1] As explained hereinafter, all reimbursements for moving expenses would be includable in gross income.

orable tax treatment without the need to satisfy the tests for deductibility. Certainly there should be no distinction between the two groups. Hence, under the proposal the entire reimbursement for both direct and indirect moving expenses would be included in income in all cases. Whether or not reimbursed, all employees will be able to claim deductions, subject to the limitations and requirements which govern the allowance of the deduction.

A minor change is also proposed in one of the present law qualifications for allowance of the deduction. Under present law, if a taxpayer does not have full-time employment in the location of the new residence for at least 39 out of the 52 weeks following the move he cannot qualify for the deduction. This rule would be amended to make specific exception for cases in which the employee is rendered unable to satisfy the rule because of death, disability, retransfer, or involuntary separation from the service of the employer from whom he had a firm employment commitment before he moved.

REVENUE EFFECT

The proposed moving expense amendments would result in an estimated annual revenue loss of $85 million.

EFFECTIVE DATE

The moving expense amendments would be effective for taxable years beginning after December 31, 1969, but only with respect to reimbursements and deductions for amounts paid or incurred after the date of enactment.

V-L. LIBERALIZATION OF MOVING EXPENSE RULES

Technical Explanation

I. BACKGROUND AND PRESENT LAW

The moving expenses incurred by a taxpayer as a result of a job-related move of his household to the area of a new principal business post give rise to two basic income tax questions: (1) whether such expenses are deductible; and (2) whether reimbursement by an employer of an employee's moving expenses is income to the employee. Prior to the Revenue Act of 1964, there were no Internal Revenue Code provisions specifically dealing with moving expenses. Thus, the law in the area developed from administrative rulings and court decisions. Prior to 1964, moving expenses were not deductible under any circumstances. Reimbursements for moving expenses were, generally, taxable, except for reimbursements for direct expenses of a transferred employee. "Direct" expenses included only the cost of transporting the taxpayer, members of his household, and their belongings from the old to the new residence, including any meals and lodging en route. Reimbursement for all other expenses, such as house-hunting trips, real estate costs, and so forth (referred to as "indirect" moving expenses), was taxable. Even reimbursement for direct expenses was taxable in the case of a new employee (as opposed to a transferred old employee).

With the intention of promoting labor mobility and of equalizing the tax treatment between reimbursed and unreimbursed employees, Congress in the Revenue Act of 1964 enacted the present section 217 of the Internal Revenue Code. Section 217 permits, under certain prescribed conditions, the deduction, from gross income, of job-connected moving expenses, which are defined as including the expenses of transporting the taxpayer, members of his household and their belongings from the old residence to the new residence, including meals and lodging en route, i.e., the same direct costs reimbursement for which is excludable by transferred old employees. The deduction is available to new employees and to unreimbursed transferred employees.

Other than to provide that the moving expense deduction would not be allowed for a reimbursed expense which is not included in gross income, Congress chose in 1964 not to deal specifically with the reimbursement question. Thus, the pre-1964 law, under which transferred employees may exclude reimbursements for direct moving expenses remains in effect today. This treatment gives the reimbursed old employee an unwarranted tax preference over new and unreimbursed employees. While the latter may deduct their expenses under section 217, they may do so only if they satisfy the qualification tests under that section; however, reimbursed old employees may simply exclude from income the reimbursement for direct moving expenses and forego the deduction, and thereby receive the favorable tax treatment without the need to satisfy the tests for deductibility. Furthermore, although the items of reimbursement which may be excluded are limited by administrative ruling to the same direct expenses as are deductible under section 217, this limitation has been challenged in litigation. While the administrative position has been sustained in most cases, one recent Tax Court decision, currently on appeal by the Government, has permitted exclusion of reimbursement for certain indirect expenses which are not deductible under section 217. To the extent that such reimbursements are held by courts to be excludable from income, reimbursed old employees are given a clear tax preference over the unreimbursed and new employees, whose tax benefit is limited to the deduction of only the direct expenses allowed under section 217.

II. GENERAL SUMMARY OF RECOMMENDATIONS

In order to eliminate fully the present distinction in tax treatment between reimbursed old employees on the one hand and unreimbursed and new employees on the other, it is recommended that the Internal Revenue Code be amended to provide specifically that all reimbursements for employee moving expenses are includible in the employee's gross income. Whether or not reimbursed, all employees will be able to claim deductions as prescribed in section 217, subject to the limitations and requirements of that section.

It is also proposed that the limited categories of moving expenses which are deductible under the present section 217 be liberalized to permit deductions of certain of the more significant indirect expenses which are commonly incurred in connection with a move. Thus, deduction would be permitted for house-hunting trips, temporary living expenses, and certain real estate costs, but deductibility of these expenses would be subject to an overall dollar limitation of $1500.

III. INCLUSION IN GROSS INCOME OF MOVING EXPENSE REIMBURSEMENTS

The proposal provides that all reimbursements or payments for moving expenses are includable in gross income of the person receiving the reimbursement or on whose behalf the payment is made. Thus, section 61(a)(1) would be amended to make clear that "compensation for services," as the term is used in that paragraph, includes reimbursements and payments for every type of moving expense. This would reverse the present administrative position that some reimbursements may be excluded, and would reverse the court decisions which have held certain reimbursements excludable. The amendment would apply, as does the paragraph which it amends, to reimbursements which are in the nature of compensation for services, whether the recipient is an employee or an independent contractor. Moving expense reimbursements received other than as compensation for services will be treated the same as under present law. For example, a reimbursement or payment by a corporation of a stockholder's moving expenses may be includable in gross income as a dividend under section 61(a)(7); a reimbursement which clearly represents a gift would be excludable under the general rule of section 102.

Amounts paid on account of a taxpayer's moving expenses are includable in gross income regardless of the manner in which payment is made. For example, gross income is realized whether the taxpayer pays the expenses and receives reimbursement or whether the payor makes payment on the taxpayer's behalf directly to the third party who renders the services for which payment is due.

Under present law remuneration for services of an employee is subject to withholding of income and social security taxes. Moving expense reimbursements, in the case of employees, are subject to this general withholding rule. However, present law provides an exception to the withholding requirements to the extent that at the time of the reimbursement or payment it is reasonable to believe that a moving expense deduction will be allowable to the employee under section 217 of the Code with respect to the expenses being reimbursed. This rule of present law would be continued. Thus, withholding would be required on moving expense reimbursements or payments made to employees only to the extent that no deduction with respect thereto is provided in section 217, as amended by the bill. Reimbursements to transferred employees which are excludable from gross income under present law and which would become includable under the bill are deductible under section 217, and, thus, they would not be subject to withholding. As under present law, withholding would be required on any reimbursement to the extent it exceeds the employee's anticipated expense.

IV. DEDUCTION FOR MOVING EXPENSES

(*a*) *General.*

Section 217 of the Code would be revised to expand the presently limited categories of expense for which deduction is allowed, and to provide an exception from one of the tests of qualification for deduction (*i.e.*, the 39-week rule) in certain cases where an action of the taxpayer's employer, or the death or disability of the taxpayer, makes it impossible for the taxpayer to satisfy the test.

As under existing law, a general rule would provide that a deduction shall be allowed for certain business-related moving expenses of employees. Also as under present law, self-employed persons would not be entitled to the deduction.

(*b*) *Definition of deductible moving expenses*

The term "moving expenses" would be specifically defined for purposes of the deduction permitted by the general rule. The specific definition would consist of several categories of expenses. Only those expenses specifically included within this definition would qualify for the moving expense deduction.

The cost of transporting the taxpayer and the members of his household, and the cost of transporting his household goods and personal effects from the former residence to the new place of residence, which costs are deductible under present law, will continue to be deductible. These are the same expenses which, under present administrative interpretation, are excludable from gross incme in the case of reimbursed transferred employees, and which will be includable in gross income under the proposal.

Three new categories of costs would be added to the definition of moving expenses deductible under present law. The first of these covers expenses for premove house-hunting trips. The costs of transportation, meals and lodging for the taxpayer or his spouse, or both, are included, provided that both the old residence and the new principal place of work are located within the United States. The trip with respect to which a deduction is claimed must be a bona fide house-hunting trip. Travel expenses related to seeking employment will not be deductible, even if some house-hunting is done during the same trip. Thus, the direct transportation expenses of a premove trip will not be deductible unless the taxpayer has already secured employment in the new location prior to embarking on the trip. Similarly, only so much of the meals and lodging expenses as is incurred subsequent to securing employment (whether or not the employment was secured before the trip was begun) would be deductible.

Deduction would also be permitted for temporary living expenses in the area of the new principal place of work prior to moving into new permanent quarters. Allowable temporary living expenses are limited to meals and lodging for the employee and members of his household. Other expenses, such as laundry, local transportation, etc., are not included. The allowable expenses for meals and lodging are limited to those incurred within the first 30 days following arrival in the area of the new principal place of work. In cases where the employee and all the members of his household arrive on the same day, the day of arrival will be treated as the first day of the 30-day limitation period. In cases where the employee and/or members of his household arrive on different days, the 30-day period will begin to run on the first day on which an expense which is claimed as a deduction under this provision is incurred. As in the case of house-hunting expenses, temporary living expenses are not deductible if related to seeking employment. Thus, deductible temporary living expenses are limited to those incurred after the taxpayer has secured employment.

Finally, deduction would be allowed for expenses related to the sale of the residence from which the taxpayer moves. If the taxpayer does not own the residence from which he moves, this provision also permits the deduction of the *cost of settling an unexpired lease.* This provision would not permit the deduction of any realized capital loss on the sale of a residence. As under present law, such losses are not deductible, even if the sale was occasioned by a change in job location.

The deduction is limited to certain expenses incurred in effecting the sale, such as a commission paid to a real estate agent and advertising expenses. Expenses incurred for physical improvements or repairs intended to enhance salability by improving the condition or appearance of the property are not included in the class of selling expenses which are deductible under this provision. Costs related to the purchase of a new residence at the new principal place of business are not deductible.

The three new categories of deductible expenses (i.e., house-hunting trips, temporary living expenses, and real estate costs) would be subject to an overall limitation of $1,500. Thus, if the total of the expenses otherwise deductible under these three new provisions exceeds $1,500, the amount of the excess will not be deductible. This limitation is applied upon the *total* of the expenses under the three categories together—not upon each category individually. Thus, if expenses are incurred within each category in amounts less than $1,500, but the total of these amounts exceeds $1,500, then the total deduction is limited to $1,500 with respect to these three categories. Regardless of the effect of the $1,500 limitation on the three new deductible categories, the costs of transportation, deductible under present law, will continue to be deductible without a dollar limitation, as under present law.

The provision in present law, which delineates the extent to which moving expenses of persons other than the taxpayer are deductible, would be retained without change. These individuals must have the same former residence and the same new residence as the taxpayer and must be a member of the taxpayer's household.

(c) *Conditions for allowance of deduction*

Two conditions must be met in order to qualify for the moving expense deduction. These two conditions are unchanged from present law. However, a new provision would be added which creates exceptions to one of the conditions in limited circumstances.

The so-called 20-mile test contained in present law would not be changed. This rule provides that the new place of work must be located at least 20 miles farther from the old residence than was the former place of work, or, if the taxpayer had no former place of work, then at least 20 miles from his former residence.

The present law 39-week test would also be continued. Under this rule, a taxpayer must be employed full-time during at least 39 of the 52 weeks following his arrival at the new principal place of work in order to qualify for the moving expense deduction. However, a new exception would be added under the proposal, providing for a waiver of the 39-week test in cases where the taxpayer is unable to satisfy that test as a result of death, disability, or an unexpected action of his employer. Thus, the 39-week test will not apply in cases in which the taxpayer moves after having received a job commitment which he could reasonably anticipate would be of sufficient duration to satisfy the 39-week test, but is later unable to satisfy that test as a result of death, disability, or a transfer by, or an involuntary separation from the service of, the employer from whom he had the premove commitment.

In order for the exception to apply in the case of a transfer, such transfer must have been at the instance of the employer, and not at the employee's request. In the case of separation from service, such separation must have been brought about by the employer rather than the employee (i.e., only if the employee is "fired," not if he "resigns" voluntarily). Dismissal of an employee which results from deliberate activity of the employee intended to provoke dismissal will not qualify as "involuntary" separation from service. Involuntary separation or transfer will operate to waive the 39-week test only if such event occurs while the taxpayer is in the employ of an employer from whom he had an employment commitment before he moved. Thus, for example, if the taxpayer is transferred by employer A from New York to California and after the transfer the taxpayer voluntarily leaves A to take a job with employer B and is subsequently involuntarily dismissed by B, the conditions are not met and the exception to the 39-week rule does not operate.

(d) Technical provisions

The present rules for application of the 39-week test in cases where the test is not satisfied before the due date of the tax return would not be changed except for very minor technical changes to conform to the proposed new exception. The authority specifically granted to the Secretary or his delegate to prescribe regulations to carry out the provisions of the moving expense deduction would be continued. The present rule providing that no deduction shall be permitted for expenses for which the taxpayer receives a reimbursement which he does not include in gross income would be eliminated. This provision is no longer necessary since the proposal would require all moving expense reimbursements to be included in gross income.

V. EFFECTIVE DATE

The amendments made by the proposal will apply to taxable years beginning after December 31, 1969, but only with respect to reimbursements and deductions for amounts paid or incurred after the date of enactment.

Thus, the amendments will apply to permit deduction of indirect expenses (which are not deductible under present law) only if they are paid or incurred after the date of enactment. Treatment of reimbursements is keyed to the date of the expense for which the reimbursement is received—not to the date of the reimbursement. Thus, present law will apply to reimbursements for expenses paid or incurred prior to the date of enactment, and the new rules will apply to reimbursements for expenses incurred thereafter—regardless of the date the reimbursement is received.

For example, if a calendar year cash basis taxpayer were to pay for a house-hunting trip during 1970 but prior to the date of enactment, and pay direct transportation and temporary living expenses after the date of enactment, and receive reimbursement for all of these expenses after the date of enactment, present law would apply with respect to the deduction of and the reimbursement for the house-hunting trip, and the new rules would apply to the deduction of and the reimbursement for the direct transportation and temporary living expenses. Thus, the entire amount of the reimbursement would be includable in gross income (the house-hunting portion under present law and the direct transportation and temporary living expense portions under the new rules), the direct transportation expense would be deductible in full (under present law as carried forward under the proposal), the temporary living expenses would be deductible up to $1,500 (under the new rules), and the house-hunting trip would not be deductible (under present law).

V-M. REVISED TAX TREATMENT OF THE ELDERLY

General Explanation

BACKGROUND

There are about 20 million people over the age of 65 in the United States. Of these, about 4.8 million pay Federal income tax. The recommendations for revising the income tax relief of the elderly basically concern only the taxpaying group. Within that group, these recommendations would result in reduced taxes for about 3.6 million individuals, including 600,000 persons who would become completely exempt from tax.

NEED FOR REVISION

In addition to social security, medicare, and other direct programs, significant assistance is afforded the elderly through special income tax relief granted to those over the age of 65. This tax relief reduces Federal income tax revenues by approximately $2.5 billion each year.

The major tax relief extended to the elderly consists of a complete tax exclusion for social security and basic railroad retirement benefits, a corresponding retirement income credit for those who are not eligible to participate in full under either of these two programs, and an extra $600 personal exemption and related extra $100 addition to the minimum standard deduction. This program of tax relief for the elderly has been developed in a piecemeal fashion over the years and, despite the very large amount of revenue which is devoted to it, has never been subject to a careful review to see whether it is accomplishing its objectives. In fact, when these provisions are subjected to careful review, it becomes apparent that they fail to meet the tests of fairness and efficiency on three grounds:

First, they afford little relief to one who continues working after age 65, although his financial needs may be no different from those of his retired neighbor. This arises because wage income operates to reduce or eliminate an individual's social security benefits and, in addition, to reduce or eliminate the amount of any retirement income credit otherwise available to him. Under the present formula an elderly person who, for example, earns $4,200 per year from employment will not be eligible to receive social security benefits or to utilize the retirement income credit. His tax liability would be $420. On the other hand, the elderly individual who is no longer working and whose $4,200 annual income consists of maximum social security benefits plus dividends, interests, and so forth, will have a tax liability of only $96. This is because his social security income is completely free of tax. Table 1 demonstrates the inequitable tax burdens as between elderly workers and elderly retirees.

TABLE 1.—COMPARISON OF TAX LIABILITY UNDER PRESENT LAW OF ELDERLY WORKER AND ELDERLY SOCIAL SECURITY RETIREE[1]

Present money income	Elderly worker with wage income only	Elderly retiree: With maximum social security benefits and other income[2]	Elderly retiree: With average social security benefits and other income[3]
Single, over 65:			
$3,000	$209	0	$35
$5,000	557	$221	358
$6,500	833	484	617
Married, both over 65:			
$6,000	450	16	138
$7,500	686	232	368
$10,000	1,114	620	770

[1] Taxpayers are not eligible for retirement income credit.
[2] Maximum social security benefits in 1969 are: Single—$1,926; married—$2,889.
[3] Average social security benefits in 1969 are: Single—$1,150; married—$2,015.

Second, in addition to this discrimination against elderly persons who continue working, the present system of benefits gives the greatest advantage to those in the highest income brackets. For example, the extra $600 exemption is of increasing benefit as the individual's tax bracket increases; it reduces the taxes of those in the highest bracket by $420 a year but is worth only $84 to a married taxpayer in the lowest bracket. Similarly, for those elderly persons eligible for the social security and railroad retirement exclusions, the value of each dollar of exclusion rises as the recipient's income and tax bracket rise.

Third, the income tax system applicable to the elderly is made exceedingly complex by the detailed and complicated rules involved in computing the retirement income credit. This computation requires an extra page on the tax return, and experience indicates that it is so complicated that many of the elderly do not understand it and, therefore, lose the benefits to which they are entitled.

It would seem abundantly clear, therefore, that the present tax program for the elderly falls far short of meeting the objective of giving financial aid to the elderly in an equitable, uniform, and efficient manner.

PREVIOUS PROPOSAL

In early 1967 the President, in his "Message on Older Americans", recommended a complete revision of the income tax treatment of the elderly to meet the problems outlined above. Legislation to implement this recommendation was introduced in Congress as part of H.R. 5710, the forerunner of the administration's 1967 social security bill. However, Congress decided not to consider this important income tax revision in the context of social security legislation. Therefore, the proposal is being resubmitted, but with modifications to meet certain problems which were raised with respect to the original proposal.

CURRENT PROPOSAL

The current proposal retains the basic framework of the original program. It would eliminate the inequitable and complex features of existing law applicable to elderly taxpayers and would provide, instead, a flat exemption applicable to all middle and lower income elderly alike. The proposal would provide overall net tax reduction for the elderly as a group, and substantial tax reductions for those at lower and middle income levels. Those in the higher income brackets would pay additional tax. Elderly taxpayers, in addition to benefiting from the changes directed specifically at the elderly, will also benefit substantially from the proposed increase in the standard deduction (from 10 to 14 percent), and the proposed increase in the minimum standard deduction (from $200 plus $100 for each exemption to $600 plus $100 for each exemption) which are being recommended for all taxpayers in another proposal.

The following is a more detailed description of the proposals for revising the tax treatment of the elderly:

PERSONS WHO HAVE ATTAINED THE AGE OF 65

The present patchwork of benefits available to persons over 65 would be replaced by a single special exemption. Thus, the retirement income credit and the extra, but not the basic, $600 personal exemption and related extra $100 increase in the minimum standard deduction would be eliminated. Social security and railroad retirement annuities paid as retirement benefits would be included in the gross income computation. On the other hand, disability benefits, death benefits, and children's benefits under these programs would remain exempt.

These existing tax benefits would be replaced by a new special exemption of $2,500 for single taxpayers 65 or over (and for married couples when only one spouse is 65 or over) and a special exemption of $4,200 for a married couple where both are over 65. These special exemptions would be available regardless of the composition of the taxpayer's income. Thus, they could be claimed by an elderly individual who is still working as well as by one who is retired. Tables 2 and 3 demonstrate that the tax liabilities of elderly workers and retirees with the same income would be equal under the proposal.

TABLE 2.—THE AMOUNT OF TAX DECREASE UNDER THE AGED PROPOSAL, SINGLE TAXPAYER AGE 65

Present money income	Present tax [1]	Tax under proposal	Tax decrease
Maximum social security benefits ($1,926):			
$3,000	0	0	0
$5,000	$221	$209	$12
$6,500	484	452	32
$6,667	513	513	0
Average social security benefits ($1,150):			
$3,000	35	0	35
$5,000	358	209	149
$6,500	617	452	165
$7,000	704	633	71
$7,365	776	776	0
Wage income only:			
$3,000	209	0	200
$5,000	557	209	349
$6,500	833	452	388
$7,500	1,031	833	191
$8,000	1,130	1,042	88
$8,400	1,220	1,220	8

[1] No retirement income credit.

TABLE 3.—THE AMOUNT OF TAX DECREASE UNDER THE AGED PROPOSAL, MARRIED, BOTH OVER 65

Present money income	Present tax [1]	Tax under proposal	Tax decrease
Maximum social security benefits ($2,889):			
$6,000	$16	0	$16
$7,500	232	$192	40
$10,000	620	552	68
$11,727	915	915	0
Average social security benefits ($2,015):			
$6,000	138	0	138
$7,500	368	192	176
$10,000	770	552	218
$12,485	1,203	1,203	0
Wage income only:			
$6,000	450	0	450
$7,500	686	192	494
$10,000	1,114	552	562
$14,500	2,062	2,062	0

[1] No retirement income credit.

On the other hand, the special exemptions would not be available to elderly individuals in the upper income brackets where there is no financial need to justify tax relief because of age. Withholding of the new benefit from these individuals would be accomplished by reducing the exemption dollar for dollar for all income (including social security and railroad retirement benefits) received during the taxable year in excess of $6,500 in the case of a single individual and $11,500 in the case of a married couple.[1] However, in order to reflect the retiree's own contributions to the social security or basic railroad retirement system, the amount of his special exemption would, in no case, be reduced below an amount equal to one-third of the amount of those benefits included in income for tax purposes.

The amount of the special exemption is higher than under the original proposal by $200 both for single individuals and for married couples. These increases will bring the special exemption to a level where it takes account of the recent increase in social security benefits.[2] The level at which the special exemption begins to phase out have also been raised: from $5,600 to $6,500 for a single person and from $11,200 to $11,500 for a married couple. Thus, as so modified, the new special exemption could not be phased out completely below an income level of $9,000 for a single taxpayer (as compared to $7,900 under the original proposal) and $15,700 for a married couple (compared to $15,200 under the original proposal). Besides raising the income levels below which tax reduction will be realized, this modification recognizes, by raising the phaseout level for single people to over half that for a married couple, that the cost of living for single elderly people is, in general, appreciably more than one-half that of elderly married couples.

PERSONS UNDER THE AGE OF 65

Under existing law, persons under age 65 need not include their social security or railroad retirement benefits in income and, in addi-

[1] Tables 2 and 3 demonstrate the income level *at which* tax liability under present law and under the proposal would be the same and *above which* tax under the proposal would be higher than under present law.

[2] The new $2,500 special exemption is roughly equivalent to the sum of the 1968 maximum primary social security benefit ($1,800 rounded) and the existing extra $600 personal exemption and its related $100 minimum standard deduction. To arrive at the $4,200 married couple's exemption, there is added $900 representing the wife's social security benefit and $700 representing her extra $600 personal exemption and related $100 minimum standard deduction, with the total rounded to $4,200.

tion, those individuals receiving a pension under a public retirement system are eligible for the retirement income credit. The proposal would eliminate these preferences and substitute instead, for the individuals involved, a special deduction equal to the lesser of (1) the actual amount of pension, social security or railroad retirement benefits received or (2) $1,600. The $1,600 limitation would be reduced at the upper income levels in the same manner as the special exemption is phased out for those over age 65.

SPECIAL PROVISIONS FOR RAILROAD RETIREMENT ANNUITANTS

In addition to his special exemption of $2,500, a railroad retiree over age 65 would be allowed a supplemental exemption for any railroad retirement benefits he receives in excess of $1,800, but with an overall limit on this extra exemption of $600. For a married couple, the extra exemption would relate to their railroad retirement benefits in excess of $2,600, but with an overall limit on the additional exemption of $600. In each case, the supplemental exemption plus the special exemption would be subject to the phaseout provisions for higher income individuals.

These special provisions were not a part of the original proposal. They have been added to assure that people now receiving a railroad retirement annuity at or near the current maximum level (which is considerably greater than the maximum social security annuity) will not realize a significant tax increase merely as a result of the inclusion of their benefits in gross income if they are not affected by the phaseout provision.

EFFECTS OF THE PROPOSED CHANGES

Effect on elderly group as a whole

About 3.6 million of the current 4.8 million elderly taxpayers would receive tax reductions under the recommendation. (See table 4.) When the proposal for increasing the standard deduction is considered, all elderly single persons with incomes below $7,222 and all elderly married couples with incomes below $12,854 would receive tax reductions. Many persons with incomes above these levels will also receive tax reductions, depending upon the nature of their income and its consequent treatment under present law. (See tables 5, 6, and 7.) Those people with incomes above these levels who realize tax increases will become taxable on, or more nearly on, the same basis as persons under age 65 with equivalent amount of income.

TABLE 4.—*Number of people affected by aged proposal*

Income levels below which there would be no tax:	
(a) Single	$3,444
(b) Married	$6,000
Number of additional people exempt from tax	600,000
Number of people who have tax reduction but remain taxpayers	3,000,000
Total number receiving tax reductions	3,600,000
Number of people who have a tax increase	1,250,000
The estimated cost of the suggested modification is	80,000,000

NOTE.—The revised proposal would provide a special exemption of $2,500 for single taxpayers age 65 or over and $4,200 for married couples both of whom are age 65 or over. These exemptions are reduced by the amount that income exceeds $6,500 and $11,500, respectively, but not below one-third of social security or railroad retirement income.

TABLE 5.—*Income levels below which taxpayers over 65 would have a tax reduction and above which a tax increase*

SINGLE INDIVIDUALS

	Income level separating tax cut from increase[1]
Maximum primary social security benefit ($1,926):[2]	
1. No retirement income credit[3]	$6,607
Average social security benefit ($1,150):[4]	
1. Maximum retirement income credit[5]	7,092
2. No retirement income credit[5]	7,365
Minimum social security benefit ($660):[6]	
1. Maximum retirement income credit[5]	7,215
2. No retirement income credit[5]	7,806
No social security benefits:	
1. Maximum retirement income credit[5]	7,350
2. No retirement income credit[5]	8,400

[1] The calculations assume use of the standard deduction. These levels are higher for itemizers.
[2] The maximum which will be received by a significant number of beneficiaries in 1969.
[3] No retirement income credit because social security or railroad retirement income exceeds $1,524.
[4] Average primary retirement benefits for those receiving such benefits.
[5] Maximum retirement income when earnings do not exceed $1,200 or taxpayer is over age 72. No retirement income credit when eliminated by earnings.
[6] Minimum primary retirement benefits.

NOTE.—The revised proposal would provide a special exemption of $2,500 for single taxpayers age 65 or over and $4,200 for married couples both of whom are age 65 or over. These exemptions are reduced by the amount that income exceeds $6,500 and $11,500, respectively, but not below one-third of social security or railroad retirement income.

TABLE 6.—*Income levels below which taxpayers over 65 would have a tax reduction and above which a tax increase*

MARRIED COUPLE, BOTH AGE 65

	Income level separating tax cut from increase[1]
Maximum primary and supplemental social security benefit ($2,889):[2]	
1. No retirement income credit[3]	$11,727
Average social security benefit ($2,015):[4]	
1. Maximum retirement income credit[5]	12,269
2. No retirement income credit[5]	12,485
Minimum social security benefit ($990):[6]	
1. Maximum retirement income credit[5]	12,510
2. No retirement income credit[5]	13,510
No social security benefits:	
1. Maximum retirement income credit[5]	12,941
2. No retirement income credit[5]	14,500

[1] The calculations assume use of the standard deduction. These levels are higher for itemizers.
[2] The maximum which will be received by a significant number of beneficiaries in 1969.
[3] No retirement income credit because social security or railroad retirement income exceeds $2,286. Assumes the husband receives retirement income and wife receives none.
[4] Average primary and supplemental benefits for those receiving such benefits.
[5] Maximum retirement income when earnings do not exceed $1,200 or taxpayer is over age 72. No retirement income credit when eliminated by earnings.
[6] Minimum primary and supplemental retirement benefits.

NOTE.—The revised proposal would provide a special exemption of $2,500 for single taxpayers age 65 or over and $4,200 for married couples both of whom are age 65 or over. These exemptions are reduced by the amount that income exceeds $6,500 and $11,500, respectively, but not below one-third of social security or railroad retirement income.

TABLE 7.—*Income levels below which taxpayers over 65 would have a tax reduction and above which a tax increase*

MARRIED COUPLE, HUSBAND AGE 65, WIFE UNDER AGE 65

	Income level separating tax cut from increase[1]
Maximum primary social security benefit ($1,026):[2]	
1. No retirement income credit[3]	$11,528
Average social security benefit ($1,150):[4]	
1. Maximum retirement income credit[5]	12,496
2. No retirement income credit[5]	13,000
Minimum social security benefit ($660):[6]	
1. Maximum retirement income credit[5]	12,798
2. No retirement income credit[5]	13,980
No social security benefits:	
1. Maximum retirement income credit[5]	13,210
2. No retirement income credit[5]	15,300

[1] The calculations assume use of the standard deduction. These levels are higher for itemizers.
[2] The maximum which will be received by a significant number of beneficiaries in 1969.
[3] No retirement income credit because social security or railroad retirement income exceeds $1,524.
[4] Average primary retirement benefits for those receiving such benefits.
[5] Maximum retirement income when earnings do not exceed $1,200 or taxpayer is over age 72. No retirement income credit when eliminated by earnings.
[6] Minimum primary retirement benefits.

NOTE.—The revised proposal would provide a special exemption of $2,500 for single taxpayers age 65 or over and $4,200 for married couples both of whom are age 65 or over. These exemptions are reduced by the amount that income exceeds $6,500 and $11,500, respectively, but not below one-third of social security or railroad retirement income. For a couple, one under 65, the exemption would be $2,500 phased out after one-half of income exceeds $5,750.

A significant number of elderly taxpayers in the group receiving tax reduction would become completely exempt from tax. This newly exempt group would consist of about 600,000 persons and would include all single people age 65 or over with income (from all sources, including social security and railroad retirement benefits) of $3,800[1] or less and all married couples where both spouses are 65 or over, with incomes of $6,279[2] or less.

REVENUE EFFECT

The substitution of the new special exemption for the current tax benefits for the elderly would produce $490 million in tax reductions for the benefit of the lower and middle income elderly groups; of this amount $235 million would go to people with incomes under $7,000 and $255 million would go to the $7,000 to $20,000 income group. There would be tax increases amounting to $355 million most of which would come from taxpayers with incomes in excess of $10,000 and more than half of which would come from those with incomes in excess of $20,000. Thus, there would be an overall net revenue loss to the Treasury of $135 million. (Table 8.) This may be compared with the original proposal which would have had a balanced revenue effect.[3]

[1] This reflects the special exemption of $2,500, a $600 personal exemption, and the recommended new minimum standard deduction of $700.
[2] This reflects the special exemption of $4,200, two personal $600 exemptions, and the new 14 percent standard deduction of $879 on $6,279 of income.
[3] The $135 million loss would be offset in part by an anticipated revenue gain of $65 million annually from persons who would lose dependency exemptions with respect to elderly relatives. The original proposal would have produced a similar revenue gain. Inclusion of social security and railroad retirement benefits in an elderly person's gross income will in many cases raise that income to an amount which exceeds the maximum which may be earned by one who is claimed as a dependent of another. This effect, however, would be offset in many cases by a proposed increase in the maximum earnings limitation from $600 to $1,200.

EFFECT OF PROPOSAL ON INDIVIDUALS WITH VARIOUS TYPES OF INCOME[4]

A single elderly person receiving *average social security* benefits (taking into account the recent increases) may have an annual *income from other sources* of up to *$2,650* before he will owe *any* tax. This $2,650 of other income will cover the pension receivable by a 30-year employee under a typical plan providing benefits equal to $5 per month for each year of service, as well as $850 of investment income (representing $17,000 of capital at 5 percent interest).

Even though he is receiving the new *maximum social security* benefit, a single person may, nevertheless, have up to *$1,875* of *other income* before owing *any* tax. For an individual who was earning $7,500 when he retired, this other income represents a pension of 25 percent of final pay.

A married couple receiving *average social security benefits* may have an annual *income from other sources* of up to *$4,260* before owing *any* tax. This other income will fully cover the pension for a 30-year employee payable under the "$5 per month" plan described above, as well as $2,460 of investment income (representing $49,000 of capital at 5 percent).

A married couple may receive the *new maximum social security* benefits *plus* annual *income from other sources* of nearly $3,400 before owing *any* tax. If the husband was earning $8,000 before retirement, this other income will cover a pension equal to 25 percent of final pay plus $1,400 of investment income (representing capital of $28,000 at 5 percent interest).

For persons living *only on social security* benefits, the maximum benefit level would have to double over the new levels before the income tax would become a factor. If they receive *average social security benefits*, their benefits would have to more than triple over the new levels before they would owe any tax.

TABLE 8.—TREASURY PROPOSAL FOR REVISION OF AGED TAX RELIEF: DISTRIBUTION OF GROSS REVENUE LOSS AND GAIN FROM MAJOR PROVISIONS, CALENDAR YEAR 1969[1]

[Dollar amounts in millions]

New adjusted gross income class[2] (in thousands of dollars)	Effect of tax revisions		
	Gross revenue loss (−)	Gross revenue gain (+)	Net revenue effect
0 to 3	−5		−5
3 to 5	−67	(3)	−67
5 to 7	−163	(3)	−163
7 to 10	−141	+21	−120
10 to 15	−105	+74	−31
15 to 20	−9	+81	+72
20 to 50		+120	+120
50 to 100		+42	+42
100 to 200		+14	+14
200 to 500		+3	+3
500 to 1,000		(3)	(3)
1,000 and over		(3)	(3)
Total	−490	+355	−135

[1] Does not include the $65,000,000 revenue gain from dependency changes, the $5,000,000 revenue loss with respect to taxpayers under 65, nor the $5,000,000 revenue loss from special treatment of railroad retirement beneficiaries,.
[2] After inclusion of social security benefits in adjusted gross income.
[3] Less than $500,000.

[4] These examples all assume enactment of the other proposals in the reform program.

In sum, for the overwhelming number of social security recipients, the proposal will have no tax effect on their social security benefits or will actually result in a tax reduction. Indeed, of the 17 million elderly persons receiving social security benefits, about 14.3 million are now free of income tax and would remain so well into the future. Only about 2.7 million are taxpayers now and 2.0 million of these would receive tax reductions under the proposal. As a result, approximately 96 percent of the recipients of social security retirement benefits will either be unaffected or have their taxes decreased under the proposal. Also unaffected will be the 7 million persons receiving disability benefits, children's benefits, and death benefits under the social security system.

EFFECTIVE DATES

These recommended changes in the income tax treatment of the elderly would take effect beginning with the 1970 tax year.

V-M. REVISED TAX TREATMENT OF THE ELDERLY

TECHNICAL EXPLANATION

I. INCLUSION OF RETIREMENT BENEFITS RECEIVED UNDER THE SOCIAL SECURITY AND RAILROAD RETIREMENT SYSTEMS IN GROSS INCOME

At present all social security benefits (by administrative ruling) and railroad retirement benefits (by law) are excludable from gross income. The proposal would provide for the inclusion in gross income of virtually all social security and railroad retirement benefits which are in the nature of retirement benefits.

More specifically, the basic retirement annuity paid to a covered worker, as well as the benefit paid to his wife, would be includible in income for tax purposes. On the other hand, the following types of benefits would not be includible in income:

(1) Annuities paid to a minor child of a retired, disabled, or deceased employee.

(2) Lump sum death benefits.

(3) Annuities paid to the widowed mother of a minor child.

(4) Annuities paid on account of disability. Annuities paid on account of disability convert to retirement benefits when the disabled recipient reaches age 65 (ages 60 and 62 in the case of disabled widows and widowers, respectively), and as such (with the exception of child's benefits) would be includible in income. This treatment corresponds with the sick pay provisions applicable to disability payments received under private plans.

II. REPEAL OF THE RETIREMENT INCOME CREDIT

Section 37 of the Internal Revenue Code, the retirement income credit, would be repealed under the proposal. The retirement income credit is a very complex provision intended to extend tax benefits, somewhat comparable to the tax benefits resulting from the exclusion of social security and railroad retirement from gross income, to retired individuals who are not covered (or only partially covered) by the social security and railroad retirement programs.

The retirement income credit is, basically, a credit against the taxpayer's tax equal to 15 percent of his first $1,524 of retirement income. The $1,524 base is raised to $2,286 in the case of a married couple with both spouses over 65 but where only one has retirement income or otherwise qualifies for the credit. Retirement income eligible for the credit includes, in the case of a person over 65, pension benefits, rents, interest, and dividends; in the case of a person under 65 it includes only pension benefits received from a public retirement system. The $1,524 maximum base is reduced by the amount of social security or railroad retirement benefits received.

III. REPEAL OF THE EXTRA PERSONNEL EXEMPTION AND RELATED MINIMUM STANDARD DEDUCTION

The provision of present law which allows each taxpayer over the age of 65 an additional $600 personal exemption would also be repealed. This will automatically result in the elimination of the $100 minimum standard deduction that is related to that personal exemption. Taxpayers over the age of 65 will still be eligible for the basic $600 personal exemption and related minimum standard deduction allowable to all taxpayers generally.

IV. SPECIAL EXEMPTION FOR INDIVIDUALS OVER AGE 65

To replace the tax benefits described above, the proposal creates a new special exemption for persons aged 65 or more. To qualify for the exemption the taxpayer must have attained age 65 before the close of the taxable year involved. For a single person the annual special exemption is $2,500. For a married couple where both are over 65, each may qualify for a $2,100 annual exemption—for a total of $4,200 on a joint return. Section 153 of the Code is applicable in determining marital status. For married couples where only one spouse is over age 65, the one over age 65 may qualify for a $2,500 exemption (i.e., the same as a single person), whether or not a joint return is filed. The one under 65 is not entitled to a special exemption but may be entitled to the new retirement income deduction if she is receiving social security, railroad retirement, or public retirement system benefits (see item V for description of this proposal).

The special $2,500 exemption for a single person over 65 is approximately equal to the total tax benefits resulting from the following provisions of existing law, which would be eliminated:

1. The exclusion from gross income of social security benefits in the amount of the current (1968) maximum annuity of $1,800 (rounded).
2. The extra $600 personal exemption allowable to individuals over age 65 and the extra $100 minimum standard deduction that is related to the extra $600 personal exemption.

The special exemption does not replace, but is an addition to the regular $600 personal exemption and related minimum standard deduction which are available to all taxpayers at any age.

The $4,200 total exemption provided for a married couple both over 65 is also comparable to the total tax benefits resulting from the following provisions of existing law, which would be eliminated:

1. The exclusion from gross income of the worker's social security benefits in the amount of the current maximum annuity of $1,800 (rounded).

2. The exclusion from gross income of the spouse's social security benefits, up to a maximum of $900 (rounded), which represents the maximum receivable by a spouse who does not qualify for benefits in her own right.

3. The two extra $600 personal exemptions plus the two $100 minimum standard deductions that are related to these extra exemptions.

The special exemptions are allowed as deductions from adjusted gross income. However, there is no requirement that the individual itemize his deductions in order to qualify for the special exemption. This method of handling the special exemption—which is the same as that followed for the $600 personal exemption—will permit the standard deduction to be computed on an income base which includes social security or railroad retirement benefits but which has not yet been reduced by the offsetting special exemption. This will, in effect, result in an added benefit to many of those taking the standard deduction.

Additional exemption for certain railroad retirees.—As indicated above, the amount of the new special exemption for the elderly is intended to offset the total dollar amount of present benefits which are to be eliminated. Thus, the exemption includes an allowance for an amount roughly equal to the current maximum social security annuity ($1,800 single or $2,700 for a married couple), which annity will no longer be excludable from income. However, railroad retirement benefits, the exclusion for which is also to be eliminated, are considerably higher than social security benefit levels. Thus, the basic $2,500 and $4,200 special exemptions do not provide a complete substitute for the benefits that would be given up by persons presently receiving tax-free railroad retirement annuities at or near the present maximum levels.

In order to reflect these higher benefit levels, an addition to the special exemption would be provided as follows:

(1) On top of his basic special exemption of $2,500, a single elderly railroad retiree (or one who is married to a spouse under 65) would be allowed an additional exemption in the amount by which his basic railroad retirement benefits exceed $1,800, but with an overall limitation of $600 on this additional exemption.

(2) A married couple (both over 65) would be allowed an additional exemption in the amount by which their combined basic railroad retirement benefits exced $2,600, but with an overall limitation of $600 on this additional exemption. Each spouse is entitled to one-half of this additional exemption if separate returns are filed.

Limitation.—The allowance of the special exemption is limited to taxpayers at the lower and middle income levels. This limitation would operate as follows: For a single person, the special exemption (as increased for excess railroad retirement benefits, if any, as described above) is reduced dollar-for-dollar by the amount of his adjusted gross income in excess of $6,500. However, the exemption is never cut back to a figure below one-third of the basic social security or railroad retirement benefits he has included in his income for that year. This represents a uniform—and generous—allowance for recovery of the employee's contributions to the social security or railroad retirement programs. Thus, for a single person with no social security or railroad retirement benefits, the special exemption will be completely phased out at a $9,000 adjusted gross income level. However, if his taxable income includes $1,500 of social security benefits, his special exemption will in no event be reduced below $500 (one-third of $1,500) no matter how high his adjusted gross income.

For a married couple the special exemption would be reduced dollar for dollar for adjusted gross income in excess of $11,500, but not below one-third of the social security and railroad retirement benefits included in the couple's income. Thus, for a couple with no social security or railroad retirement income, the special exemption will be completely phased out at $15,700 of adjusted gross income. However, if $2,700 of their taxable income consists of social security benefits, their combined special exemption will level out at $900 once they reach $14,800 of adjusted gross income.

For a married couple filing separate returns, the cutback is applied separately to each spouse's exemption but on the basis of their combined incomes. That is, each special exemption is cut back by the amount by which one-half of their combined income exceeds $5,750. The use of the combined income in their case will remove any artificial incentive to file separate returns in order to take advantage of an uneven distribution of income among the spouses.

The social security and railroad retirement benefits that are being included in income under the bill will also be included in the adjusted gross income base for applying the cutback provisions.

V. SPECIAL RETIREMENT INCOME DEDUCTION FOR PERSONS UNDER AGE 65

In addition to the special exemption provided for persons over 65, each individual under age 65 would be entitled to a deduction equal to the amount of social security, railroad retirement, and public retirement system benefits included in his gross income—subject to a ceiling on the deduction of $1,600 and a phaseout provision for higher income taxpayers. The definition of "public retirement system" would be identical to the definition presently in the retirement income credit.

The new retirement income deduction replaces:

1. The exemption from gross income of social security retirement benefits received by a person under 65.
2. The comparable railroad retirement exemption.
3. The retirement income credit for persons receiving pensions under a public retirement system.

The $1,600 ceiling on the deduction more than maintains the present maximum retirement income credit base of $1,524.

This deduction is personal to the taxpayer receiving the specified types of income; thus, married couples cannot combine their deductions to permit the deduction of more than $1,600 of benefits received by one of the spouses. For example, if a retired teacher under age 65 is receiving an annual pension of $2,000 and his wife, who is also under 65, receives no social security, railroad retirement, or public retirement system benefits, the husband may qualify for a deduction of no more than $1,600 and the wife is allowed no retirement income deduction—even if a joint return is filed.[1]

The new retirement income deduction will be allowed as a deduction in arriving at adjusted gross income. Thus, the retirement income (social security, railroad retirement, and public retirement pensions) which is includable in gross income and then offset by the new deduction will not be included in adjusted gross income upon which the standard deduction is computed. If this were not true, the mere receipt of social security, railroad retirement, or public retirement system benefits could produce a tax lower than that which would have been payable if this income were not received. On the other hand, the limitations on the charitable contribution and medical expense deductions would be computed without regard to the retirement income deduction.

As in the case of the special exemption for those over age 65, the $1,600 retirement income deduction *ceiling* will be reduced dollar-for-dollar to the extent that adjusted gross income, including social security and railroad retirement benefits, exceeds $6,500 in the case of a single taxpayer and $11,500 in the case of a married couple. The deduction ceiling will never be reduced, however, to an amount less than one-third of any social security and railroad retirement benefits included in the taxpayer's gross income. In the case of a married person filing separately, the cutback is applied on the basis of one-half of the combined adjusted gross income of both spouses.

VI. FILING REQUIREMENT

Under existing law a person age 65 or over must file a tax return if his gross income exceeds $1,200. As a part of the present proposal, this requirement can be raised and a person 65 or over will only be required to file a tax return if his income, together with his spouse's income if married, exceeds $3,400. The $3,400 amount reflects the income level below which no individual will be taxable.

VII. DEPENDENCY EXEMPTIONS

A taxpayer may claim a personal exemption for any dependent with less than $600 of gross income and for whom he provides half the support. Frequently, this exemption arises in the case of a taxpayer supporting an elderly parent. At present, in applying the "$600 gross income test," social security and railroad retirement benefits are ignored because they are not included in gross income for tax purposes. This would no longer be true under the proposal since the gross income of elderly taxpayers receiving social security or railroad retirement benefits will automatically be increased by the amount of these benefits, and, thus, if no change were made the possibility would exist that many elderly persons formerly claimed as dependency exemptions by their children or by others could no longer be so claimed. This result is not improper, since social security and railroad retirement benefits are as much economic income as are private retirement pension bene-

[1] A special rule is provided for the application of the new retirement income deduction in such a manner as to avoid treating residents of community property States any more or less favorably, as a result of the application of community property law, than all other taxpayers.

fits. Nonetheless, in order to prevent in many cases the loss of a dependency exemption by relatives who support an elderly social security or railroad retirement pensioner, and to liberalize the income requirement where the dependent has nonsocial security income, it would be provided that persons aged 65 or over may receive up to $1,200 of gross income and still be claimed as dependency exemptions.

VIII. EFFECTIVE DATE

The new special exemption and retirement income deduction—as well as the repeal of the present provisions—would apply to taxable years beginning in 1970.

IX. APPLICATION OF SECTION 1341

Under present law, a person who is required to repay or refund an amount which he had erroneously received and reported as income in an earlier year may elect in the year of repayment either to take a deduction for the amount repaid or to claim a current tax credit for the tax previously paid on the amount. However, the election of the latter alternative (under section 1341 of the Code) is limited to cases where the amount repaid is $3,000 or more. This limitation, which was originally imposed for administrative reasons (i.e., as a de minimis rule to eliminate the need to verify computations in cases involving very small amounts), has proved restrictive in many situations, which may increase under the proposal on account of the interyear adjustments of social security payments that are frequently made.

For these reasons the $3,000 limitation of section 1341 would, under the proposal, be lowered to $100.

V-N. VOLUNTARY WITHHOLDING

General Explanation

BACKGROUND

The existing system of income tax withholding provides most employees with a convenient and efficient method of currently paying their income taxes. By providing for automatic current taxpayment evenly over the year, withholding obviates the need for employees having to make large lump-sum payments of tax at any one time. As a consequence, withholding also greatly simplifies the Government's collection problems.

There are, however, various payments of wages, and payments in the nature of wages, which are by law excluded from the withholding system. The excluded items include wages paid to agricultural and domestic employees, as well as retirement payments made to an employee. These payments cannot even be voluntarily subjected to withholding if the employees and employer desire it. This has frequently led to complaints from both parties, since both have an interest in enabling the employees to meet their tax liabilities in a uniform and efficient manner.

PROPOSAL

While a requirement of mandatory withholding in all these situations may not be feasible at this time, the proposal provides that in situations where both parties want it, withholding for tax purposes will be made available on a voluntary basis.

More specifically, provision would be made for an employer and one or more of his employees to enter into a voluntary agreement for the withholding of income tax on any remuneration connected with employment that is not now covered by the withholding system. This voluntary system could cover not only current wage payments, such as wages paid to farm employees, but also payments under deferred compensation plans, such as pension or profit-sharing benefits.

Once an agreement is entered into, the normal withholding rules would come into effect. Thus, the amount to be withheld would be computed on the basis of the normal withholding rates or tables. Moreover, as under the mandatory withholding procedures, the employer would furnish the employee with a withholding statement at the end of the year; and the employer would be required to deposit the withheld taxes according to the same schedule as is applicable in other withholding situations.

EFFECT OF PROPOSAL

This is not intended to be a revenue-oriented proposal. Rather, it will make it easier for those not covered by the present withholding system to handle their income taxpayments. Because it is a proposal for a voluntary withholding in these situations, it is difficult to know how many persons may take advantage of it. However, it is expected that a significant number of persons will do so.

V-X. VOLUNTARY WITHHOLDING PROVISIONS

Technical Explanation

Under existing law, the requirement of income tax withholding is imposed only on persons making payments which constitute "wages" as that term is defined in the Internal Revenue Code. The definition of the term "wages" excludes amounts paid as remuneration for services to agricultural laborers, domestic employees, and a number of other individuals. Such individuals are not permitted to make use of the existing withholding system as a means of paying their income taxes, even though these individuals and their employers may want this convenience.

Under the present law, voluntary private agreements between employer and employee, permitting the employer to set aside amounts from each paycheck for use by the employee in paying taxes, are not a fully satisfactory solution to this problem. For example, in such a case, the employee would get no credit against his income tax liability for the amounts withheld, unless and until the deducted amounts were actually withdrawn and used to pay his Federal taxes. Consequently, if the withheld amounts were to be lost while in the employer's hands, the employee would nevertheless remain liable for the payment of Federal taxes with respect to his wages.

PROPOSAL

Under the proposal, the Secretary of the Treasury would be authorized to promulgate regulations providing for income tax withholding from remuneration for services which does not constitute "wages," as defined in section 3401 of the code. The authority to withhold would apply in those cases in which both the person paying and the individual receiving such remuneration agree voluntarily to such withholding, and in which the withholding agreement conforms to the requirements which would be provided by regulations.

In cases in which a voluntary withholding agreement is executed, the remuneration covered by the agreement would be deemed to be "wages" for purposes of the provisions of the Internal Revenue Code which relate to the collection of income tax at the source on wages. Accordingly, the employer would be liable for the timely payment to the Federal Government of amounts which are withheld pursuant to the voluntary withholding agreement. Further, the amounts withheld would be credited to the recipient of the remuneration as a payment against his Federal income tax liability. The provisions of the code relating to penalties for nonpayment to the Government of withheld amounts, and the provisions relating to information documents regarding wages paid and amounts of tax withheld are likewise applicable to remuneration covered by voluntary withholding agreements.

The amount to be withheld would normally be computed on the basis of the regular withholding rates or tables. However, as in the case of mandatory withholding, the employee could request the withholding of additional amounts.

Voluntary withholding agreements may be entered into whether the remuneration paid relates to present, past, or future services. Accordingly, voluntary withholding agreements can be entered into with respect to annuities which are paid under an employees' pension plan.

VI. CORPORATE INCOME TAX PROPOSALS

General and Technical Explanations

VI-A. MULTIPLE CORPORATIONS

General Explanation

BACKGROUND

Income of corporations is subject to tax at the rate of 22 percent on the first $25,000 and 48 percent on all income in excess of $25,000.* This lower rate, on the first $25,000 of income, referred to as the surtax exemption, is the most important of several provisions of the tax laws designed to help small corporate businesses.

The congressional intent underlying the surtax exemption was clearly expressed by the Senate Finance Committee in 1950 when the present system of a single surtax exemption was substituted for the then existing graduated corporate tax rates:

> A single [surtax] exemption * * * best expresses the idea of a flat tax rate modified by a concession for small business.

Despite this clear congressional intent, the benefits of the surtax exemption in actual operation have not been confined to small businesses. Many large corporate organizations carry on their business activities through a series of separate corporate units. By this device, for whatever reason utilized, the total income of what is in reality one large enterprise is divided among numerous corporate entities, each one of which claims a surtax exemption (the lower rate of tax on the first $25,000 of income). In many cases, the separate corporate units are arranged so that most of them have less than $25,000 of income with the result that almost all of the enterprise income is claimed to be taxable at reduced rates. The claiming of more than one surtax exemption by related corporations results in an estimated annual revenue loss of $235 million which goes to larger enterprises not intended to be benefited by the surtax exemption.

1964 LEGISLATION

The Revenue Act of 1964 made substantial reductions in the income tax rates applicable to corporations. It reduced the tax rate on the first $25,000 of income from 30 percent to 22 percent, and after a 1-year transition period, the tax rate on income over $25,000 from 52 percent to 48 percent. One effect of this rate reduction was to increase the value of the surtax exemption from $5,500 to $6,500.[1] In order to prevent this rate reduction from increasing even further the advantages claimed by multiple corporations, the Revenue Act of 1964 contained provisions designed to deny the increase in the value of the sur-

*The figures presented herein do not reflect the 10-percent surcharge.

[1] The value of the surtax exemption is a constant amount for all corporations that utilize it fully equal to the amount of additional tax on $25,000 that would have to be paid if that $25,000 were taxed at the higher rather than the lower rate. Before the 1964 rate reduction the value of the surtax exemption was 22 percent (52 percent less 30 percent) times $25,000. Since the 1964 rate reduction became fully effective the value of the surtax exemption has been 26 percent (48 percent less 22 percent) times $25,000.

334-891 O - 69 - pt. 2 - 9

tax exemption to ostensibly small corporations which were in reality parts of larger corporate complexes. Generally, controlled groups of corporations (corporations related through stock ownership in certain specified ways) were given the option of sharing one $25,000 surtax exemption or electing to continue claiming separate surtax exemptions at the cost of paying a penalty tax of 6 percent on the first $25,000 of income of each corporation.[2] This penalty tax had the effect of slightly reducing the value of the surtax exemption, where claimed by multiple corporations, to $5,000 from its pre-1964 value of $5,500.

Thus, the 1964 legislation slightly reduced, but did not eliminate, the substantial tax savings claimed by business entities operating through multiple corporations. In 1964, the first year for which the changes described above were effective, about 104,000 (or three-fifths) of the total number of corporations in controlled groups elected to claim multiple surtax exemptions and pay the 6-percent penalty. The net savings to these groups, after allowing for the additional 6-percent penalty required to be paid and the surrender of certain tax advantages which can be obtained only by groups agreeing to share one surtax exemption,[3] was more than $180 million. On the same basis, the tax savings at 1968 levels would be $235 million.

The remaining 69,000 corporations which could have claimed multiple surtax exemptions lost little by their agreement to share one surtax exemption per group. In the first place these corporations retained $379 million (or 90 percent) of the $420 million of surtax exemptions they would have been entitled to on a multiple basis. Apparently, the reduction was slight because in most cases where multiple surtax exemptions were voluntarily surrendered, the groups were made up of only a few corporations with aggregate income near $25,000. Thus, even with only one surtax exemption, most, if not all, of the income of the group was taxed at the lower rates.[4]

Furthermore, while some groups chose to share one surtax exemption solely to avoid the 6-percent penalty, others chose to share one surtax exemption in order to obtain certain tax benefits[5] which outweighed the advantages of multiple surtax exemptions.

Moreover, the use of the multiple-surtax-exemption device has increased over the 1964 levels. Although information for 1965 is incomplete, the indications are that the number of corporations electing to claim multiple surtax exemptions rose to 118,000, an increase of nearly 14 percent over 1964 levels.[6]

Perhaps even more significant than the estimates of aggregate revenue losses, however, are the substantial benefits obtained in individual cases. For example, in one actual case a single parent corporation with 516 wholly owned subsidiaries claimed multiple surtax exemptions in 1964. If each corporation had $25,000 of taxable income, the tax savings

---

[2] Of course, nothing in this change created a right to multiple surtax exemptions where none existed prior to the change.

[3] Parent-subsidiary controlled groups agreeing to share one surtax exemption are entitled, under other provisions of the Internal Revenue Code, to receive intercorporate dividends among members of the group without tax, and, upon filing consolidated returns to offset losses among members of the group and make fuller use of investment credits.

[4] If a group comprised of two corporations had a total income of $50,000, sharing one exemption would result in a 50-percent reduction in the amount of the exemption available to the group. On the other hand, as was apparently the case among a large number of groups forgoing multiple surtax exemptions, if the total income of the group is $25,000 or less, nothing is lost by sharing one surtax exemption.

[5] See footnote 3.

[6] The total number of corporations filing tax returns increased by only 0.05 percent.

of this group would have been $2,580,000 or 42 percent of the tax they would have paid had that enterprise operated through a single corporation.

Moreover, it is not necessary to break a business down into so many separate corporate units in order to obtain substantial tax benefits. For example, a business that finds it impractical to operate through more than one corporation has an effective rate of tax of 41.5 percent on $100,000 of corporate income. On the other hand, if that business is able to operate through one parent corporation and three subsidiaries, it can reduce the effective rate of tax (including the 6 percent penalty) on $100,000 of corporate income spread equally among the corporations to 28 percent.

Finally, while the purpose of the surtax exemption is to aid small businesses, table 1 demonstrates that the multiple surtax exemption device is being used to reduce the income taxes of essentially large business entities.[7] Five percent of all business entities were operated through controlled groups in 1965. Two-fifths of that 5 percent claimed multiple surtax exemptions.[8] While that two-fifths constituted only 2 percent of the total number of business entities, as a group they had more than 26 percent of the total income of all business entities and more income than the combined income of the 95 percent of all business entities operated through individual corporations. The average income of a business entity claiming the benefits of multiple surtax exemptions in 1965 was over $800,000 as compared with an average of under $17,000 for business entities operated through individual corporations. The data clearly indicate that the benefits of the multiple surtax exemption device are heavily concentrated in a small number (2 percent of all business entities) of business entities which are large both in absolute terms (average income—$800,000 per business entity) and in relative terms (more aggregate income than all business entities operated through individual corporations).

As these data clearly show, the allowance of multiple surtax exemptions to enterprises operated through multiple corporate entities is a distortion of its purpose of aiding small businesses and is unfair in that essentially similar enterprises pay markedly different taxes depending upon whether or not they are willing and able to make use of the multiple corporation device.

SOME CASE EXPERIENCE UNDER THE 1964 CHANGE

In 1963, in connection with the Treasury recommendations for the elimination of the multiple surtax exemption device, information concerning 55 cases of large corporate groups that were claiming the advantages of multiple surtax exemptions was presented to Congress. These 55 groups averaged 115 surtax exemptions each. Some details of these 55 cases presented in 1963 are again presented on table 2, but rearranged to reflect their responses to the 1964 legislation. These responses indicate that the extensive use of the multiple surtax exemption device continues. Of the 55 actual cases studied, only 5 groups (or

[7] For purposes of this analysis, a controlled group of corporations is considered as one business entity regardless of the number of separate units into which it is divided.

[8] The remaining three-fifths filed consolidated returns or agreed to share one surtax exemption.

9 percent) representing 521 (or 8 percent) of the 6,300 member corporations chose, for one reason or another, to share one surtax exemption per group. Thirty-nine groups (or 71 percent) representing 5,719 member corporations (or 91 percent) elected to continue claiming multiple surtax exemptions upon the payment of the 6 percent penalty.[9] Of the 39 groups electing multiple surtax exemptions, 29 increased in numbers of corporations included in the groups over 1963 levels. Of these, four groups more than doubled in size with one increasing from 35 to 159 corporate members. The average number of corporations in the 39 groups claiming multiple surtax exemptions in 1964 was 147.

On the basis of the above presentation, it fairly can be concluded that the 1964 legislation had little impact upon eliminating the multiple surtax exemption problem. Groups of corporations continue to derive substantial tax advantages from the use of this device.

PROPOSAL

The proposal would restrict the surtax exemption so that only one would be available to each business entity (i.e., "controlled group of corporations") regardless of whether it is operated as one or a group of corporations. To provide a smooth transition, but at the same time cut down on the worst abuses first, the change to a single surtax exemption would be accomplished in 8 years as follows:

> In the first year no single controlled group of corporations may have more than 500 surtax exemptions.[10]
>
> In the second year, 250 surtax exemptions.
>
> In the third year, 100 surtax exemptions.
>
> In the fourth year, 50 surtax exemptions.
>
> In the fifth year, 25 surtax exemptions.
>
> In the sixth year, 10 surtax exemptions.
>
> In the seventh year, 5 surtax exemptions.
>
> In the eighth and subsequent years, 1 surtax exemption.

During the transition period, those controlled groups claiming use of the multiple surtax exemptions (subject to the maximum ceiling) would remain subject to the 6-percent penalty tax. In cases where the proposal operates to reduce the number of surtax exemptions, the reduced number would be apportioned among the members of the affiliated group either equally or under any other method proposed by the group so long as no one member received more than $25,000. The 6-percent penalty would apply to all income covered by the reduced number of exemptions and would be paid by each corporation to the extent it claimed an exemption.

DEFINITION OF CONTROLLED GROUP

The controlled groups of corporations to which this provision would apply would be defined as:

---

[9] The remaining groups dissolved, merged, did not fit within the controlled group definition adopted under the 1964 rules, or fell in a miscellaneous category. No information was available for one of the two groups placed in the miscellaneous category. With respect to the other, the 1963 group apparently consisted of two or more groups in 1964. One such group elected a single surtax exemption while the other group elected multiple surtax exemptions. Since the 1963 group responded in two ways to the 1964 legislation, it is not placed in any of the above categories. Therefore, the continued use of multiple surtax exemptions is somewhat understated by the above figures.

[10] Of course, the maximum number of surtax exemptions allowed by the transition schedule would not create a right to multiple surtax exemptions where they are not available under present law.

(1) *Parent-subsidiary groups.*—A group of corporations which are connected through 80 percent stock ownership, either directly or through one or more intermediary corporations, with a common parent corporation. For example, a corporation which owns 80 percent or more of the value of voting power of the stock of another corporation is a parent corporation and, together with its subsidiary corporation, constitutes a parent-subsidiary group. And if the subsidiary owned 80 percent of another corporation, that corporation would also be included in the parent-subsidiary group. There is no change in this definition from present law dealing with multiple surtax exemptions.

(2) *Brother-sister groups.*—A group of corporations in which five or fewer persons[10a] own, to a large extent in identical proportions, at least 80 percent of the stock of each of the corporations. This provision expands present law by considering the combined stock ownership of five individuals, rather than one individual, in applying the 80-percent test. Even the mild 6-percent penalty under existing law for brother-sister corporations claiming multiple surtax exemptions is made largely ineffectual because of the present requirement that one person own 80 percent of the stock of each corporation before the group of corporations is subject to the penalty.

However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation, considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.

Thus, even where the 80-percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations *also* meet the 50-percent identical ownership test.

For example, if A owns 55 percent of Corporation Y and 45 percent of Corporation Z, and B owns 35 percent of Y and 40 percent of Z, the two tests would apply as follows:

	Percent of stock ownership		Percent of identical ownership	
	Corporation		Corporation	
	Y	Z	Y	Z
Shareholder:				
A	55	45	45	45
B	35	40	35	35
Total	90	85	80	80

As the table illustrates, A and B together own 90 percent of Y and 85 percent of Z. Thus, the basic 80-percent ownership test is met. However, since A owns 55 percent of Y but only 45 percent of Z, his stockholdings in the two are identical only to the extent of 45 percent.

10a "Persons" in this discussion refers to individuals, estates, or trusts.

Similarly, B's stockholdings are identical only to the extent of 35 percent. Together A and B hold 80 percent each of Y and Z and the 50-percent test is met. Thus, in this example, Y and Z are members of a brother-sister controlled group.

Expanding the 80-percent ownership test from one person to five will close the present opportunity for easy avoidance of that 80-percent test. However, adding the 50-percent identical ownership test will insure that the new expanded definition is limited to cases where the brother-sister corporations are, in fact, controlled by the group of stockholders as one economic enterprise.

AVOIDANCE OF RULES THROUGH EXEMPT ORGANIZATIONS

Under present law, some taxpayers might seek to avoid the percentage of ownership tests through use of controlled tax-exempt foundations. For example, an individual who owns two corporations might seek to avoid the 80-percent portion of the brother-sister controlled group test by transferring a 21-percent stock interest in one of the corporations to a nonstock [11] tax-exempt foundation which he, or interests related to him, controls. In order to eliminate this opportunity for circumventing the percentage of ownership test for parent-subsidiary and brother-sister controlled groups, a provision would be added disregarding stock held by such controlled tax-exempt foundations when applying these tests. Thus, in the above example, the 21-percent stock interest owned by the exempt organization would be ignored. The individual, therefore, would own 100 percent of the stock of both corporations for purposes of applying the 80-percent ownership test.

OTHER TAX BENEFITS TO WHICH THE PROPOSAL APPLIES

While the surtax exemption is the major benefit, it is by no means the only benefit claimed in multiple form by controlled groups of corporations. The other tax benefits which would be similarly restricted by the proposal (under the same 8-year transition rule) are:

(1) *The $100,000 minimum accumulated earnings credit.*—Under present law, a corporation which unreasonably accumulates earnings and profits in order to avoid the dividend tax on shareholders is subject to a penalty tax imposed on the amount of income unreasonably accumulated.

However, a corporation is entitled to accumulate $100,000 without being subject to accumulated earnings tax. As in the case of the surtax exemption, this accumulated earnings credit is designed to allow small businesses to accumulate a minimum amount of capital without being subject to the extra tax. However, it is also claimed in multiple amounts by large enterprises operating in multiple corporate form as a device to accumulate large amounts of earnings and profits sheltered from the tax by the multiple "minimum" credits.

(2) *The small business deduction for life insurance companies.*—Under present law, life insurance companies are allowed a small business deduction of 10 percent of investment yield, up to a maximum of $25,000. As with the surtax exemption, this provision is intended

---

[11] The constructive stock ownership rules of existing law might preclude the use of foundations organized in corporate form with outstanding stock.

to aid small companies to meet the competition of larger corporations in the field. However, the limited benefit intended by Congress for small businesses is being claimed in large amounts by large enterprises which divide their incomes among several corporate entities.

3. Investment credit and additional depreciation limitations.—In addition, the following adjustments in the present restrictions on multiple-investment credit and additional first-year depreciation deduction limitations would be made under the proposal:

(*a*) *Investment credit.*—The investment credit provisions contain two special rules designed as small business benefits. First, the investment credit is generally limited to 50 percent of a taxpayer's tax liability. This limitation does not, however, apply to the first $25,000 of tax liability.

Second, the investment credit is generally allowed only on new assets. However, as an aid to small businesses the credit is allowed on up to $50,000 of used equipment.

In order to prevent avoidance of these limitations by controlled groups of corporations, certain parent-subsidiary groups of corporations are now limited to one of each of these special provisions for the group. The proposal would extend this present restriction (A) by conforming the definition of parent-subsidiary group to that applicable under the multiple surtax provisions of present law and (B) by expanding the limitation to apply, also, to brother-sister controlled groups as defined in the proposal for purposes of the multiple surtax exemption. In view of the provision allowing for the carrying over of excess investment credits (including any amount of credit disallowed under this proposal) from one year to the next, no special transition rule is necessary.

(*b*) *Additional first-year depreciation.*—Under present law, a taxpayer may elect to take as a depreciation deduction for the year the property is acquired, 20 percent of the cost of certain qualified property. However, since this provision is designed as an aid to small business, the aggregate cost of property subject to this special provision is limited to $10,000 per year. In order to carry out the policy of restricting the benefit to truly small businesses, certain parent-subsidiary groups are presently restricted to one $10,000 limit. The proposal would extend this policy by applying the restrictions to parent-subsidiary groups as defined under the multiple surtax provisions of present law and by extending them to cover brother-sister groups as defined in the proposal. Since any depreciation deductions not allowed in the first year by reason of these changes would be allowable in subsequent years under the normal depreciation rules, no transition rule is necessary.

SUMMARY

These proposals will prevent business enterprises from taking undue advantage of provisions designed as aids to small businesses and will insure competitive fairness to those business firms which do not utilize the multiple surtax exemption device.

REVENUE

This provision after the transition period will increase Federal revenues by $235 million a year.

EFFECTIVE DATE

These provisions would become effective for taxable years beginning after December 31, 1969. Thus, the transition period would start with taxable years beginning in 1970 and would end with taxable years beginning in 1977.

TABLE 1.—ESTIMATED BUSINESS ENTITIES AND NET INCOME, BY METHOD OF FILING, 1965 RETURNS

[Dollar amounts in millions]

Method of filing	Business entities[1]		Net income		Legal entities	
	Number	Percent	Amount	Percent	Number	Percent
Total[2]	1,080,354	100.0	$70,770	100.0	1,286,824	100.0
Individual corporations	1,034,254	95.7	16,851	23.8	1,034,254	80.4
Controlled groups filing consolidated returns or electing single surtax exemptions	[3] 24,500	2.3	35,298	49.9	134,481	10.5
Controlled groups electing multiple surtax exemptions	[3] 21,600	2.0	18,621	26.3	118,089	9.1

[1] For purposes of the analysis, a controlled group of corporations is counted as one business entity regardless of the number of separate units into which it is divided.
[2] Does not include life insurance companies or those qualifying corporations electing to be taxed as partnerships.
[3] The number of groups filing consolidated returns and the number of subsidiaries is known. There is no direct data on the number of non-consolidated groups voluntarily agreeing to share one surtax exemption or the number of groups electing multiple surtax exemptions. However, the total number of separate corporations in each of these categories is known. The number of groups in these categories has been estimated by assuming that the average size of a group is the same as it is in the consolidated return category.

TABLE 2.—METHOD OF FILING TAX RETURNS IN 1964; 55 ACTUAL CONTROLLED GROUPS OF CORPORATIONS UTILIZING MULTIPLE SURTAX EXEMPTIONS PRIOR TO THE REVENUE ACT OF 1964, WITH NUMBER OF CORPORATIONS IN GROUP

Method of filing in 1964; 1963 case number		Number of corporations in group			
		1963		1964	
		Parent-subsidiary	Brother-sister	Parent-subsidiary	Brother-sister
Summary					
All filing methods		5,146		6,292	
Multiple surtax exemption (39 groups).		4,201		5,719	
Single surtax exemption (5 groups).		321		521	
Other[1]		624		52	
Electing multiple surtax exemptions: Total		4,201		5,719	
Detail of cases	**Nature of business**				
1	Retail sale of food products through stores		12	3	2
2	Sale of beer, soft drink, and food at wholesale in one State.		19	3	
3	Operation of a chain of stores in 10 States. In addition operations include feeder-plants to produce many food products.	56		60	
4	Own and operate apartment buildings		14		61
5	Corporations lease transportation equipment to the stockholders, plus furnishing facilities and repair services related thereto.		22		16
8	Manufacturer and distributor of textiles. In addition, factors accounts receivable and operates a chain of retail clothing stores.	405		395	
9	Beauty salons located throughout the United States.	250		361	
10	Fleet of taxicabs in 1 city	50			33
11	Chain of retail jewelry stores located in a number of States.	191		383	
12	Finance business	92		157	
13	do	137		169	

See footnotes at end of table.

TABLE 2.—METHOD OF FILING TAX RETURNS IN 1964; 55 ACTUAL CONTROLLED GROUPS OF CORPORATIONS UTILIZING MULTIPLE SURTAX EXEMPTIONS PRIOR TO THE REVENUE ACT OF 1964, WITH NUMBER OF CORPORATIONS IN GROUP—Continued

Method of filing in 1964; 1963 case number	Nature of business	Number of corporations in group			
		1963		1964	
		Parent-subsidiary	Brother-sister	Parent-subsidiary	Brother-sister
14	Retail furniture stores in several cities		23	24	
15	Retail stores at several hundred locations. Related activities include feeder-type plants to produce merchandise.	142		173	
16	Retail and wholesale distribution of merchandise, such as appliances and housewares.	74		86	
20	Finance business	43		53	
21	Chain of restaurants		51		11
22	Development and lease of real estate in connection with apartment houses and shopping centers.		69		89
23	Chain of stores engaged in the retain sales of dairy products produced by a partnership consisting of the stockholders of the corporations. Other activities of the corporations include operation of a chain of supermarkets; leasing of autos and trucks to the partnership; building and loan associations, and operation of a radio station, a life insurance company, and a real estate company.		36		71
24	Finance business	63		66	
25	Distribution and sale of fuel	21		25	
26	Chain of drugstores	38		82	
27	Manufacturers and retailers of dry goods. The retail operations are conducted through more than 100 stores.	110		185	
28	Finance business	46		70	
29	Chain of retail stores selling gift items	35		159	
31	Personal loans through approximately 900 offices in 41 States.	345		516	
32	Chain of foodstores	38		70	
35	Taxicab business	151		155	
37	Chain of general merchandise stores	67		85	
39	Chain of clothing stores	207		344	
40	Chain of general merchandise stores	72		65	
41	Personal loans, automobile financing and various types of insurance.	280		367	
42	Sale of cigarettes, food, and related items through vending machines. In addition some of the vending products are manufactured and programed music is provided on a contract basis.	56		51	
44	Food brokerage	7	2	4	2
46	Retail sale of clothing		12	22	
48	Eating establishments in 14 areas		14	4	
51	Finance business		10	11	
52	Manufacture and retail sale of shoes	139		212	
53	do	734		997	
54	Fabrication and sale of furniture and fixtures	68		77	
Electing 1 surtax exemption: Total.[1]		321		521	
6	Beverages. Subsidiary companies distribute parent company's products.	14		16	
19	Wholesale, installment and commercial financing, and factoring. Other activities include credit, health, automobile, and life insurance; the manufacture of metal, glass, and plastic products, and heavy machinery; and processing of meat products throughout the United States.	128		195	
33	General merchandise stores	45		131	
43	Clothing concessions in shopping centers		16	44	
55	Chain of repair shops. Activities also include the operation of several supply houses.		118	135	
Other:[2] Total			624		52

[1] See footnotes at end of table.

TABLE 2.—METHOD OF FILING TAX RETURNS IN 1964; 55 ACTUAL CONTROLLED GROUPS OF CORPORATIONS UTILIZING MULTIPLE SURTAX EXEMPTIONS PRIOR TO THE REVENUE ACT OF 1964; WITH NUMBER OF CORPORATIONS IN GROUP—Continued

Method of filing in 1964; 1963 case number	Nature of business	Number of corporations in group: 1963 Parent-subsidiary	1963 Brother-sister	1964 Parent-subsidiary	1964 Brother-sister
7	Chain of restaurants. In addition, catering services are offered.		26	(3)	(3)
15	Retail stores at several hundred locations. Related activities include feeder-type plants to produce merchandise.		142		
17	Optometric services, including manufacture of plastics and eye glass frames, and sale of optical goods and supplies at wholesale and retail		22		
18	Milling; storage and sale of grain, feed, and seed; wholesale grocery; wholesale drug items, and sundries; oil production; trucking; and wholesale paper products	5	37	12	40
34	Chain of retail shoe stores. In addition, manufacturing facilities produce some of the merchandise for the retail stores as well as merchandise for other distributors	251			
36	Chain of variety stores	60			
38	Chain of general merchandise stores	157			
45	Sale of paint products	20			
47	Wholesale distribution of food products as well as operating retail food stores.		11		
49	Sale of new and used cars in 3 locations, as well as auto financing and insurance, auto repairs, car and truck rental, and real estate rental.		10		
50	Buying and developing unimproved real estate as well as building and selling residential houses.		10		

[1] Of the 5 groups in this category only 1 (#6) elected to share a single surtax exemption, the 4 others filed consolidated returns in 1964.

[2] This includes 11 of the original 55 cases. Of these, 1 (#18) apparently consisted of 2 or more groups in 1964, 1 of which elected a single surtax exemption and the others multiple surtax exemptions. For another (#7), 1964 data are unavailable The remaining 9 controlled groups selected in 1963 had either merged or were dissolved by 1964.

[3] Not available.

VI-A. MULTIPLE CORPORATIONS

Technical Explanation

A. SURTAX EXEMPTIONS

1. *Present law.*—Existing law provides for a two rate structure for corporate income tax with the lower rate, called the surtax exemption, applicable to the first $25,000 of corporate income. Many large corporate organizations carry on business activities through a series of separate corporate entities, dividing the total income of what is in reality one large enterprise among numerous corporate entities, each one of which claims a surtax exemption. In many cases, the corporations are arranged so that most of them have less than $25,000 of income with the result that almost all of the enterprise's income is claimed to be taxable at reduced rates. In order to restrict somewhat the tax benefits of multiple surtax exemptions, present law provides that corporations which constitute a parent-subsidiary or brother-sister controlled group (defined as two or more corporations related through stock ownership in certain specified ways) must share one $25,000 surtax exemption, or elect to continue claiming separate surtax exemptions upon payment of a penalty tax of 6 percent of the first

$25,000 of income of each corporation. This penalty tax has only the effect of reducing the surtax exemption benefit from $6,500 to $5,000.[1]

2. *General description of recommendation.*—The proposal would limit, gradually over an 8-year transition period, corporations which are members of a parent-subsidiary or brother-sister controlled group to one $25,000 surtax exemption per group. During the transition period the present option to claim multiple surtax exemptions (subject to the maximum number allowable under the transition rule) upon payment of a 6-percent penalty tax would be continued. The exemption (or exemptions during the transition period) available to the group would be allocated either evenly or under any other plan consented to by all members of the group which did not allocate more than $25,000 to any one member of the group. The definition of a brother-sister controlled group under present law would be broadened to include groups of corporations owned and controlled by five or fewer persons, rather than only those owned and controlled by one person as provided in existing law.

3. *Specific provisions:*

(*a*) *Limitation of surtax exemptions.*—The proposal would limit the maximum number of surtax exemptions that could be claimed by a controlled group of corporations in accordance with the following transition schedule:

Taxable years including the first Dec. 31 after	*Maximum number of surtax exemptions*
Jan. 1, 1970	500
Second Dec. 31	250
Third Dec. 31	100
Fourth Dec. 31	50
Fifth Dec. 31	25
Sixth Dec. 31	10
Seventh Dec. 31	5
Eighth and subsequent Dec. 31's	1

During the transition period the present provision for election to claim multiple surtax exemptions upon payment of the 6 percent penalty would be continued, subject to the maximum number available under the transition schedule. For example, in the fourth year, a controlled group of 100 corporations could claim multiple surtax exemptions, but would be restricted to 50 under the transition schedule. If it did, it would be required to pay the penalty of 6 percent of the amount of income (50×$25,000=$1,250,000) subject to the surtax exemptions as provided under existing law. The penalty would be allocated to each member to the extent that it claimed a surtax exemption.

(*b*) *Allocation of surtax exemptions.*—The one $25,000 surtax exemption available to a controlled group after the transition period would be divided equally among the members of the group, or allocated according to a plan consented to by all members of the group. The group would be allowed to change the plan from year to year if all members consented. In the absence of consent by all members, the surtax exemption would be allocated equally. During the transi-

[1] The value of the surtax exemption is a constant amount for all corporations that utilize it fully equal to the amount of additional tax on $25,000 that would have to be paid if that $25,000 were taxed at the higher rate than the lower corporate rate. The value of the surtax exemption, under existing corporate rates, is 26 percent (48 percent less 22 percent) times $25,000, or $6,500.

tion period these allocation rules would apply in the same manner, but to the limited amount of surtax exemption under the transition schedule and with the proviso that no more than $25,000 be allocated to any one corporation.

(*c*) *Definition of controlled group.*—As indicated above, the restrictions on the claiming of multiple surtax exemptions would apply to corporations which are components members of a parent-subsidiary or brother-sister controlled group.[1]

(1) *Parent-subsidiary controlled group.*—The present definition of a parent-subsidiary controlled group—coproprations connected through 80 percent stock ownership, either directly or through one or more intermediary corporations with a common parent would remain unchanged.

(2) *Brother-sister controlled group.*—Present law defines a brother-sister controlled group as a group of corporations in which the voting stock or value of shares of each member is owned 80 percent by the same person (i.e. individual, estate or trust). Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the same *five* or fewer persons own at least 80 percent of the voting stock or value of shares of each corporation, and (2) these five or fewer individuals own more than 50 percent of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. This definition is the same as that under section 1551 (relating to the disallowance of surtax exemptions and accumulated earning credits in cases of transfers in order to secure the exemption or credit).

Part (1) of this test is satisfied if the group of five or fewer persons as a whole owns at least 80 percent of the voting stock or value of shares of each corporation, regardless of the size of the individual holdings of each person. Thus, for example, part (1), but not necessarily part (2)) is met whether one person owns 80 percent of the voting stock of each corporation, four persons each own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation and 40 percent of another, and another person owns 40 percent of the voting stock of the first and 60 percent of the second.

Part (2) of the test is satisfied only if the same five or fewer persons own more than 50 percent of the voting stock or value of shares of each corporation, considering stock owned by a particular person only to the extent that it is owned identically in each of the corporations. Thus, for example, a person who owns 80 percent of the voting stock of one corporation and 30 percent of another would be considered as owning 30 percent of both corporations for purposes of part (2) of the test.

---

[1] There are two minor kinds of controlled groups, (1) combined groups consisting of three or more corporations each of which is a member of a parent-subsidiary or brother-sister controlled group and one of which is both a common parent and a brother-sister corporation, and (2) certain insurance company groups. Membership in both types depends in part upon membership in a parent-subsidiary or brother-sister controlled group. Therefore, these groups are affected by these proposals in the same manner as parent-subsidiary and brother-sister controlled groups and are not independently discussed herein.

The following two examples illustrate the operation of this two-part test:

EXAMPLE 1

	Percent of stock ownership (pt. 1)		Percent of identical ownership (pt. 2)	
	Corporation No. 1	Corporation No. 2	Corporation No. 1	Corporation No. 2
Shareholders:				
A	30	75	30	30
B	70	25	25	25
Total	100	100	55	55

EXAMPLE 2

	Percent of stock ownership (pt. 1)		Percent of identical ownership (pt. 2)	
	Corporation No. 1	Corporation No. 2	Corporation No. 1	Corporation No. 2
Shareholders:				
A	80	20	20	20
B	20	80	20	20
Total	100	100	40	40

In both examples, individuals A and B together own 100 percent of both corporations. Thus, part (1) of the test is met. However, under part (2) of the test, the stock holdings of A and B are restricted to the lowest percentage of any member to be included in the group. Thus, in Example 1, because stockholder A owns only 30 percent of Corporation No. 1 he is considered to own only 30 percent of Corporation No. 2. Part (2) of the test is satisfied in Example 1, but not in Example 2. Consequently, the corporations in Example 1 would constitute a brother-sister controlled group while those in Example 2 would not.

(d) *Excluded stock.*—Under present law, some taxpayers might seek to avoid the percentage of ownership tests through use of controlled tax-exempt foundations. For example, an individual who owns two corporations might seek to avoid the 80 percent portion of the brother-sister controlled group test by transferring a 21-percent stock interest to a nonstock [1] tax-exempt foundation which he, or interests related to him, control. Under the multiple surtax exemption provisions of existing law, stock owned by certain specified persons and entities (such as certain employee pension plans) is treated as if it were not outstanding for purposes of applying the percentage of ownership tests involved in the parent-subsidiary and brother-sister controlled group definitions. However, for these rules to apply, one person must own at least 50 percent or more of the voting power or value of shares of each of the corporations to be included in the group.

These rules are designed to defeat attempts to circumvent the percentage of ownership tests by transferring stock to the specified entities. The proposal would add organizations exempt from tax under section 501(a) controlled by certain specific persons to the entities whose

[1] The constructive stock ownership rules of existing law might preclude the use of foundations organized in corporate form with outstanding stock in some cases.

stock holdings would be ignored for purposes of applying the controlled group definitions. In the parent-subsidiary case, stock owned by such an organization would be ignored if the organization is controlled directly or indirectly by (i) the parent corporation or subsidiary corporation, (ii) an individual, estate or trust who is a principal stockholder of the parent corporation, (iii) an officer of the parent corporation, or (iv) any combination thereof. For purposes of this provision, the term "principal stockholder" means an individual who owns (within the meaning of the constructive stock ownership rules contained in the multiple surtax exemption provisions) 5 percent or more of the voting power or value of shares in such corporation. Direct or indirect control of an exempt organization would include any kind of control whether or not legally enforceable and regardless of the method by which control is exercised or exercisable.

In the brother-sister case, stock in a corporation owned by an exempt organization would be ignored if such organization is controlled, directly or indirectly, by (i) such corporation, (ii) an individual, estate or trust who is a principal stockholder of such corporation, (iii) an officer of such corporation, or (iv) any combination thereof. "Principal stockholder" and "directly and indirectly controlled" would have the same meaning as those referred to above. In addition, the 50 percent stock ownership requirement for application of the excluded stock rules would be expanded from one to five persons in the case of brother-sister controlled groups, consistent with the change in the definition of a brother-sister controlled group.

B. OTHER TAX BENEFITS TO WHICH THIS PROPOSAL APPLIES

1. *The $100,000 Minimum Accumulated Earnings Credit.*—Section 535(c)(2) of the code provides a minimum accumulated earnings credit of $100,000 for purposes of applying the accumulated earnings tax. This tax applies only to a corporation which is formed or availed of for the purpose of avoiding income tax with respect to its shareholders, by permitting earnings and profits to accumulate instead of being distributed. The tax does not apply to earnings and profits of the taxable year which are retained by a corporation for the reasonable needs of the business. Furthermore, even if reasonable needs are not present, the first $100,000 of accumulated earnings on a cumulative basis is exempt from the tax.

Present law does not restrict, solely by virtue of being a member of a controlled group of corporations, the number of these credits that can be claimed. The proposal would limit the maximum number of minimum accumulated earnings credits available to a controlled group of corporations in accordance with the transition schedule applicable to the surtax exemption. As under present law, the 6-percent penalty would not be imposed on those groups claiming multiple benefits during the transition period.

The one minimum accumulated earnings credit available to a group, after the transition period, would first be allocated evenly to each member of the controlled group, and then, to the extent that any member does not have sufficient accumulated earnings to utilize fully its pro rata share of the credit, that excess credit would be allocated evenly to the members of the group who do have unprotected accumulations. For example, if in the first year of operation, one of two corporations constituting a controlled group retains earnings of $25,000 and the other retains earnings of $75,000, the credit would first be divided equally between the two corporations and then the excess credit from the first ($25,000) would be allocated to the second, and the entire $100,000 of retained earnings would be protected. Similar allocation rules would apply during the transition period where a group of corporations is allowed less than one credit per corporation.

The restrictions on the number of minimum accumulated earnings credits would apply to parent-subsidiary controlled groups as defined under present law and brother-sister controlled groups as defined under this proposal.

2. *The Limitation on the Small Business Deduction for Life Insurance Companies.*—Under present law, life insurance companies are allowed a small business deduction of 10 percent of investment yield, up to a maximum of $25,000. Present law does not restrict, solely on the basis of membership in a controlled group of corporations, the number of these limitations that can be claimed. The proposal would limit the maximum number of such limitations available to a controlled group of corporations in accordance with the transition schedule applicable to the surtax exemption. As under present law, the 6-percent penalty would not attach to multiple use of the $25,000 limit in accordance with the transition schedule. Rules similar to those applicable in the case of the surtax exemption would be provided for allocating the $25,000 limitation on the small business deduction for life insurance companies. However, consistent with the substantive provision itself, no one member of the group would be entitled to a deduction of more than 10 percent of its investment yield, which is the limitation imposed under present law.

As with the minimum accumulated earnings credit, the restrictions on the number of limitations on the small business deduction for life insurance companies would apply to parent-subsidiary controlled groups as defined under present law and brother-sister controlled groups as defined under this proposal.

3. *Investment Credit.*—The investment credit provisions allow a taxpayer to use his investment credit to offset 100 percent of the first $25,000 of tax liability but only 50 percent of amounts above $25,000. These provisions also allow a taxpayer to use up to $50,000 of his cost of acquiring used property in the computation of his investment credit. Corporations which constitute a parent-subsidiary group, defined somewhat differently than the parent-subsidiary definition contained in the multiple surtax exemption provisions and somewhat differently for each limitation, are restricted to one of each of these two limitations per group. The proposal would conform the parent-subsidiary definition to that used in the multiple surtax exemption provisions and extend the present law restriction on multiple investment credit limitations to brother-sister controlled groups as defined under this proposal. This restriction would make use of the definitions and special rules under the surtax exemption provisions, but since the investment credit contains provisions for carrying over from one year to the next excess investment credit (including any amount of credit disallowed under this proposal), no special transition rule is necessary.

4. *Additional first year depreciation.*—Under present law a taxpayer may elect to take, as a depreciation deduction, 20 percent of the cost of certain qualified property in the year the property is acquired. The aggregate cost of the property subject to this special provision is limited to $10,000 per year. Corporations which constitute a parent-subsidiary group, defined somewhat differently than the parent-subsidiary definition contained in the multiple surtax exemption provisions, are restricted to one $10,000 limitation per group. The proposal would conform the parent-subsidiary definition to that used in the multiple surtax exemption provisions and extend the present law restriction on multiple additional first-year depreciation deductions to brother-sister controlled groups as defined under this proposal. This restriction would make use of the definitions and special rules under the surtax exemption provisions but since any depreciation deduction not allowed in the first year by reason of these changes would be allowable in subsequent years under the normal depreciation rules, no transition rule is necessary.

C. EFFECTIVE DATE

These provisions would become effective for taxable years beginning after December 31, 1969. For those covered by the transition schedule, the full effect of the provision would take place with taxable years beginning in 1977.

VI-B. MINERAL PRODUCTION PAYMENTS

GENERAL EXPLANATION

Background and present law.—The use of mineral production payments has a long history in the extractive industries. However, in the past few years, primarily for tax purposes, the use of production payments has rapidly increased, both in the number of such transactions and in size. The reported amount of so-called ABC transactions in 1966 totaled $1.85 billion, with a resulting revenue lose of $85 million. And the use of the ABC transaction has spread to industries not previously involved in such transactions. For example, the use of production payments was almost unknown in the coal industry several years ago. But within the past 2 years, coal properties have been sold subject to retained production payments of about $800 million.

The same situation prevails with respect to carved-out production payments. In 1965, the reported carved-out production payment transactions totaled $214 million. But in 1966, this amount had more than doubled to a figure of $540 million. This represented a revenue loss to the Federal Government of $70 million.

It is estimated that the combined revenue loss from ABC transactions and carved-out production payments is between $200 million and $350 million. This acceleration of revenue loss can be expected to continue unless the spread of these transactions is checked.

The use of production payments constitutes a tax abuse because they are being employed to circumvent the limitations on the depletion deduction and to distort the benefits that the net operating loss carryback and carryover provisions were designed to provide. The use of production payments also distorts the economic structure of the extractive industries since the mismatching of income and expenses that results from the use of production payments is counter to sound accounting practices.

The owner of a mineral interest can "carve-out" a production payment from his interest and sell it to an outside party, often a financial institution. The production payment may be for a specific dollar amount, and it usually bears interest. The payment is secured by an interest in the minerals, and usually the known mineral reserves available are substantially in excess of that required to pay off the production payment.

Under present law, the seller of the production payment receives depletable income in the year of the sale. But the expenses of producing the income necessary to pay off the production payment are then claimed as deductions in the subsequent years when the mineral is produced. Thus income and the expenses attributable thereto are mismatched with a consequent distortion of income in each of the years involved.

This mismatching has produced tax benefits that are far in excess of the advantage Congress intended to grant. First, the sale of the carved-out production payment is used to obtain a greater percentage depletion allowance than Congress intended to grant. In the case of percentage depletion, the present rules provide that the deduction with respect to any mineral property shall not exceed 50 percent of the net income (before depletion) for the taxable year from the property. That is, the maximum benefit to be derived from percentage depletion during any one year is to cut in half the taxable income from a mineral property.

But the use of carved-out production payments has vitiated this statutory limitation of 50 percent. For example, assume that a corporation derives all of its income from a lead mine which it operates at a profit of $1 million each year, having $10 million each year in gross income and $9 million of expenses. Before applying the 50 percent limitation, the percentage depletion deduction would be $2,300,000 (23 percent of $10 million) but the 50-percent limitation in the statute limits the percentage depletion deduction in this case to $500,000 (50 percent of the net profit of $1 million). Thus, if the company operates its mine in a normal manner it would pay Federal income taxes of approximately $240,000 and the percentage depletion deduction would have reduced its taxable income each year to one-half of what it would otherwise be. But, by resort to carved-out production payments, the company can drastically alter its tax picture. If it sells an $8 million production payment payable out of the following year's production, the percentage depletion allowance in the year of sale is increased from $500,000 to $4,140,000 (23 percent of $18 million). This result follows because the $8 million is treated not as a loan, but as income subject to the depletion allowance in the year of the sale.[1] While the company will pay Federal income taxes in the year of sale of approximately $2.3 million, these are claimed as refunds in the following year when the company will claim a net operating loss carryback of $7 million. (This results from the fact that the $8 million production payment is

[1] Other limitations in the Federal income tax law are avoided by the same device. Thus, the limits on the foreign tax credit, the investment credit, loss carryforwards, and loss deductions can all be circumvented by the sale of production payments.

excluded from income by the seller in the following year, leaving $2 million gross income and $0 million in expenses.) Thus, by the simple expedient of selling a production payment, the corporation has eliminated payment of Federal income taxes over the 2-year period of approximately $480,000. Yet for its book purposes it has continued to show a $1 million operating profit. Each year the corporation repeats this cycle, it can continue in a tax-free status.

The net result of the use of production payments in the manner described is to permit a mineral operator to obtain the benefit of the depletion allowance far in excess of 50 percent of the profit derived from a mineral property and to distort the purposes of the net operating loss carryback and carryforward provisions. This impact is even greater if, in the above example, the corporation had nondepletable income to absorb the unused portion of the "loss" in the year of the payout of the production payment.

The use of another form of production payment—the retained production payment—has also in recent years given rise to greater increased abuse of the tax laws governing the extractive industries, especially in connection with the so-called ABC transaction. In an ABC transaction A, the owner, sells a mineral property to B (who will own and operate the property) for a small downpayment, and A reserves a production payment (bearing interest) for the major portion of the purchase price. A then sells the production payment to C who is often a bank, a tax-exempt charity, or pension fund. A realizes capital gain on the sale of his interest to C and B.[2] C receives income subject to depletion (normally cost depletion sufficient to eliminate taxable income) on the production payment. B excludes the production payment from his income, but, until recently, B deducted currently the expenses of producing the minerals applied to the production payment.

This treatment of the ABC transaction produces anomolous tax results. For example, in a recent ABC transaction, a major oil company purchased all of the coal properties of another corporation, subject to a reserved production payment of $460 million payable out of a large percentage of the net profits to be derived from the operation of the coal properties by the buyer. Under present rules, the buyer excludes from income the $460 million of profits derived from its operation of the coal properties and paid over to the holder of the production payment. This feature alone represents a Federal income tax saving to the oil company of approximately $175 million over the payout period, or an annual tax saving of between $10 million and $18 million per year depending on the actual length of the payout period. (It was estimated that it would take 7 to 16 years to discharge the production payment out of profits derived from the operation of the coal properties.) In addition, all of the costs of mining the coal used to discharge the production payment were deducted by the buyer even though its capitalized those costs on its books as a cost of acquiring the coal properties. Although the receipt of the $460 million proceeds from the production payment would constitute depletable income to the coal corporation, in fact no Federal income taxes were imposed on the sale of the coal

[2] If A is a corporation even the tax on the gain may be deferred if the corporation liquidates under sec. 337.

properties, since the company was liquidated under section 337 of the Internal Revenue Code. And, as noted, no income taxes at all will be paid on the $460 million of profits derived from the coal lands by the oil company.

As a result of these situations—

There is a distortion of the Federal income tax laws that produces special benefits far in excess of those intended to be granted by the allowance for depletion.

There is discrimination between different types of extractive industries, since some can utilize the production payment vehicle more readily and to greater advantage than others.

There is an undermining of the confidence of the average taxpayer in the efficiency and fairness of our tax system.

There is an annual revenue loss of at least $200 million to the Federal Government. . . .

To remedy these problems, the proposal would in general treat production payments as loan transactions. Such treatment recognizes that in fact production payment transactions are financing transactions—in the case of ABC transactions, the production payment is akin to a purchase money mortgage; in the case of a carved-out production payment, the transaction is treated as an ordinary mortgage-loan arrangement. The result is that the income and expenses of the mineral property will be matched in the same year and the distortions now being experienced will be eliminated.

OPERATION OF PROPOSAL

Carved-out production payments.—Under the proposal, the seller of a carved-out production payment will be required to match the income from the production payment with the expenses incurred to generate that income. This result will be accomplished by treating the transaction as a loan. Thus, in the year of the "sale" of the production payment, the owner of the working interest will not take the proceeds into income. In the year(s) in which the production payment is paid off, the income used to make the payment will be depletable income in the hands of the operator and he will be allowed a deduction for the expenses incurred to produce the income. The corollary of this rule is that the "purchaser" of this production payment does not have an economic interest in the mineral production; therefore, the income he receives is not subject to depletion. However, his tax position will not be changed from present law, since his receipts will constitute a nontaxable return of principal and taxable interest.

This proposal will produce a proper matching of income with the expenses incurred to produce that income, and will conform tax procedures to sound accounting practices. In a recent report on the accounting practices of the petroleum industry, all but one of the major oil companies participating in a survey conducted by the American Petroleum Institute treated the proceeds from a carved-out production payment as deferred income. The reason given for this treatment is that income should be recorded as earned when it can be definitely measured, and, in the case of oil and gas extraction, this can only be done when the lifting costs are known. The proposal here will thus conform tax accounting practices to sound book accounting procedures.

This proposal will also correct an existing disparate treatment of production payments. Under present rules, if the "seller" of the production payment guarantees the payout of a production payment, the transaction is treated as a loan. The seller does not report the proceeds as income in the year of "sale", and he pays out the production payment with depletable taxable income. This same result will now obtain whether the production payment is guaranteed or not.

ABC transactions and retained production payments.—In the case of ABC transactions, the retained production payment will be treated as a loan—similar to a purchase money mortgage—used to acquire full ownership of the entire mineral property.

Thus, the purchaser of the working interest (B) will treat as depletable income the amounts used to pay out the production payment in the year of the payment. Expenses attributable to that income will be deductible in the year incurred. The tax treatment of A will remain unchanged—he will realize capital gain on his sale. The tax result to C, the purchaser of the production payment, will also remain the same. C will treat the payments as the receipt of nontaxable return of principal plus taxable interest.

This proposal will provide a proper matching of income and expenses for B, the owner of the working interest. It recognizes that in fact the production payment B is paying out is part of the cost of acquiring the entire unencumbered mineral interest. This result also accords with sound accounting principles.

The proposal also corrects disparate treatment of ABC transactions that exists under present law. As in the case of carved-out production payments, under present law if B, in an ABC transaction, guarantees the production payment, then the transaction is treated as a loan. There is no reason to differentiate the tax treatment of these financing transactions, and the proposal reaches this result.[3]

Two recent decisions by the Tax Court of the United States have clarified some problems with respect to ABC transactions and retained production payments.[4] These decisions required that the operator of the working interest capitalize the lifting costs allocable to the production payment rather than treat them as currently deductible expenses. These decisions are a correct interpretation of present law. However, even with capitalization of lifting costs, problems remain which this proposal solves.[5]

EFFECTIVE DATE

The proposal would be effective for all transactions entered into after the date of enactment.

---

[3] This conforms to tax treatment of financing transactions in other areas. For example, the tax treatment of the mortgagor and mortgagee in a real estate transaction is the same regardless of whether the mortgagee looks only to the property as security or whether he also has the personal liability of the mortgagor. There is no reason for a different rule where the property involved is a mineral interest.

[4] *L. W. Brooks, Jr.*, 50 T.C. No. 94 (Sept. 26, 1968) and *Producers Chemical Co.*, 50 T.C. No. 95 (Sept. 26, 1968). As a result of these decisions the Internal Revenue Service announced that it would suspend the issuance of advance rulings on the tax treatment of the costs of lifting oil, gas, or other minerals which are attributable to production payments on transactions entered into after Sept. 25, 1968 (TIR, 939, dated Oct. 28, 1968).

[5] In part, this proposal and the result reached in the Tax Court decisions overlap. The estimated revenue gain of $200 million from this proposal does not take this overlap into account. If the decisions of the Tax Court are affirmed on appeal, then the net revenue gain from the present proposal would, of course, be less than the $200 million estimate used here.

VI-B. MINERAL PRODUCTION PAYMENTS

TECHNICAL EXPLANATION

GENERAL BACKGROUND

A production payment is a right to a fixed amount of production from a mineral property if, as, and when the production occurs and, depending upon the manner in which it is created, it may be classified as either a carved-out production payment or a retained production payment. The production payment may be for a specific dollar amount, and it usually bears interest. The payment is secured by an interest in the minerals, and usually the known mineral reserves available are substantially in excess of that required to pay off the production payment.

In the case of a carved-out production payment, the owner of the mineral interest sells the payment to an outside party, usually a financial institution. Under present law, the purchaser of the production payment treats the payments received as income subject to the allowance for depletion (usually cost depletion). The amounts utilized to pay the production payment are excluded from income by the owner of the burdened interest during the payout period but, the expenses attributable to producing that income are deducted in the year incurred.

In the case of a retained production payment, the owner of the mineral interest sells the working interest but reserves the production payment in himself. Under present law, the owner of the retained production payment receives depletable income during the payout period. The purchaser of the working interest excludes the amounts used to pay off the production payment during the payout period but, until recently, deducts the costs of producing the minerals subject to the production payment.

The retained production payment is utilized in connection with the so-called ABC transaction. In an ABC transaction A, the owner, sells a mineral property to B (who will own and operate the property) for a small downpayment, and A reserves a production payment (bearing interest) for the major portion of the purchase price. A then sells the production payment to C who is often a bank, a tax-exempt charity, or pension fund. A realizes capital gain on the sale of his interest to C and B. C receives income subject to depletion (normally cost depletion sufficient to eliminate taxable income) on the production payment. B excludes the production payment from his income but, until recently, B was permitted to deduct currently the expenses of producing the minerals applied to the production payment.

The proposal generally would treat production payments as loan transactions.[1] As a result, the owner of the mineral interest subject to the production payment will take income and expenses with respect to the production payment into account in the same taxable year.

[1] This proposal does not apply to production payments pledged for, or because of, exploration or development. Such transactions are not financing transactions and do not operate to distort the depletion allowance.

OPERATION OF PROPOSAL

Carved-out production payments

It is proposed that a carved-out production payment, whether relating to a working interest or a nonoperating interest, be treated as a loan. Accordingly, the proceeds of the "sale" of the carve-out would not be taxable to the seller thereof, but income derived from the property subject to the carve-out would be taxable to him in the years of production, subject to the allowance for depletion. Costs of producing the mineral subject to the carve-out would be deductible in the year incurred.

The tax result to the purchaser of the production payment would not in most cases be affected by this proposal. He would be treated as receiving a return of capital plus interest.

Example.—The A coal company transfers a $300,000 production payment to B bank. The production payment is payable out of 90 percent of the net profits to be derived from the operation of the coal properties and bears 5½-percent interest. The payout period is estimated to be 3 years. In the year of the transaction, A treats the proceeds as a loan (nontaxable receipt). In each of the 3 payout years, A includes as taxable income subject to depletion the amounts used to discharge the production payment, and deducts the expenses incurred in each year to produce the coal subject to the carve-out. If the payment is made on the basis of $100,000 each year plus the interest due, the B bank will treat the $100,000 as a return of principal, and will treat the interest as ordinary income.

ABC transactions and retained production payments.—Where a mineral property is transferred subject to a production payment (whether or not created by the immediate transferor), it is proposed that the transferee of the mineral property be treated as if he acquired the property subject to a mortgage. Thus, the income derived from the property used to satisfy the production payment will be taxed to the owner of the mineral property and will be subject to the allowance for depletion. In the case of a working interest burdened by a retained production payment, the production costs attributable to minerals applied to satisfy the production payment would be deductible in the year incurred. A similar result will be obtained in the case where a production payment is retained by the lessor in a leasing transaction, by treating the retained production payment as a bonus granted by the lessee to the lessor payable in installments.

Example.—A, the owner of a producing oil and gas lease, sells the lease to B for $1 million and retains a production payment of $3 million (plus interest at 5½ percent) payable from 75 percent of the production from the lease. Simultaneously, A sells the retained production payment to C for $3 million cash. A will treat the gain on the sale of his interest as capital gain. B will include the production payment revenue in his gross income, subject to depletion, during the payout period, and will deduct as current expenses the lifting costs incurred with respect to the oil used to satisfy the production payment. C will treat the $3 million as a nontaxable return of capital and will treat the interest as ordinary income.

EFFECTIVE DATE

The proposed rules would be made effective for transactions entered into after the date of enactment. Transactions which the parties entered into prior to the date of enactment would continue to be treated under present law.

VI-C. TAX-FREE RESERVES OF MUTUAL SAVINGS BANKS

General Explanation

BACKGROUND

Until 1952 mutual savings banks (hereafter referred to as MSB's), savings and loan associations (hereafter referred to as S. & L.'s) and certain cooperative banks[1] were exempt from Federal income tax. In 1951 Congress examined the premises underlying the exemption for these mutual thrift institutions and concluded that:

> The income which is added to reserves and undivided profits * * * is income of the associations. The fact that it is retained for the benefit of the members makes it analogous to the income retained by an ordinary taxable corporation for the benefit of stockholders. (S. Rept. 71, 82d Cong., 1st sess., 25–28 (1951)).

Accordingly, Congress repealed the statutory exemption of these mutual thrift institutions and subjected them to the regular corporate income tax. At the same time, however, these institutions were allowed a special deduction for additions to bad-debt reserves that considerably exceeded the deduction allowed ordinary businesses.

Although all businesses are entitled to use the reserve method of accounting for bad-debt losses, ordinarily they are allowed a tax deduction for an addition to a reserve for bad debts only to the extent it is justified by their actual loss experience. Mutual thrift institutions, as an alternative to this generally available method of deducting additions to reserves, were permitted in 1951, under a statutory formula, to take tax deductions for reserves in amounts which far exceeded losses.[2] The treatment was, in fact, so generous that these institutions remained virtually tax exempt—paying an effective rate of tax of about 1 percent of their income.

In 1961 and 1962, Congress reexamined the tax treatment of mutual thrift institutions, and in the Revenue Act of 1962 sought to end this virtual tax exemption. However, Congress decided to retain for these institutions at least some favorable treatment for their bad-debt reserve "in light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions."[3] Therefore, in lieu of the then existing bad-debt formula, Congress provided two new alternative formulas for the computation of the addi-

---

[1] A cooperative bank is a type of State-chartered S. & L. which is separately defined in the tax code in a manner that parallels the tax definition of an S. & L. References to S. & L.'s will also encompass cooperative banks.

[2] The 1951 legislation provided that additions could be made to a reserve for bad debts in whatever amount the institution deemed appropriate so long as (*a*) the amount set aside each year did not exceed the income of the institution for the year, or (*b*) its total reserves and surplus did not exceed 12 percent of its deposits or withdrawable accounts at the close of the year.

[3] H. Rept. No. 1447, 87th Cong., 2d sess., p. 33 (1962).

tion to the reserve for bad debts for MSB's and S. & L.'s which, while permitting reserve additions in excess of actual losses, were more restrictive than prior law.

One special method permits a thrift institution to deduct each year, subject to certain limitations, an amount equal to 60 percent of its taxable income. A second method permits a thrift institution to deduct each year an amount necessary to bring the existing reserve balance up to 3 percent of outstanding qualified real estate loans including insured and guaranteed loans.[4]

Under the 60-percent method, at least 40 percent of income will be taxable and at least some tax must be paid. (Assuming an effective tax rate on "taxable income" of 40 percent, the effective rate on "economic income" would be about 16 percent under the 60-percent method.)

Under the 3-percent alternative the annual addition to the reserve, to maintain the reserve at 3 percent of outstanding loans, would be equal to 3 percent of the growth in qualifying loans plus actual losses incurred during the year. If there is a large increase in outstanding loans in relation to taxable income this method could result in the payment of no income tax. It could also have the same result in the case of a taxpayer whose present reserve is substantially less than 3 percent of outstanding loans since if it makes up the difference in 1 year it may offset its entire income for that year.

Under the 1962 legislation, on the basis of estimates used by the Congress, annual tax payments of $168 million from S. & L.'s and $32 million from MSB's were anticipated as compared to $7.2 million and $1.5 million, respectively, in the year prior to the effective date of the new legislation. This assumed an effective tax rate of about 18 percent on "economic income" for both types of institutions.

While most S. & L.'s are currently paying taxes in the manner generally anticipated by the Congress under the tax formula adopted in 1962,[5] most MSB's have been able to remain completely exempt from Federal income tax. In fact, MSB's as a group paid only $3 million in taxes in 1963 on earnings that were at the level anticipated when the expected tax payment of $32 million was estimated.

Moreover, the situation has not improved materially since then. For example, of the 332 MSB's for which we have information (those insured by the FDIC), only 133 paid any income taxes in 1966. Of the 25 largest insured MSB's, those with assets of $500 million or more, only nine paid any Federal income tax in 1966. In all, the effective tax rate on MSB's was only about 3 percent in 1965. Thus, the 1962 legislation has been an almost total failure insofar as its application to MSB's is concerned.

Congress concluded in 1962 that the 3-percent method should be made available as an alternative that would primarily benefit a limited number of rapidly growing institutions. Its intent was confirmed by the representation of the MSB industry that "Most of our insti-

[4] The 3-percent method is applied to a considerably broader base than is the reserve ratio method available to commercial banks which is based on 2.4 percent of eligible loans. The principal difference as far as MSB's and S. & L.'s are concerned is that they include Government-guaranteed loans in the base while commercial banks do not.

[5] Earnings of S. & L.'s in 1963 were substantially lower than the projected earnings upon which the $168 million revenue estimate was based. Accordingly, the $116 million actually paid in taxes in that year, while less than the payment estimated, reflected that the formula adopted by Congress was working in the manner anticipated.

tutions will probably compute their deduction under the 60-percent-of-income limitation",[6] which as indicated above requires the payment of some tax. The revenue estimates were made on this assumption. However, the assumption that the use of the 3-percent method would be so limited has not proved correct. In fact, the MSB industry has been growing at a somewhat slower rate than the S. & L. industry. Yet, while about 90 percent of the S. & L.'s use the 60-percent method, most MSB's use the 3-percent method and avoid tax entirely.

The 3-percent method is ordinarily used in all cases where 3 percent of the growth in qualified investments is more than 60 percent of taxable income. Thus, the 3-percent method is of benefit to an institution which has a significant increase in real estate loans in relation to its taxable income. There can be such an increase, however, without the institution actually having a significant growth in its assets. For instance, there can be a growth in qualified investments resulting merely from a shifting of the composition of the portfolio from nonqualified to qualified investments. The 3-percent method also may become applicable when a significant part of an institution's net income is from "tax-exempt sources" and therefore does not appear in the "taxable income" base for purposes of applying the 60-percent test, so that the 3-percent method provides the larger deduction. MSB's invest significantly in common stocks subject to the 85-percent intercorporate dividend deduction (S & L's do not generally hold common stock) and have a relatively greater holding of tax-exempt bonds than S & L's.

In both of the described cases, the 3-percent method is being used by MSB's in situations which were not contemplated or intended by Congress. This use is the primary reason why MSB's have not paid the tax they were expected to pay.

PROPOSAL

Accordingly, it is recommended that the 3-percent method of computing additions to a reserve for bad debts be eliminated as a generally available alternative to MSB's.[7] In order to continue consistent treatment between MSB's and S & L's, the proposal would also remove the 3-percent method for S & L's where it presently has very limited application. Most S & L's (about 90 percent) presently use the 60-percent method and thus will not be affected by this proposal.

Thus, thrift institutions would either compute their reserve for bad debts on the basis of actual experience or by deducting, subject to certain limitations, an amount equal to 60 percent of taxable income.

BASIC EFFECTS OF THE PROPOSAL

The proposal would produce an annual revenue gain of about $40 million.

Both MSB's and S & L's would continue, however, to enjoy bad debt deductions greatly in excess of actual losses and thus would ob-

---

[6] Testimony of Alfred S. Mills, representing the National Association of Mutual Savings Banks, Senate Finance Committee hearings on H.R. 10650, 87th Cong., second sess., p. 1446.

[7] This method of computing the addition for the reserve for bad debts will be retained for new companies as defined by current law.

tain favorable tax rates. As a result of the proposal, it is expected that the effective tax rate on the "economic income" of S & L's and MSB's will approximate 13 to 18 percent.

INVESTMENT STANDARDS

There is another possibility for structural change which may be appropriate for consideration in connection with the foregoing proposal.

An S & L is entitled to use the 3- or 60-percent method only if it meets a comprehensive set of investment standards established by Congress in 1962 to insure that the tax benefits are available only to S & L's primarily engaged in the business of home mortgage financing. In general, these standards require that at least 82 percent of an S & L's assets must be in cash, Government obligations, mortgages on residential real estate, and certain related assets. Under present law, failure to meet this test results in complete loss of the special tax benefits. MSB's are not subject to similar investment criteria.

Since it is clear that Congress provided the special tax benefits based on the fact that residential real estate lending "is the principal function of these institutions" (see House Report cited above), it may be appropriate to require MSB's to meet investment standards similar to those imposed on S & L's, if they are to receive the same tax privileges, rather than granting such tax benefits to MSB's regardless of their investment portfolio. However, the standard now applied to S & L's is inappropriate for MSB's who have substantially greater investment flexibility. Moreover, particularly in light of recent efforts to increase their investment flexibility, the standard may not be valid as applied to S & L's themselves. Increased flexibility in the investment powers of S & L's would not achieve its objective due to the tax detriment to an institution if it alters its investments in such a manner as to violate the strict test in the tax law. Therefore, it may be preferable to devise a new method applicable to both S & L's and MSB's to insure that the favorable tax treatment accorded these institutions is related in a flexible manner to the extent of their investment in mortgage funds for residential housing.

The allowance of a bad debt deduction in excess of actual losses has the effect of increasing the after tax yield on investments. For the special tax benefit to accomplish its purpose it should increase the yield on investments in residential real estate only.

A possible approach to accomplish this goal would be to replace the existing standards with a sliding scale provision applicable to both S. & L.'s and MSB's which would merely reduce the amount of the bad debt deduction allowable under the 60 percent method commensurate with the degree to which an institution falls below holding a specified portion of its investments in mortgages on residential real property.[8] For example, an institution could be allowed the full 60 percent of taxable income deduction if 85 percent of its nonliquid assets were invested in residential real estate. The 60 percent deduction

---

[8] Certain transition rules may be desirable for MSB's that do not presently meet the investment criteria.

would then be reduced proportionally as the investment in residential real estate fell below that amount. Perhaps a reduction at the rate of two percentage points for each percentage point by which residential investment fell below 85 percent would be appropriate for the intended purpose.

TECHNICAL AMENDMENTS

The following revisions in the application of the 60 percent method would be made to correct technical problems:

1. *Capital Gains.*—An error in the 1962 legislation currently permits institutions using the 60 percent method to include the full amount of capital gain in the taxable income measuring base even though capital gains are taxed at preferential rates. As a consequence of this rule, for an institution on the 60 percent method and in the 48 percent corporate tax bracket, each one dollar of capital gain gives rise to a 60 percent deduction for a tax saving of 28.8 cents. On the other hand, this dollar of capital gain is only taxed at a 25 percent rate. The net effect is as if the institution paid no tax on capital gains and in addition the presence of each dollar of capital gain decreased the tax on other income by 3.8 cents. Since capital gains are taxed at about one-half the normal tax rate, it is appropriate to eliminate one-half of capital gain income from the measuring base in order to restore the correct relationship between the tax on these gains and the value of the reserve deduction.

2. *Investment Income.*—The base for applying the 60 percent formula should be related to the income from investments which give rise to potential bad debts. However, under present rules, all income including income from services is included. Although income from investments is now the primary source of income for all thrift institutions, under certain circumstances it would be possible for thrift institutions to earn substantial income from services (for example from the sale of mutual fund shares). If such a source of income does materialize, it would be inappropriate to include such income in the taxable income measuring base for purposes of computing additions to a reserve for bad debts. For this reason the proposal would limit the 60 percent of taxable income deduction to investment income and provide appropriate allocation rules for allocating expenses between investment income and service income. This provision would not apply if there is only a minimum amount of income from services.

3. *Corporate Stock.*—Congress thought that the 60 percent method would produce a significant tax (15–18 percent) on the "economic income" of thrift institutions because they would pay tax on 40 percent of net income. However, to the extent that these institutions have "tax exempt" income from corporate stock subject to the intercorporate dividend deduction or from State or local government bonds, this would not be true.

Tax exempt bonds which generally produce a somewhat lower return may not be particularly advantageous to an institution 60 percent of whose income from any source is tax-free. However, it may be appropriate to exclude tax-exempt bonds from the category of liquid assets which is not taken into account in applying the 85 percent test under the investment standard described above.

Thus if such investments together with other investments which are not in residential real property exceed 15 percent of "non-liquid" assets the 60 percent deduction would be reduced.

Corporate stock represents a more serious potential interference with the intended effect of the 60 percent method in that institutions with substantial investment in corporate stock can retain far more than 60 percent of their economic income tax free. Consideration should be given to revising the 60 percent method to remove this deficiency.

EFFECTIVE DATE

The proposal would be effective for computing tax liabilities for taxable years beginning on or after January 1, 1970. Thus operating loss carryforwards derived from the use of the 3 percent method would be disallowed.

VI-C. TAX-FREE RESERVES OF MUTUAL SAVINGS BANKS

Technical Explanation

The Internal Revenue Code allows taxpayers to create a reserve against possible future bad debts and take an annual tax deduction for additions to that reserve. Generally, the amount of the addition to the reserve must be supported by actual loss experience but special methods have been developed for certain financial institutions.

Thus, under present law mutual savings banks, savings and loan associations, cooperative banks and similar thrift institutions are provided with two special methods for computing the maximum tax deduction for additions to a reserve for bad debts which may be used in lieu of a deduction based on actual experience.

One such special method permits these institutions to deduct each year, subject to certain limitations, an addition to the reserve equal to 60 percent of their taxable income. The second method permits them to deduct each year an amount necessary to bring the existing reserve balance up to 3 percent of outstanding qualified real estate loans.

This proposal would revise these special methods as follows:

1. ELIMINATION OF THE 3-PERCENT METHOD

The 3-percent method would be eliminated except in the case of new companies during their first 10 years of business.

The new rule would apply in determining tax liability for taxable years beginning after December 31, 1969. Thus, addition to reserves for these years must be based either on actual experience or on the 60-percent method. Moreover, there would be no deduction allowed for any net operating loss carryforward to these years derived from a deduction for an addition to a reserve for bed debts for a prior year which was based on the 3-percent method. However, the institution's reserve would be reduced by the amount of any loss carryforward that is so eliminated.

II. PERFECTING CHANGES IN THE APPLICATION OF THE 60-PERCENT METHOD

Under present law, thrift institutions may deduct as an addition to their reserve an amount equal to 60 percent of their taxable income from all sources. The amount of the addition so determined cannot exceed the amount necessary to increase the balance of the reserve (as of the close of the taxable year) to 6 percent of loans outstanding at such time.

Under the proposal, two changes would be made in the concept of taxable income for this purpose:

A. *Capital Gains.*—If net long-term capital gains from the sale or exchange of assets exceed net short-term capital losses from such sale or exchange, one-half of such excess would be excluded from taxable income, to account for the fact that the tax rate on capital gains is about one-half the tax rate on other income.

B. *Service Income.*—Only income from investments would be included in computing taxable income for purposes of the 60-percent method. Income from services would, therefore, be excluded.

In applying this rule, an institution would be required to segregate its total income into gross income from investments (including gains or losses from the sale or exchange of investment assets) and gross income from sources other than investments. Adjusted gross income from investments and adjusted gross income from sources other than investments would be determined by deducting from the respective amounts of gross income, expenses directly attributable to the production of such income. All other allowable deductions (including interest or dividends paid depositors) would be allocated between adjusted gross income from investments and adjusted gross income from sources other than investments in accordance with the fraction that each such amount is of total adjusted gross income. Taxable income, for purposes of the 60-percent method, would be equal to adjusted gross income from investments less the deductions allocated to such income in accordance with the preceding sentence.

III. INVESTMENT STANDARDS

Under present law, an eligible institution other than a mutual savings bank, cannot use either the 3-percent or 60-percent method of determining allowable deductions for additions to the reserve for bad debts unless at least 82 percent of its assets is invested in residential real estate, liquid reserves, and certain other assets. No similar test is applied to mutual savings banks. In connection with the foregoing proposal it may be appropriate to replace this standard with a flexible standard applicable to all covered institutions.

A possible approach would provide that the allowable deduction for the addition to the reserve for bad debts under the 60-percent method would be proportionately reduced below 60 percent of taxable income from investments to the extent the institution's investment in residential real estate fell below a specified level. Under this approach, to qualify for the full deduction equal to 60 percent of taxable income from investments, at least 85 percent of an institution's assets (other than cash, demand deposits, certain other liquidity type assets and certain assets used in the trade or business—defined below as Class A assets) would have to consist of loans (or participations therein) on residential real estate.

The maximum allowable deduction (60 percent) would be reduced a specified number of percentage points (for example, two) for each percentage point by which residential assets fall below the 85-percent level.

Transition rule.—In the case of mutual savings banks, a transition to the new standard could be provided under which the level of investments qualifying for the full 60 percent would be 77 percent instead of 85 percent for the first full taxable year beginning after December 31, 1969. In each succeeding taxable year the level would be increased by two percentage points so that by the fifth taxable year, mutual savings banks would be required to meet the same 85 percent investment standard as savings and loan associations in order to be eligible to deduct the full 60 percent of taxable income from investments. No transition rule would be provided for savings and loan associations and other eligible institutions because generally those associations meeting the present standards would also meet the proposed 85-percent level.

Class A Investments.—Class A investments would consist of the following:

(1) Liquidity items including (*a*) cash, (*b*) time and demand deposits in banks, (*c*) general obligations of the United States, (*d*) obligations issued by any agency or instrumentality of the United States, (*e*) bankers' acceptances, (*f*) stock of a Federal Home Loan Bank, and (*g*) loans secured by a deposit or share of a member.

(2) Student loans guaranteed by a governmental unit

(3) Property used in the conduct of the institution's business, including (*a*) buildings and equipment, (*b*) receivables and prepaid expenses (*c*) stock of corporations primarily engaged in providing services to the institution of the type which the institution could lawfully provide for itself.

In applying the 85-percent test the aforesaid items would be excluded and the percentage of the remaining assets that are invested in residential real property would be determined.

Residential real property investments.—Residential real property investments which form the base for the 85 percent test would consist of the following:

(1) Loans secured by residential real estate, i.e., property upon which there is located or will be located:

(*a*) a single or multifamily residence,

(*b*) dormitories or nursing homes,

(*c*) facilities in residential developments dedicated to public use (e.g., schools and libraries) or property used on a nonprofit basis by residents (e.g., swimming pools and other recreational facilities).

(2) Loans secured by mobile homes, not used on a transient basis.

(3) Loans secured by an interest in property used primarily for church purposes.

(4) Property acquired through liquidation of defaulted loans described in (1), (2), or (3).

If part of the property securing the loan is used for residential purposes and part for other purposes, a pro rata portion of the loan would be deemed to be a residential real property investment provided that if less than 10 percent of the property is used for nonresidential purposes the entire loan would qualify.

IV. EFFECTIVE DATE

The proposal would be generally effective for taxable years beginning on or after January 1, 1970.

VI-D. SUBCHAPTER S

General Explanation

BACKGROUND AND PURPOSE

At present subchapter S of the Internal Revenue Code allows small corporations, those with 10 or fewer shareholders, to elect not to pay the regular corporate income tax and instead to have the income or loss of the corporation taxed directly to the shareholders. This results, in a general way, in a pattern of taxation similar to that of partnerships. Subchapter S is now being used by more than 200,000 corporations which number is constantly increasing. However, because of the hybrid nature of the entity—not quite a corporation and not quite a partnership—the governing rules have been complex. As a result they are frequently misunderstood in ways which lead to unintended hardships. On the other hand, certain taxpayers have made use of these provisions to obtain tax benefits which are inconsistent with the partnership nature of the entity for tax purposes.

As a result of a joint study undertaken by the Treasury Department and the Committee on Partnerships of the American Bar Association Section on Taxation, a legislative proposal has been developed which will alleviate these problems. The aim has been to tax subchapter S corporations as much like partnerships as is possible in view of their hybrid nature, and in so doing remove those undesirable restrictions and complications which have been barriers to those who are aware of them and traps for those who are not. At the same time, the unwarranted advantages of subchapter S as compared to the partnership form would be eliminated.

DETAILS OF PROPOSAL

Under current law, the amount and the timing of the taxation of the electing corporation's income to the shareholders vary depending on whether the income is distributed and when such distributions are made. In order to conform more closely to the partnership rules which are more widely understood by taxpayers, the proposal would allocate corporate income to shareholders on a day-by-day, share-by-share basis and include it in the shareholder's income for his taxable year during which or with which the corporation's year ends regardless of whether it is distributed. Cash distributions to the extent they do not exceed amounts so taxed for past years or for the current year would not be subject to tax. Moreover, tax free income received by electing corporations would retain its tax free character when distributed to shareholders rather than being converted to dividends as under existing law. Furthermore, corporate capital losses in excess of capital gains for the first time will pass through to shareholders to be used on their individual returns.

The following additional liberalizations will apply to the use of subchapter S—

Under present law electing corporations may not have more than 20 percent of their gross receipts from passive sources such as rents, interest, and dividends. The proposal would remove this restriction.

Under present law only individuals and estates may own shares in electing corporations. The proposal would permit voting trusts and trusts all the income of which is taxed to the grantor to own shares. Furthermore, transitory ownership by ineligible shareholders will not automatically be disqualifying.

Under present law subchapter S corporations may have only one class of stock. Therefore, a determination by the Internal Revenue Service that an interest which the shareholders designated as debt actually represented equity and a second class of stock would lead to disqualification. This would, in general, no longer be true under the proposal. Moreover, although substantial restrictions remain on the use of stock with different rights to profits, distributions on liquidation, etc., stock which differs as to voting rights only will be permitted.

The proposal also addresses the problem of inadvertent termination of a subchapter S election. Under present law each new shareholder of an electing corporation must consent to the election within a specified time. Failure to do so terminates the election. The proposal would continue the election in this case unless a new shareholder affirmatively objects to the election.

Despite the changes described above, an election may still be inadvertently terminated. To alleviate the hardship that now arises in this situation the proposal contains a series of liberalizing changes. One would provide that termination will be prospective only, rather than retroactive to the beginning of the year in which the event causing termination takes place, as under existing law. Another change would permit distributions of income which had been taxed to the shareholders but not yet distributed to be made within a specified period following termination. In other situations the proposal would permit a shareholder to repay distributions to the corporation and recover the tax paid thereon. The latter two procedures would apply to terminations occurring or discovered after the date of enactment of this legislation. There is also a provision permitting retroactive consent by the Commissioner to a new election for periods after the situation causing the termination has been cured, when the fact of termination is not discovered until a later date.

On the other hand, unintended benefits available to some taxpayers under subchapter S would be eliminated—

Under present law, shareholders can defer taxation of up to 11 months' income by electing a fiscal year for the corporation. For example, if a fiscal year ending January 31 is selected, income earned by the corporation between February 1 and December 31, 1968, will be taxed to the shareholders as 1969 income if it is not distributed in 1968 since the corporation's year ends during the shareholder's taxable year comprising the calendar year 1969. The proposal, subject to transition rules which would preserve existing fiscal years as long as a majority of the stock does not change hands, would require all electing corporations to use the calendar year as their taxable year unless their shareholders are on a different taxable year or they have a business purpose for selecting a fiscal year. This conforms to the partnership rule.

Contributions to qualified pension plans for 10 percent shareholders which exceed the limitations under H.R. 10 for partners or sole proprietors (10 percent of earned income or $2,500 whichever is greater) will be treated as if paid to such shareholder and will be taxable to him. With this change it would no longer be necessary to deny the benefits of subchapter S to corporations with more than 20 percent of their income from passive sources, such as interest and rents.

It is now claimed to be possible for shareholders to avoid self-employment tax or the restrictions on social security benefits while continuing to work by simply not paying themselves a salary and withdrawing the profits as "dividends." It is proposed to eliminate this practice.

Use of subchapter S by dealers in property in order to obtain capital gains will be curtailed by denying capital gain treatment to shareholders who would have had ordinary income had they sold the property individually. This change is particularly necessary if real estate corporations are to be allowed to use subchapter S.

EFFECT OF PROPOSAL

It is expected that the changes in subchapter S will make this procedure more useful to those businesses for whom it was intended. However, it is not expected that the amendments will result in any significant effect on revenue.

EFFECTIVE DATE

The new rules would in general be applicable to taxable years beginning after the date of enactment.

VI-D. SUBCHAPTER S

TECHNICAL EXPLANATION

1. GENERAL

A. Background

A comprehensive revision of subchapter S of the Internal Revenue Code (secs. 1371-1378) is proposed to make it easier and simpler to comply with and to eliminate unintended hardship and benefits.

In general, the Internal Revenue Code treats a corporation as an entity separate and apart from its shareholders. Thus, income earned by the corporation is taxed to it and distributions are taxed to shareholders. Under subchapter S, however, certain qualifying domestic corporations can elect not to pay the regular corporate income tax and instead to have the income or loss of the corporation taxed directly to shareholders. This results, in a general way, in a pattern of taxation similar to that of partnerships and is made available to small corporations with a simple structure that is essentially similar to most partnerships. For larger, more complicated corporations, the ordinary pattern of taxation is considered more appropriate. However, because of the hybrid nature of the subchapter S entity—not quite a corporation and not quite a partnership—the governing rules have been complex and frequently misunderstood in ways which lead to unintended hardships. On the other hand, certain taxpayers have made use of these provisions to obtain tax benefits which are inconsistent with the partnership nature of the entity for tax purposes.

B. Proposal

The proposal would alleviate these problems. The aim has been to simplify the provisions of subchapter S, in part by incorporating some of the rules applicable to partnerships. In so doing, unnecessary restrictions which have been barriers to those who are aware of them and traps for those who are not would be eliminated. At the same time, the unwarranted advantages of subchapter S as compared to the partnership form would be denied.

2. ELIGIBILITY TO USE SUBCHAPTER S

A series of tests have been developed to limit the use of subchapter S to the small business essentially equivalent to a partnership and to mitigate administrative problems in taxation of income. The proposed rules closely follow present law with several liberalizations to deal with specific problems which have developed. The following conditions, which must be satisfied for the entire period the election is in effect, would be imposed as prerequisites to being considered a "small business corporation."

A. Number of shareholders

Under existing law a corporation must have 10 or fewer shareholders. This is a more administrable test of size than a standard based upon total assets or gross receipts which are subject to frequent fluctuation.

To permit some flexibility when in the course of operations it becomes necessary to increase the number of shareholders (e.g., to issue stock to key employees), an increase to no more than 15 shareholders would not be disqualifying if it occurs:

(i) After the corporation has been an electing corporation for 5 consecutive taxable years, or

(ii) As a result of a transfer of stock by bequest or inheritance prior to the passage of the 5-year period.

Under present law, stock owned by a husband and wife which is community property or which is held as joint tenants, tenants by the entirety, or tenants in common, is considered to be owned by one shareholder. This has caused a problem in cases where one spouse dies and his interest goes to the estate. Under the proposal the death of either or both of the husband and wife in these circumstances would not change the number of shareholders as long as the stock is held by the estate of the deceased spouse and the survivor or the estates of both in the same proportion as held by the husband and wife before death.

B. Affiliated group

Under the proposal, as well as present law, an electing corporation cannot be a member of an "affiliated group" of corporations, that is, it cannot own 80 percent or more of the stock of another corporation unless such other corporation has not begun business and has not had any gross income (taxable income under present law).

This requires an essentially simple structure but permits the organization of wholly inactive subsidiaries, perhaps to reserve a corporate name in another jurisdiction.

C. Rights and interests of stockholders

The outstanding shares of the corporation must be identical as to the rights and interests which they convey in the profits and assets of the corporation, whether such rights and interests are created by the corporate charter or by separate agreement. However, unlike present law, differences in voting rights would be permitted.

This provision to allow only "one class of stock" is consistent with the intent to limit subchapter S to simple corporations, mitigates against income shifting among family groups, and avoids the accounting problems of allocating income when the stockholders have varying rights.

The major difficulty under current law is the possible loss of qualification when a purported debt interest is determined to represent an equity investment for tax purposes. The regulations originally provided that if an instrument purporting to be a debt obligation were actually stock, it would be considered a second class of stock. This was later changed to provide the current rule that if the purported debt obligations are owned in the same proportion as the nominal stock, they will not be considered a second class of stock. However, the danger of disqualification remains when the "debt" interest is not proportional. This risk would be eliminated under the proposal.

Under the proposal the existence of any interest not designated as stock, which has neither voting rights nor rights to distributions beyond a fixed annual interest rate and a fixed amount upon redemption or payment, will not cause the corporation to be disqualified even if the interest is determined to be equity capital.

The holders of such interests, although shareholders for certain purposes, including except as indicated below the treatment of distributions, would not be considered shareholders for purposes of the special rules under subchapter S (for example, they would not be counted in determining the number of shareholders nor would they have to consent to an election). Further, all "interest" distributions with respect to such "obligations" would be taxed as ordinary income whether or not there were earnings and profits.

D. Nature of shareholders

As under present law, all shareholders would have to be individuals, other than nonresident aliens, or estates. Individuals would have to have outright ownership; life tenancy for example would not be sufficient. However, two liberalizing changes would be made.

Stock owned by a trust would, in two circumstances, be considered as owned by the holders of the beneficial interests:

(i) If under sections 671 through 677 of the Code all income of the trust, including capital gains, is taxed to the grantor of the trust because of the control he has maintained over the trust, the grantor would be treated as the shareholder.

(ii) Stock owned by a voting trust would be considered to be owned by those persons who would be entitled to receive the stock on termination of the voting trust. A voting trust would be defined as a written agreement which confers on the trustee the right to vote, requires all distributions with respect to the stock of the corporation to be paid to or on behalf of the beneficial owners and requires title and possession of the stock to be delivered to such beneficial owners on termination. The agreement or State law must provide for termination of the trust on or before a specified day.

Furthermore, transitory ownership by a person or persons for a period of 60 consecutive days or less during an election year (including ownership prior to an election made within the first month of the year) would not be disqualifying if no distributions were made to ineligible shareholders. If these conditions are not met by virtue of a distribution or ownership for 61 days, the corporation would be disqualified as of the day the ineligible person became a shareholder rather than the day of the disqualifying event. If the conditions are met then for purpose of allocating income and loss, the stock owned by the ineligible shareholder would be deemed to be owned by the person to whom it is transferred.

E. Source of income

The provision of present law that a small business corporation may not derive more than 80 percent of its gross receipts from sources outside the United States would be retained.

However, the requirement that a small business company may not have more than 20 percent of its gross income in the form of passive investment income would be eliminated.

F. Taxable year

Under present law a significant deferral of tax can result if a fiscal year is selected for the corporation which differs from the taxable year of the shareholders. A 1-year deferral of taxation on 11 months of income can be obtained by selecting a fiscal year ending January 31. In the latter case, income earned by the corporation between February 1 and December 31, 1968, for example, will be taxed to shareholders on a calendar year as 1969 income if it is not distributed in 1968 since the corporation's year in which such income is earned ends during the shareholder's taxable year comprising the calendar year 1969. This result cannot ordinarily be accomplished by the use of a partnership since unless there is a business purpose for a different year, a partnership's taxable year must conform to the taxable year of its principal partners.

Accordingly, under the proposal the taxable year of an electing corporation subject to transitional rules would be required to be one of the following:

(i) The calendar year.

(ii) The taxable year of all shareholders owning more than 10 percent of the shares of the corporation's stock.

(iii) Any year for which it has a business purpose shown to the satisfaction of the Secretary of the Treasury or his delegate.

If a corporation makes an effective election under subchapter S, its first electing year would end on the following December 31 unless the corporation establishes a business purpose for another taxable year or all 10 percent shareholders have a taxable year other than the calendar year and the corporation chooses to end its taxable year on the last day of such year.

An existing electing corporation on the date of enactment would be permitted to retain its existing taxable year only so long as persons owning 50 percent of the outstanding stock of the corporation on the date of enactment continue to own at least 50 percent of the outstanding stock for an uninterrupted period continuing through the first day of the taxable year. For this purpose, the percentage owned by any shareholder shall be taken into account only to the extent it does not exceed the percentage owned on the date of enactment. Furthermore, an electing corporation which has adopted a year other than a calendar year because of a valid business purpose or because it conforms to the taxable year of its 10 percent shareholders could not maintain such year for a period during which the subchapter S election were in effect unless the conditions which permitted such fiscal year were satisfied on the first day of such period. If any of the conditions allowing a fiscal year were not satisfied on such first day, the corporation would be automatically changed to a calendar year unless it satisfied the conditions for another fiscal year.

A subchapter S corporation could, at any time, change to the calendar year or to the taxable year of all shareholders owning more than 10 percent of the corporation's shares without consent.

3. ELECTION

A. Time for election

An election to be taxed under subchapter S may be made for any taxable year at any time during the first month of such year or at any time during the preceding taxable year. For a new corporation the first month of its taxable year does not begin until it has shareholders, acquires assets or begins doing business, whichever is first to occur. Unless an election is terminated, it continues in effect and need not be renewed annually.

The proposal would continue present law except that the rules would be liberalized to permit an earlier election. Thus, if a corporation on a calendar year decides in June of 1969 that it would like to elect subchapter S for 1970 it could do so immediately and need not make a note to do so in December 1969, or January 1970, as required under present law.

334-891 O - 69 - pt. 2 - 11

B. Consent

As under present law, a consent to the election must be filed by all persons who are shareholders on the first day of the taxable year for which the election is effective unless the election is made after such first day (that is, within the first month of the taxable year). In the latter case, persons who are shareholders on the day of the election must consent and for the purpose of allocating income and loss, such persons would be deemed to be shareholders since the first day of the taxable year.

Thus, persons who were shareholders during the year but who disposed of their shares prior to the election would not be charged with subchapter S income or allowed a deduction for losses. This represents a change from present law under which losses can be allocated to such persons. The change is needed since income, as hereafter explained, would be allocated on a daily basis in accordance with the present procedure for allocating losses. Income, unlike losses, should not be allocated to nonconsenting shareholders.

C. Election following termination

If an election is effective for any time or is terminated retroactively during the first year in which it was to take effect then, as under present law, following the termination of such election a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective unless the Secretary or his delegate consents to such new election.

This rule has caused some difficulty in cases of inadvertent termination because frequently the fact of termination is not discovered until it is too late to apply for consent to make a new election for a period in which the corporation qualified and thought it was an electing corporation.

Therefore, under the proposal, if an election is terminated because a corporation ceased to be a small business corporation (e.g., it had 11 shareholders, a trust as a shareholder for 61 days, it owned 100 percent of the stock of another corporation, etc.) and if the corporation qualified for a later year, filing a timely return as a subchapter S corporation for such later year would be deemed to be a binding request for consent to a new election for such year. In determining whether consent will be granted, the fact that a termination was inadvertent would be taken into account.

4. TERMINATION OF AN ELECTION

Under present law termination of an election is generally retroactive to the first day of the taxable year even if it is caused by an event occurring at the end of the year. This has led to hardship in some cases and opportunity for manipulation in others. Therefore, under the proposal a termination would generally take effect on the day of the triggering event. This rule could enable taxpayers to cut short an electing year prior to the realization of income in order to pass losses through to shareholders. Therefore, in order to limit the opportunity for such manipulation, an election for less than an entire taxable year would not be permitted and terminations during such first year will take effect retroactively.

An election could be terminated by reason of the failure to qualify as a small business corporation or by a revocation.

A. Failure to qualify as a small business corporation

The election would not be effective for any time in which the corporation failed to meet the six conditions for a small business corporation set forth above. The election would terminate on the date in which the corporation ceased to be a small business corporation unless this occurred during the first year of the election, or because the corporation had more than 80 percent of its gross receipts from foreign sources (which must be determined on the basis of a full taxable year). In these two cases, the election would terminate as of the first day of the taxable year.

B. Revocation

The election could be revoked by the consent of all shareholders or by a new eligible shareholder who has not consented to the election and who is a shareholder during a period following the time of such election and for which the election is effective. To terminate an election a new shareholder would be required to file a revocation of the election within 60 days after he becomes a shareholder or, if the shareholder is an estate, within 60 days after the executor or administrator qualifies or 60 days after the end of the corporation's taxable year, whichever is earlier.

This procedure differs from present law under which the election terminates unless there is affirmative consent by new shareholders. The necessity of furnishing such consent has in some cases been overlooked and has caused serious hardships when new shareholders who, though wishing to continue the election, failed to consent within the required time and the procedure for granting an extension could not be satisfied. Therefore, it seems better to put an affirmative burden on a shareholder wishing to terminate.

A revocation during the first year of the election takes effect on the first day of such year. A revocation by a new shareholder would take effect on the day he becomes a shareholder. However, if the revoking shareholder acquires the stock from an ineligible shareholder [1] who did not cause the election to be terminated because he held the stock less than 60 days and did not receive a distribution, then the termination would take effect on the date the ineligible shareholder acquired his stock. This rule is needed because the shareholder who follows an ineligible shareholder would pick up income allocable to the ineligible shareholder's shares for the latter's period of ownership.

A revocation by consent of all shareholders would take effect on the day of filing with the Internal Revenue Service unless a different date is specified. Any later date in the same taxable year could be specified and if the revocation is filed within the first month of the taxable year, the first day of such year could also be specified.

5. EFFECT OF ELECTION BY SMALL BUSINESS CORPORATIONS

If a valid election is made, the corporation, with two exceptions, will not be subject to corporate income tax and the income and loss will

[1] An ineligible shareholder would have no power to revoke an election.

be passed through to the shareholders. Furthermore, special rules will be in effect for determining the earnings and profits of the corporation, and the taxation of distributions to shareholders as well as the basis of their shares. Although this pattern continues existing law, substantial changes have been made in the applicable rules. These are hereafter explained.

A. Corporation

A tax would be imposed on the corporation in the following two situations:

(i) The tax under present section 1378 on capital gains, which is imposed in order to limit the use of subchapter S on a temporary basis to realize capital gains and pass the proceeds through to shareholders with only one tax, would continue.

(ii) The tax imposed under section 47 in the case of an early disposition of property on which an investment credit was claimed would be imposed with respect to property purchased by the corporation during the period prior to the election.

This latter rule is a change from present law. In the case of an acquisition during election years, the investment credit is made available to those persons who are shareholders on the last day of the year and these persons would be responsible for any recapture. This rule is unchanged. However, where the investment credit was claimed by the corporation prior to the election, under present law the shareholders cannot be charged with recapture income and neither can the corporation when a disposition occurs during the period the election is in effect. Thus, under current law an election under subchapter S is treated as a disposition unless the shareholders and the corporation agree to be jointly and severally liable for the tax that would be incurred if there is a future disposition by the electing corporation. Under the proposal the tax would be imposed on the subchapter S corporation and the rule that an election is a disposition in the absence of an agreement, as referred to above, would be eliminated. The new rule would apply to dispositions in an electing year beginning after the date of enactment except where the subchapter S election in a prior year was treated as a disposition.

B. Shareholders

(1) *In general.*—New rules are proposed for the taxation of income and the allowance of losses incurred by subchapter S corporations, including such matters as allocation of items among the shareholders, time for inclusion, basis adjustments and determination of corporate earnings and profits.

Present law is unsatisfactory both because it is extremely complex and because planning of corporate distributions has an unnecessary effect on tax treatment of the shareholders. The partnership rules have, on the other hand, led to less difficulties. Therefore, the general rules for taxation of partners and partnerships would be applied to subchapter S corporations. However, the partnership provisions would not be carried over intact to subchapter S. There are two principal reasons for this result:

(i) Subchapter S can be elected by existing corporations with accumulated earnings and profits. Such corporations cannot become partnerships without liquidating and paying a capital gains tax. To impose such a tax as a prerequisite to an election is inconsistent with the intent to make subchapter S more readily available. On the other hand, allowing future distributions to be made without regard to such earnings is inappropriate. Moreover, an avenue for tax avoidances would be opened if a corporation could have its accumulated earnings taxed at capital gains rates by electing under subchapter S and then, after the earnings are distributed, resume regular corporate status perhaps by failing to qualify as a small business corporation.

(ii) A partnership, to a large extent, is considered an aggregate of individual interests and not a separate entity. Complex rules have been developed to carry out this concept (e.g., basis adjustments on transfer of interests, treatment of gain on sale of partnership interest as ordinary income to the extent allocable to certain items, separate allocation of items of income and deductions, including items related to contributed property). These rules may not cause great difficulty for simple partnerships, but the potential for complexity exists and it is advisable to avoid it. Moreover, the entity approach seems more appropriate for subchapter S corporations both because of the legal attributes attached to corporations under State law and because their status as electing corporations is easily ended and therefore may not be permanent.

(2) *Taxation of income and loss to shareholders.*—(a) *Allocable amount.*—Each shareholder would be required to include in his gross income or would be allowed (subject to certain limitations) a deduction for his portion of the subchapter S income or loss attributable to each share of stock owned by him during the taxable year.

Each shareholder's portion of income or loss would be computed by determining the daily income or loss (the total amount divided by the number of days in the year) and allocating it on a pro rata basis to the stock outstanding on each such day.[2]

This is the present rule for allocating losses of a subchapter S corporation. It also tends to be the method of allocating partnership income and loss although the partners may allocate income on any other reasonable basis if there is no tax avoidance motive. The current scheme of taxation of income of subchapter S corporations retains the regular corporate rules and thus the allocation of income depends upon the nature and timing of distributions. This results in a potential shifting of income either intentionally as a planning device or inadvertently.

Thus, under present law if there are no distributions, the taxable income for the year is taxed (as a constructive dividend) to those persons who are shareholders on the last day of the year regardless of how long they held their stock. If money distributions during the year equal or exceed the taxable income, then the taxable income for the year is in effect taxed as ordinary dividends to the shareholders who receive the dividends. If money distributions are less than the taxable income, the remainder is taxed to those persons who are shareholders on the last day of the taxable year.

---

[2] As provided under present law income may be reallocated among shareholders who are members of the same family if this is necessary in order to reflect the value of services rendered.

Property distributions during the year do not affect the amount of undistributed income potentially taxable to shareholders on the last day of the year. But, since current earnings and profits are allocated between property distributions and the constructive distribution, unless there are sufficient accumulated earnings and profits, the constructive dividend will not equal the full taxable income. The property distributions would account for at least the difference, however. These rules are needlessly complex and confusing and under the proposal the amount of current income taxed to each shareholder would not be affected by distributions during the year.

(b) *Computation of subchapter S income.*—Subchapter S income would be defined to mean taxable income determined in the same manner as a regular corporation with the following adjustments (items iii and v represent a change from current law):

(i) Net operating loss carryovers would not be allowed.

(ii) Dividend received deductions would be disallowed.

(iii) A capital loss carryover would be allowed only for capital losses incurred by a corporation, which is an electing corporation on the date of enactment, in taxable years for which the present subchapter S rules are applicable. This represents a change from present rules, under which such carryovers are generally allowed, because as hereafter explained a capital loss pass through would be permitted.

(iv) A deduction would be allowed for any capital gains tax paid pursuant to section 1378.

(v) Subchapter S income allocable to the nominal shareholders would be reduced but not below zero by payments made with respect to "obligations" determined to be equity capital (and which did not cause loss of qualification) if—

(*a*) Payments are not pro rata to the shareholders (pro rata distributions would generally be treated in the same manner as distributions with respect to nominal stock);

(*b*) There is a fixed and noncontingent obligation to pay "interest" annually, not dependent upon profits;

(*c*) Distribution is made within 2½ months of the close of the corporation's taxable year; and

(*d*) The payment is reasonable in relation to the investment.

(c) *When included*—(i) *In General.*—As indicated above, subchapter S shareholders at present are taxed on income when it is distributed which can lead to bunching of 2 years' income in one. For example, assume an electing corporation had $10,000 of income for both the taxable year ended June 1967, and the year ended June 1968, and distributed $10,000 in November 1967. The 1967 income was not distributed and will be taxed as a dividend on June 30, 1967. The $10,000 distributed in November 1967, although considered a distribution of income for the year ended June 1968, is taxable when distributed in 1967. As a result, the shareholders would include $20,000 or 2 years' income in their income tax returns for 1967. This problem has been alleviated under a 1966 amendment which treats distributions within the first 2½ months after the end of a taxable year as distributions of the undistributed taxable income for the prior year. However, a doubling up still occurs in this case since the November distribution was made after the 2½-month period ended.

On the other hand, in the absence of a transfer of interests, a partner's share of income and losses is included in his tax return for his year during which the partnership year ends. In the above example, as applied to a partnership, the partners would be taxed on $10,000 of income in 1967 and $10,000 in 1968, which seems to be a more logical result.

Therefore, the adoption of the partnership rule which is now applied to the losses of subchapter S corporations is proposed.

(ii) *Termination of election in middle of taxable year.*—If a subchapter S election is terminated in the middle of a taxable year, the short period would be treated as a taxable year ending on the date of termination for the purpose of determining income and loss and the time of inclusion on the shareholder's return.

The corporation's income or loss for its entire taxable year would be allocated between subchapter S income for the electing period and corporate taxable income for the balance of the year on a daily basis unless the corporation elects to compute its actual income for the period in the same manner as it would in the case of a full taxable year. The corporation would not be required to annualize income for either the electing period or the balance of the year.

(iii) *Transfer of shares.*—If a share of stock is disposed of during a taxable year by sale, liquidation, gift, or inheritance, the income or loss allocable to the transferred share would be included on the return of the transferor for the year which includes the day of transfer. This is the partnership rule in the event of a complete termination of a partner's interest by sale or liquidation and the current subchapter S rule for losses allocable to a deceased shareholder. This is also the result under the partnership provisions if the transfer of interests causes a termination of the partnership's taxable year.

However, the successor of a deceased partner picks up the income or loss for a year which has not terminated at the time of death including the portion applicable to the period the decedent was alive. Further, a donor of an interest, or an individual who sells part of his interest, although he includes his allocable portion of the income or loss applicable to the transferred interest, does not do so until the partnership year ends.

The suggested rule seems most logical, particularly since it makes income inclusion and the adjustment of basis coincide. It would also avoid the complexity caused by the diversity of the current partnership provisions.

Upon the transfer of a share, the allocable portion of the subchapter S income would be determined on the basis of the entire year's income unless the corporation and the transferor elect to determine the actual income or loss derived by the corporation up to the date of transfer, as if this period were an entire taxable year. Allocation on the basis of actual income would be permitted only in the event of death or a transfer which results in a complete termination of interest in the corporation within the meaning of section 302(b)(3). (Family attribution, sec. 318(a)(1), would not apply if immediately after the transfer the former shareholder has no interest in the corporation (including an interest as officer, director, or employee) other than an interest as a creditor without regard to whether there is a reacquisition within the 10-year period.)

If this exact method is utilized to determine income, the section 1378 tax would be computed for each separate period except that if a greater tax would be due on the basis of an entire year the latter amount would be payable.

(d) *Nature of income and loss.*—Income or loss of a subchapter S corporation would be considered attributable to a trade or business carried on by the shareholder. This is in accord with current law with respect to losses. Income is currently considered a dividend.

As under present law, subchapter S income would not be subject to tax under the self-employment tax or affect the recipient's right to social security benefits. However, if the corporation fails to pay an adequate salary to an employee who owns more than 10 percent of its shares of stock (directly or by family attribution under sec. 318(a)(1)), the Commissioner would be authorized to treat all or a part of the shareholder's portion of subchapter S income as salary for social security tax purposes. This would eliminate the present practice of designating all profits as dividends rather than salary in order to avoid social security taxes or the restrictions on social security benefits while continuing to work.

Items of income and loss would not retain their separate character in the shareholder's hands as under the partnership rules, but as under current law capital gains would be passed through to the extent of subchapter S income. In addition, each shareholder would be allowed to take account of his pro rata share of the corporation's long term and short term capital loss in excess of capital gains earned by the corporation.

Capital gains treatment would be denied to shareholders owning more than 10 percent of the shares of the corporation's stock at any time during the year, with respect to their allocable share of income from the disposition of property which would not have been treated as a capital asset in their hands.

(3) *Distributions.*—(a) *No accumulated earnings.*—Distributions by a corporation which had always been an electing corporation under the new rules [3] or which at the time of its election under the new rules had no accumulated earnings and profits would, under the proposal, never be considered to be dividends while the election remains in effect. All such distributions would be treated as a return of capital; i.e., they would first reduce the basis of the shareholder's stock and if they exceed such basis they would be treated as capital gains. The shareholder's basis for this purpose would be determined as of the last day of the taxable year in which the distribution is made or the day the stock is disposed of if earlier. All distributions would be taxed as if received on such day regardless of their nature or the actual time of receipt.

(b) *Earnings and profits in electing years.*—This result follows under the proposal because, unlike the situation under present law a subchapter S corporation would not increase accumulated earnings and

[3] As h after explained, under present rules a corporation could under certain circumstances accumulate earnings and profits in electing years.

profits during election years.[4] It would, however, keep account of earnings and profits in a special account known as subchapter S earnings and profits. In general, subchapter S earnings and profits would equal the total earnings and profits for all years that the current election has been in effect minus the sum of—

(i) The deficit in earnings and profits for each such year to the extent that the deficit in any year did not exceed the amount of the corporation's subchapter S earnings and profits as of the beginning of the year in which the deficit occurred (i.e., subchapter S earnings and profits would not be reduced below zero), and

(ii) All distributions of money treated as distributions of subchapter S earnings and profits.

However, a pro rata portion of subchapter S earnings and profits would be eliminated in the event of transfer of a share of stock to the corporatoin in a transaction which is treated as a distribution in exchange for stock.

The corporation's subchapter S earnings and profits account at the beginning of the first taxable year under the proposal would be the total amount of the previously taxed income accounts of all shareholders under present law at the end of the preceding taxable year (including such amounts as would be taxed to the shareholders during their taxable year which may not yet have ended).

(c) *Corporations with accumulated earnings.*—If a corporation has accumulated earnings and profits, distributions would be taxed in the following manner. Money distributions to the extent of subchapter S earnings and profits as of the end of the year in which the distribution takes place would not be considered dividends.[5] Money distributions in excess of such amount and all property distributions would be dividends to the extent of the accumulated earnings and profits at the end of the year in which the distribution takes place. Accumulated earnings and profits would be reduced by any deficit for the year in excess of subchapter S earnings and profits at the beginning of the year and this adjustment would be made before the tax effect of any distribution is determined. Accumulated earnings would also be reduced by any distribution therefrom.

A special rule would be provided for money distributions within the first 2½ months of a taxable year following a year for which an election was not in effect. The purpose of this rule is to remove an unintended benefit under present law. Today if a corporation elects subchapter S, and makes a distribution within the first 2½ months of the year, it may obtain a double benefit from this distribution; i.e., it may reduce its accumulated earnings tax base for the prior year without incurring any additional tax on its shareholders. Under the proposal a distribution in these circumstances would be a dividend.

---

[4] Under present law the accumulated earnings and profits of a subchapter S corporation is not increased by undistributed income taxed to shareholders nor is it reduced by the amount of an operating loss which is passed through. However, it would be increased by items not taken into account in computing income and loss but which affect earnings and profits, e.g., tax exempt interest or the excess of percentage over cost depletion.

[5] In order to prevent tax avoidance by tax-free money distributions to high-bracket shareholders and taxable property distributions (or no distributions) to low-bracket shareholders, money distributions for this purpose means only pro rata distributions.

Except for this special rule, distributions up to the amount of income[6] earned during subchapter S years, including the year of distribution, could be distributed even where there were accumulated earnings without fear of ordinay income treatment (and ordinarily the shareholders would have sufficient basis to avoid capital gains taxation). This is not necessarily true today.

For example, under present law if a corporation's first electing year ended on June 30, 1967, and it had $20,000 of income for such year and $5,000 for the year ended June 30, 1968, a distribution in November of 1967 in excess of $5,000 will be a dividend if there were accumulated earnings.

Although the shareholders in this case will pick up $20,000 of income for the year ended June 1967, they will not do so until December 31, 1967, and therefore they are not credited with previously taxed income (PTI) until such time. Thus, although over the 2-year period the corporation earned $25,000, if $25,000 were distributed in November 1967, the shareholders could, if there were sufficient accumulated earnings, include $45,000 in their gross income for the 2-year period.

Since PTI cannot be transferred upon the transfer of shares, if there is a new shareholder in the corporation a similar result can occur under present law even if distributions are more carefully timed.

(d) *Distributions after termination.*—Another problem concerns distributions following the termination of an election, particularly when the shareholders are unaware that termination is impending. Under current law distributions of previously taxed income must be made while the corporation's election is in effect. Once the election terminates, all PTI accounts are lost and the regular corporate rules apply. It is proposed to allow a 1-year period following termination during which distributions would be treated as distributions of subchapter S earnings and profits to the extent thereof. A 120-day period would also be allowed following a determination that an earlier inadvertent termination took place. Such distributions could be made in money or in the obligations of the corporation and could be made to any shareholder, even though such person was not a shareholder of the corporation while the election was in effect and even if the shareholder is a person who would be an ineligible shareholder in a subchapter S corporation. Although the concept of subchapter S earnings and profits is of no importance to a corporation without preelection accumulated earnings and profits while its election remains in effect, the amount remaining undistributed at the time of termination must be known in order to determine the tax effect of postelection distributions.

(e) *Repayment of distributions.*—The subchapter S election of a corporation may have terminated without its shareholders being aware of the termination. These shareholders may have caused the corporation to make distributions to them in the belief that these distributions would be subject to only one tax. If, however, the Commissioner subsequently determines that the corporation's election did in fact terminate for a year during which such distributions were made, the

[6] Since subchapter S earnings and profits are based on earnings and profits rather than taxable income this would not be the case where deductions which are not allowable in computing income reduce earnings and profits below taxable income.

distribution may be treated as dividends taxable in full to the shareholders and the corporation would be separately taxable on its income.

Under the proposal, a refund would be allowed for the tax payable by a shareholder with respect to distributions made in the bona fide, but erroneous, belief that an election was in effect at the time of the distribution. In order to obtain the refund, repayment of the distribution would be required to be made to the corporation within 120 days after the time the Commissioner's determination became final. The refund would be payable as of the year of repayment to the corporation and no interest would be paid for prior years.

Repayments would be deemed to be repayments of the latest distribution first and the tax attributable thereto would be determined by computing the decrease in the tax which would result for the taxable years during which the distributions involved were actually made if the amount of repaid distributions had not been distributed in such taxable years. Corporate earnings and profits would be increased as of the time of the original distribution by the amount deemed to be a repayment of a distribution out of earnings and profits. Provision would be made for waiver of the statute of limitations and appropriate consents from the corporation and all shareholders affected.

If the shareholder so elects, he could repay the amount of a distribution net of any tax attributable thereto and the refund of tax would be allowed to the corporation.

An estate could obtain a refund for repayment of distributions made to a deceased shareholder, but to the extent that any repayment obligation is deductible as a claim against the estate, it would have to be offset by the amount of tax refundable.

(4) *Basis.*—A shareholder's basis for his interest in an electing corporation would be adjusted on the last day of the taxable year or with respect to an interest disposed of during the year on the day of disposition by increasing such basis by the shareholder's portion of subchapter S earnings and profits or decreasing such basis, but not below zero, by the shareholder's portion of the deficit for the year. Earnings and profits or deficit would be allocated to shareholders in the same manner as income and loss as described above. Any portion of a deficit which is applied to reduce accumulated earnings and profits would not be allocated to shareholders to reduce basis. Unlike present law, basis reduction on account of distributions would not be applied until after the above adjustments are made.

A basis decrease would first reduce the shareholder's basis for each share of stock by the amount of deficit allocable thereto; secondly, if his basis for such stock is exhausted, but he still has basis for other shares of stock owned by him at any time during the taxable year, the basis of other shares would be reduced pro rata, and finally, if his basis for all of his stock in the corporation is exhausted, his basis for debt in the corporation would be reduced. These rules follow present law.

A basis increase would generally be applied to the share of stock to which the earnings and profits are allocable. However, if the basis of debt in the corporation held by the shareholder at the end of the taxable year has at any time been reduced as provided in the preceding paragraph and the shareholder's basis for such debt reflects the reduction, the increase in basis would first apply to the basis of such debt to the extent of the reduction. This is a new rule and would mitigate against the recognition of ordinary income on the disposition of debt which would be required under the proposal as hereafter explained. Any remaining increase would apply to the basis for stock. The amount would be allocated among shares of stock in proportion to the shareholder's portion of earnings and profits attributable to each such share.

Adjusting basis by items which are not included in determining taxable income or loss would represent a departure from current law and follows the partnership rules. It would enable a corporation to pass through tax-exempt income to shareholders. For example, if the only item of income accrued by a subchapter S corporation were $1,000 of tax-exempt interest, the shareholders' basis would be increased by $1,000 and a distribution would be applied against such basis. Under today's law basis is not increased, the corporation has $1,000 of earnings and profits and the distribution of tax-exempt interest is a dividend.

(5) *Limitation on allowance of losses.*—(a) *In general.*—As under present law, the shareholder's deduction of his portion of the corporation's loss would be limited by the sum of the adjusted basis for his stock owned at any time during the year and the adjusted basis of any indebtedness of the corporation to such shareholder. The basis of indebtedness would be determined at the close of the taxable year or on the last day on which the taxpayer was a shareholder.

In either case, the basis would be determined before reduction for the current year's deficit. Further, to take account of the fact that the deficit may include some positive items, for the purpose of computing the allowable loss a shareholder's basis would be increased by the amount, if any, by which the shareholder's portion of the loss exceeds his portion of the subchapter S deficit for the year.[7] For example, assume a corporation has tax-exempt income of $100 and an operating loss of $200. The deficit will be $100 and since the loss exceeds the deficit, basis will be increased by $100 before applying the loss limitations. If there were no deficit for the year the entire amount of the loss would always be allowable.

If a portion of a loss were disallowed, it would reduce pro rata the amount of ordinary loss and short-term and long-term capital loss which would otherwise be allowable. In determining the timing of inclusion of such loss in the event of a transfer of a portion of a shareholder's interest during the taxable year, the portion allowed would be allocated to shares in the ratio that the shareholder's loss (long-term capital, short-term capital, or ordinary as the case may be) allocable to each share bears to the shareholder's total loss.

A shareholder's portion of the corporation's loss not allowed as a deduction in a taxable year of such shareholder because of the limitation described above would be allowed as a deduction in any succeeding taxable year of such shareholder. This represents a liberalization of current law and is in accordance with the partnership provisions. The nondeductible part of such loss would not be transferable but might be deducted only by the same shareholder in a subsequent year.

[7] Under the proposal, basis would not be increased by subchapter S income in order to allow capital loss (or in certain unusual circumstances an ordinary loss) to the extent that there are nondeductible items in excess of tax-exempt income. This is an unlikely concurrence of components and it would not justify the complexity necessary to alter the result.

If the corporation's election remains in effect, the carryover loss would be deductible during the shareholder's taxable year during which the electing year ends, to the extent that such shareholder's basis for stock or debt, after giving effect to all transactions in such electing year, is increased above zero at the end of such taxable year of the corporation or at the date of disposition of his interest if earlier. If any part of the shareholder's loss has not been allowed as a deduction at the time the corporation's election terminates, it would be allowed as a deduction when and to the extent that the basis of such shareholder's stock or debt is increased above zero within the 12 calendar months immediately following the date of termination. Any deduction so allowed would result in a corresponding reduction in basis.

One further departure from present law and the partnership provisions should be noted. The suggested procedure adjusts basis (and also subchapter S and accumulated earnings) by the amount of any loss and determines the tax effect of any loss before giving effect to distributions during the year. Thus, if a partner's basis is $100 and he receives a $100 distribution in a year in which his share of the partnership's loss is $100, the distribution is applied against basis and the loss is disallowed. Under the proposal in the case of an electing corporation, the loss would be allowed and the distribution could be a dividend. The suggested rule appears simpler and more logical in that it is consistent with the treatment given to income both under the proposal and in the case of partnerships.

(b) *Treatment of loss if corporation has accumulated earnings and profits.*—If a corporation has accumulated earnings and profits, the treatment of losses can become more complicated. This situation arises if there is a deficit for the year in excess of the subchapter S earnings and profits at the beginning of the year. As indicated above, such excess would reduce accumulated earnings and profits to the extent thereof. Since the loss is deemed to be out of a presubchapter S accumulation of earnings, it should not be allowed to the shareholders. This procedure also tends to produce consistent results regardless of the timing of income, loss and distributions. The loss allowed to shareholders in these circumstances would be the loss for the year less that portion of the deficit applied to accumulated earnings and profits which consists of an allowable loss. The loss is not simply disallowed to the extent of the reduction in accumulated earnings, however, because such reduction could in part be the result of items which are not deductible in computing either an ordinary or capital loss. In general, it is proposed that such items (i.e., nondeductible items in excess of tax exempt income) be applied against earnings and profits first. Thus, the loss would be disallowed to the extent that the deficit applied to accumulated earnings and profits exceeds the amount, if any, by which the deficit exceeds the loss. This approach will accomplish the desired result, except in the unusual case referred to above where there is a combination of subchapter S income, capital loss and nondeductible items.

Any loss disallowance would be applied pro rata to reduce the allowable ordinary, long-term capital loss and short-term capital loss otherwise available.

6. SPECIAL RULES

The following rules are proposed to eliminate unwarranted advantages now available by using subchapter S.

A. RECAPTURE ON DISPOSITION OF DEBT

A. *Recapture on disposition of debt.*—If the basis of debt in a corporation has after the effective date of the proposal been reduced by reason of a deficit in subchapter S earnings and profits and if the basis of the debt in the hands of the holder (who may be a transferee) reflects all or part of such reduction, then gain on sale, redemption or other disposition of the debt which would otherwise result in capital gain, and which does not result in a complete termination of interest in the corporation would be treated as gain from the sale or exchange of an asset which is not a capital asset to the extent of the lesser of:

(i) The amount of the reduction reflected in the shareholder's basis for debt, or

(ii) The earnings and profits of the corporation at the time of redemption or sale.

This rule prevents the possibility of converting income into capital gain by holding a portion of a subchapter S interest in the form of debt, reducing the basis of such debt by subchapter S losses, and then after the election is terminated redeeming the debt at a time when a partial stock redemption would be treated as a dividend.

As indicated above, the occasions when this situation would otherwise arise is reduced by a new rule which would require the basis of debt to be restored in the event of subsequent subchapter S earnings.

B. *Certain employee benefits.*—The advantage in utilizing subchapter S instead of a partnership for the purpose of granting tax favored employee benefits to the owners of the business would be reduced in two areas:

1. *Pensions.*—The amount by which the sum deductible by an electing corporation on account of a contribution to a qualified employee benefit plan on behalf of an employee, who owns at any time during the taxable year more than 10 percent of the shares of the corporation's stock, including ownership by attribution under section 318(a)(1), exceeds either 10 percent of the employee's "earned income" from the corporation or $2,500, whichever is less, would be included in the employee's gross income as compensation.

Unless a profit-sharing plan has both a definite contribution formula and a provision that forfeitures will be applied to reduce contributions, any contribution reallocated to such shareholders in a subsequent year, whether or not an election is in effect in such year, would be treated as if contributed on behalf of such shareholder in the year deducted for the purpose of applying the above limits, except that any income resulting would be taxable in the year of reallocation. (This applies to the amount originally contributed which is forfeited, or the amount reallocated, whichever is less.)

Amounts included in the employee's income under this provision would be treated as contributions by the employer in determining whether the plan meets the requirements of section 401 relating to qualification. "Earned income" would mean the amount of the salary paid by the corporation to the employee plus any corporate income which may be allocated to the employee by the Commissioner to reflect reasonable compensation for services rendered.

In the case of a profit-sharing plan, carry-forwards under the second sentence of section 404(a)(3) (credit carryovers) would not be permitted from an electing year to a nonelecting year or vice versa.

An ordinary loss would be allowed in determining adusted gross income to the extent any amounts included in gross income under this provision exceed amounts actually distributed under the plan.

2. *Food and lodging.*—The exclusion provided by section 119 would not apply to the value of food and lodging provided by the corporation to employees who own more than 10 percent of the shares of the corporation's stock.

O