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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 6, 1969

PART 1

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.

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COMMITTEE ON WAYS AND MEANS,
Washington, D.C., January 29, 1969.

Hon. DAVID M. KENNEDY,
Secretary of the Treasury.

DEAR MR. SECRETARY: As you know, by letter to the Speaker of the House of Representatives dated December 31, 1968, President Johnson formally advised the Congress of the existence of the studies and proposals for tax reform which were developed by the staff of the Treasury Department, pursuant to the Revenue and Expenditure Control Act of 1968, and of his decision to make no recommendations to the Congress in the light of the fact that he would be leaving office on January 20. This communication also referred to the fact that the material contained in the studies and proposals would be made available to the Committee on Ways and Means of the House of Representatives and to the Finance Committee of the U.S. Senate at such time as those committees might request such material.

You will also recall the meeting which we had some days ago at which time the senior members of our respective committees discussed with you the procedures which might be followed with regard to obtaining these studies and proposals.

The purpose of this letter is to request, on behalf of the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate that you make available to our respective committees the studies and proposals to which reference is made. It would be appreciated if you could provide a copy to each committee at your earliest convenience.

With kindest regards,

Sincerely yours,

WILBUR D. MILLS,
Chairman, Committee on Ways and Means, House of Representatives.

RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate.

THE SECRETARY OF THE TREASURY,
Washington, D.C., January 30, 1969.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: In response to our earlier understanding and your request in the letter of January 29 from both you and Chairman Russell B. Long, Committee on Finance, U.S. Senate, I enclose herewith a copy of the tax reform studies and proposals for the Committee on Ways and Means of the House of Representatives. As you know, these studies and proposals for tax reform were developed by the Treasury Department during the administration of President Johnson and were transmitted to me by then Secretary Joseph W. Barr on January 17, 1969.

Sincerely yours,

DAVID M. KENNEDY.

THE SECRETARY OF THE TREASURY,
Washington, D.C., January 17, 1969.

Hon. DAVID M. KENNEDY,
Secretary-Designate,
U.S. Treasury Department,
Washington, D.C.

DEAR MR. KENNEDY: The attached are the studies and proposals regarding tax reform which were reviewed by Secretary Fowler prior to his leaving the Treasury Department, together with his accompanying statement which was approved by him. The last paragraph of that statement states as follows:

> We have been conducting Treasury staff studies as background respecting proposals for * * * particular industries. However, they are not sufficiently mature or complete to support specific proposals at this time. These studies are going forward and should be available to Congress in the next session.

Since that date some of the material referred to in that last paragraph has been completed. These staff studies are therefore attached hereto as supplementary material, as background for the development and assessment of proposals in the areas with which they deal.

Sincerely yours,

JOSEPH W. BARR.

TAX REFORM STUDIES AND PROPOSALS
U.S. TREASURY DEPARTMENT

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I. STATEMENT OF THE HONORABLE HENRY H. FOWLER, SECRETARY OF THE TREASURY, FOR THE CONGRESS OF THE UNITED STATES, ON THE TAX REFORM PROGRAM

(December 11, 1968)

We present to the Congress proposals for comprehensive reform of the Internal Revenue Code of 1954. This program contains proposals for tax reform developed by the Treasury Department over more than 2 years and meets the request of the Congress in section 110 of the Revenue and Expenditure Control Act of 1968.

Most of our individuals, families, and business firms are paying their fair share of the Federal tax bill which yielded $150 billion in fiscal 1968. They do this primarily by a process of voluntary self-assessment, under a system of tax administration that employs the most modern technology and methods of management, and operates efficiently and at low cost. Furthermore, as a result of major steps that have been taken in recent years—through the Revenue Acts of 1962 and 1964, the Excise Tax Reduction Act of 1965, the Foreign Investors Tax Act of 1966, the Tax Adjustment Act of 1966, the Federal Tax Lien Act of 1966, the Revenue and Expenditure Control Act of 1968, and administrative reform of depreciation procedures—our tax system is today better attuned than ever before to the requirements of high-level investment and economic growth.

We can take pride in these facts.

At the same time, however, we must recognize that there are other facts about our tax system which we cannot, by any means, view with pride. On the contrary, as believers in justice and fairness we can only deplore circumstances like these:

Under present law, 2.2 million families with incomes below the poverty level are required to pay Federal income taxes. These persons of all our taxpayers are least able to pay taxes. For example, a married couple with an income of the poverty limit of $2,200 would generally pay an income tax of $84. Such a tax burden on these low-income individuals and families is inconsistent with a tax based on ability to pay and a national commitment to eliminate poverty.

On the other hand, there are a sizable number of individuals with very high incomes who pay little or no income tax. Indeed, although the Federal income tax is designed and understood to be progressive, the fact is that many persons with incomes of $1 million or more actually pay the same effective rate of tax as do persons with incomes only one-fiftieth as large.

In contrast to the group just described, there are other persons with high incomes who are fully taxable on all their income and thus pay effective rates of tax in the 60- to 70-percent range, well above the average effective rate on persons at these income levels.

There are many billions of untaxed capital gains income included in the assets owned by persons who die each year—in 1966 about $15 billion. Simply because the owners found it neither necessary nor desirable to sell the assets during lifetime, these gains are not and will never be subject to income tax under present law, unlike other wealth accumulated during lifetime out of taxed income, such as wages.

When a husband dies, his widow may be subject to tax on a substantial part of the property which he leaves to her. This may mean a heavy burden of estate taxes on the widow, even though the property has been accumulated in part through her efforts and is intended to provide for her old age. The burden on the widow will be accentuated if there are minor children. The problem is especially difficult if the property is in the form of a family business or farm.

There are a number of large business organizations, with millions of dollars of wealth subject to overall common control, which pay tax almost entirely at the special rate designed for small businesses—not at the substantially higher rate applicable to large corporations—by organizing their businesses in the form of a chain of small corporate units, and claiming multiple exemptions from the corporate surtax rates. An enterprise with total assets of many millions can divide itself into hundreds of separate corporations with the aim of achieving an annual tax saving of millions of dollars.

Some tax-exempt private foundations are being used to accumulate assets and wealth. Over a period of years, such foundations do not realize any appreciable amount of income and consequently do not distribute any significant percentage of their resources to charity. Thus such foundations accumulate wealth, and thereby deprive charitable activities of funds which the tax-exempt status accorded the foundation (and contributions to it) was designed to accomplish. This abuse is compounded when the motivation of the accumulation is to further personal or business purposes of the donors of the foundations and their families.

Through situations such as these, and other types as well, a minority of the population pays far less than its share of tax while others may bear special hardships to meet their tax liabilities. Many of these special benefits and devices are intricate, subtle, and difficult for the average person to understand. But all of them flaw our tax system and undermine the standards of justice and fairness which should prevail. For the minority who benefit, these special advantages add up to substantial windfalls.

There is no comfort to be found in the view that, after all, no tax system is perfect. The flaws are too severe, too widespread, and—in some cases—too notorious for that.

As indicated earlier, much has been done by the four Congresses since 1961 to improve our revenue laws. Some examples of the important reform provisions in individual and corporation income taxes enacted in the Revenue Acts of 1962 and 1964 would include:

Introduction of the minimum standard deduction to lighten the income tax burden on the poor.

Corrections of abuses that arose through the use of deductible expense accounts for personal expenses.

Information returns on dividends and interest to improve compliance in reporting these items.

Repeal of the dividend credit.

Recapture of gains on depreciable personal property.

Fuller taxation of foreign tax-haven corporations, and other forms of foreign income.

Fuller taxation of mutual casualty insurance companies and cooperatives.

Limitations on tax-free reserves of mutual thrift institutions.

Revised taxation of certain employer-financed fringe benefits, such as sick pay, group life insurance, and stock options.

Introduction of averaging under the individual income tax.

Introduction of deduction for employee moving expenses.

Limitation on use of multiple properties for computing depletion.

Strengthened personal holding company provisions.

Further tax reforms were accomplished in 1965, 1966, and 1968. The 1965 Excise Tax Reduction Act provided equity, simplification, and reduction, by repealing most of the discriminatory excise taxes levied by the Federal Government. The 1966 and 1968 acts introduced graduated withholding and also completed the structure for shifting the payment of corporate income taxes to a current payment basis, consistent with payments by individuals.

To build upon what has been done, this effort must be continued. Toward this end the Treasury submits herewith for congressional consideration a program of comprehensive reform of the Internal Revenue Code. The program of reform we are recommending will accomplish the following major objectives:

For the individual income tax it will—

Take a major step, through increasing the minimum standard deduction, toward lifting the anomalous burden of income taxation from families and individuals who live on the margin of poverty.

Assure that those who are financially able will pay at least a *minimum tax* in support of their Government, covering that minority of high-income individuals who are able to arrange their sources of income so that they pay little or no tax under present law.

Assure that the system of deductions for personal expenses and the provisions excluding certain sources of income operate consistently and do not provide a double benefit. This would be accomplished by allocating itemized deductions between *taxable* income and *excluded* income for taxpayers who have large amounts of excluded income, rather than by allowing the full amount of the deductions to be offset only against *taxable* income, as is now permitted.

Establish a *maximum* tax to assure that henceforth no individual will pay more than half his total income in Federal income tax.

Simplify greatly the income tax by raising the standard deduction limits to bring them more closely into line with current patterns of personal deduction outlays and current levels of personal income, thereby restoring the use of that deduction to the level which prevailed when it was established in our tax system.

Revise the structure of the charitable contribution deduction to retain and even increase the encouragement for charitable giving while still achieving simplification through the expanded use of the standard deduction.

Simplify the income tax for the elderly and channel the tax relief to the taxpaying elderly who need it most.

Limit the deductibility of "farm losses" from nonfarm income to correct the abuse of farm accounting rules by wealthy nonfarm taxpayers and corporations.

Liberalize the tax treatment of moving expenses for the steadily increasing number of our working force who change residence because of a change in the place of their employment.

Correct other defects and provide important simplifications of present law.

For the death and gift taxes it will—

Achieve fundamental revisions of an area which has not been thoroughly reexamined or revised since 1942.

Reduce rates of estate taxation by 20 percent over a period of time.

Change present law income tax treatment of appreciation in the value of assets transferred at death or by gift, so that in the future such appreciation, to the extent it occurs after the date of enactment, will be taxed at death or gift under the income tax in the same manner as other capital gains. Only the net value of the assets after deducting the income tax will be subject to the estate tax.

Permit transfers of property between husband and wife by gift or by bequest to be entirely tax free.

Replace the present dual system of treating lifetime gifts separately from transfers at death, by a single unified system for taxing both. The unified system will eliminate a source of very considerable tax advantage now accorded to those fortunate enough to be able to distribute wealth by gift during life as compared to those who, for various reasons, are not in a position to make lifetime gifts.

Deal with the tax advantage now available through the use of long-term trusts to avoid estate tax for a generation or more.

Provide special estate tax relief where property is left to orphaned children.

Provide liberalized rules for the payment of death taxes to avoid possible forced sale of closely held businesses and farms.

Provide additional structural improvements.

For tax-exempt organizations the program will—

Carry out the recommendations made in the Treasury Department report on private foundations to the Congress on February 2, 1965, to eliminate serious abuses which have arisen among some private foundations and their donors.

Remove the marked inducement which present law provides for tax-exempt organizations to purchase businesses and other income-producing property with borrowed funds.

Expand the tax on unrelated business income to cover additional tax-exempt organizations.

Tax the investment income of social clubs and certain other tax-exempt membership organizations.

For the corporate income tax the program will—

Restrict the use of the $25,000 exemption from the corporate surtax so that it serves the purposes for which it was intended—relief for truly small business—and thereby end the advantage of multiple exemptions now obtained by corporations operating in chain form.

Correct a defect in the 1962 legislation reforming the tax treatment of mutual savings banks, so that such banks will be paying the amount of tax expected from them under that legislation.

Correct the tax treatment of mineral production payments to prevent avoidance of the limits on the allowance for depletion and eliminate distortions arising from the mismatching of income and expenses.

Some of the recommendations I now submit to implement this program will increase revenues; others will decrease them. Together, their revenue effects are balanced; they produce no significant net revenue gain or loss. This balanced approach reflects the conviction that the basic work of tax reform need not await general tax increases or decreases involving an overall adjustment in rates, nor should the basic work of tax reform be tied to temporary tax changes for countercyclical purposes.

The proposals recommended have been framed to provide a fair and orderly transition in those cases where individuals and businesses have made their arrangements based on existing law. We do not intend to have the harsh impact of abrupt changes. On the other hand, we do not want to be frozen into the status quo where it causes special inequities or preferences.

Tax reform is used here to mean structural tax reform—revision of those provisions of our law which shape the tax structure through defining the taxable base, rates of tax, and the administrative requirements of reporting and payment.

This program therefore does not extend to fiscal policy measures designed to influence economic stability and the level of economic activity (such issues as possible continuation of the tax surcharge and authorization for the President to make discretionary changes in tax rates), nor does it include programs to spend or distribute revenues (such as the negative income tax and other income-maintenance programs, and revenue sharing with State and local governments).

In working on the structure of our tax system, one is confronted with the suggestions for tax incentives to enlist private initiative to meet our social and economic problems. We have given careful consideration in this proposed revision of our tax system to such possible solutions to these problems. We believe that our social and economic needs can better be served through direct measures outside the tax system, rather than by tax credits and other forms of tax incentives. Consistent with this conclusion, we have also attempted to minimize distortions caused by existing special tax provisions.

Indeed, it has been our experience that when the proposed tax incentives are viewed as alternatives to budget expenditures, there are direct nontax methods available which are feasible and helpful, and which give greater benefits for the budgetary costs involved than do the tax incentives. Examples of effective nontax methods of achieving objectives that had been sought through the tax system include guaranteed loans, equal opportunity grants, and other programs to assist students and their families with the costs of higher education; direct grants for water pollution control projects; rent supplements and interest subsidies to increase the supply of low- and middle-income housing; and Government contracts with private employers to train hard-core unemployed for jobs. These methods achieve the important objectives in a manner consistent both with an equitable tax system and with careful and responsible budgetary control by the executive and the Congress.

Also adoption of tax credits and other special tax provisions, which generally are inefficient in accomplishing their objectives, would cause an unnecessary loss of revenue and thereby delay or make less likely general reduction in income tax rates. General rate reduction is the most equitable and most neutral form of tax reduction.

The proposals I am recommending represent a minimum but comprehensive program for tax reform which the Treasury Department urges Congress to act upon in the coming session. These proposals are important, specific, positive, carefully researched, and fully documented. They merit prompt action by the Congress. They represent significant improvements over existing law.

Let me emphasize that we are recommending a minimum plan with the hope that it will receive widespread support and be enacted into law as promptly as possible. We are therefore not covering areas and issues, whose inclusion might delay prompt consideration and approval of the proposals recommended here.

More specifically, the recommendations do not extend to the taxation of certain industries—extractive industries, timber, real estate, financial institutions—which receive special tax preferences to such an extent that the effective tax rates on these industries are far below the average for all industries. The omission of recommendations for these industries affects mainly the corporate income tax, and not the individual income tax. The proposals for taxation of appreciated property transferred at death, the minimum tax, and allocation of deductions will go far to prevent the treatment accorded particular industries from distorting the application of the individual income tax in a manner contrary to the ability-to-pay concept.

The lack of specific proposals, however, should not be taken to mean that the current tax treatment of these industries is necessarily correct. For example, there are many proposals by Members of Congress and others regarding the current taxation of the extractive industries especially oil and gas which deserve consideration.

The tax treatment of this industry, however, is only one aspect of many relating to our energy industries and therefore bears a relationship to our overall energy policies. These policies are of importance to national security, our balance of payments, foreign trade, and other important areas of public concern in addition to tax fairness.

President Johnson almost 2 years ago directed his science adviser and his Office of Science and Technology to sponsor a thorough study of energy resources and to engage a staff to coordinate energy policy on a Government-wide basis. The study was to include examination of, and recommendations concerning, the tax treatment of our natural resources, including petroleum, nonenergy minerals, and timber. Unfortunately the appropriation recommended by the President to finance this study has not been approved by the Congress.

We have been conducting Treasury staff studies as background respecting proposals for these particular industries. However, they are not sufficiently mature or complete to support specific proposals at this time. These studies are going forward and should be available to Congress in the next session.

In addition to this statement of mine, the Treasury Department presents the following materials to describe the tax reform proposals and the reasons and data which support them:

Part II.—General description of proposals.
Part III.—Concise summary of proposals and summary tables.
Part IV.—The case for and the dimensions of tax reform.
Parts V–VIII.—General and technical explanations.

The program here presented represents a major step in the continuing task of tax reform. The proposals will materially strengthen the structure of our system of income and estate and gift taxes.

We recommend this program to the Congress for prompt action in the next session.

II. GENERAL DESCRIPTION OF PROPOSALS

II. GENERAL DESCRIPTION OF PROPOSALS[1]

INDIVIDUAL INCOME TAX

RELIEF FOR PERSONS IN POVERTY

Minimum standard deduction

Under today's law single individuals and all but the largest families may be subject to income tax even though they are living in poverty. This results from the fact that the present individual exemptions and standard deduction are lower than the poverty income levels. There is thus a clear case of the need for tax relief at these income levels. The most effective way to provide relief at low income levels and to concentrate the associated revenue loss at such levels is through an increase in the minimum standard deduction.

Thee Treasury recommends that the minimum standard deduction be increased from the present $200 plus $100 for each allowable exemption to $600 plus $100 for each allowable exemption (subject to the same overall limit of $1,000 that exists under present law). Out of the 2.2 million families in poverty who are subject to Federal income tax under present law, about 1¼ million would become nontaxable and the remaining 1 million would receive tax reductions.

ELIMINATION OF UNACCEPTABLE TAX ABUSES

A number of the recommendations relate to the elimination of unacceptable tax abuses or advantages, which are primarily available to higher bracket individuals especially those who can choose their income sources. These provisions have the effect of creating considerable variation in effective tax rates among taxpayers in these income levels, causing considerable unfairness in the allocation of the tax burden.

A. Minimum individual income tax

Tax reform must come to grips with the fact that under present law it is possible for some individuals with very large incomes to pay little or no tax, while other individuals with far less income are required to pay a higher percentage of their income in tax and persons with low and modest incomes are required to pay a significant share of their income in tax. This situation is indefensible. It arises because certain types of income enjoy a favored tax status under the Internal Revenue Code. Whatever may be the merits of each of these tax preferences, of overriding importance is the principle that every individual with substantial income should pay a minimum tax toward the cost of Government that in itself bears a relationship to the income involved.

The preferential provisions and the resulting exclusions from in-

[1] The text contains a general description of the specific proposals. A concise summary of the proposals, together with revenue estimates and summary tables and the effects of the proposals, appear in III.

come that contribute most significantly to this disparity in treatment among individuals are:

The exclusion of one-half of the taxpayer's net long-term capital gains, with the alternative of taxation of the entire gain at a maximum rate of 25 percent.

The exclusion of interest received on State and local government bonds.

The exclusion resulting from percentage depletion in excess of the capital invested in the ownership of minerals or other natural resources.

The exclusion of the appreciation on charitable gifts of appreciated property, such as stocks, to the extent that this appreciation is taken as a deduction.

The Treasury recommends a minimum tax to be applied to an income base broadened to include the amounts now omitted because of the exclusions referred to above. The schedule of rates for the minimum tax would be graduated from 7 to 35 percent. The tax is designed so that when applied to the expanded income base it yields a tax equal in amount to the tax payable under the regular rates on half as much income. Thus the minimum tax would have the effect of placing a 50-percent ceiling on the amount of an individual's total income which may be excluded from tax. The individual would be required to pay this minimum tax whenever it exceeded his liability under present law definition.

An individual would ordinarily not be subject to the minimum tax (that is, he would not find the minimum tax to be larger than his regular tax) unless the sum of his excluded items exceeds the amount of his regular taxable income. In no event, however, would an individual need to be concerned at all with the minimum tax computation if his total income—computed on the expanded basis—is less than $10,000 (or $5,000 for a married individual filing a separate return).

As examples, a married couple:

With $5,000 of wage income (i.e., adjusted gross income) and $4,500 of the excluded type income, would not come under the minimum tax. Their total of regular plus excluded income is below the $10,000 exemption.

With $25,000 of regular taxable income, after deductions and personal exemptions are allowed for, would not be subject to minimum tax so long as excluded type income was also $25,000 or less.

With $150,000 of regular income, after deductions and exemptions, and $400,000 of completely excluded income, would be subject to minimum tax. Present law tax would be $76,980—only 14 percent of total income. The minimum tax on their total income of $550,000 would amount to $163,280, $86,300 more than present law tax, and would equal 30 percent of total income. This is approximately the same amount of tax as would be paid on $275,000 of regular taxable income (equal to half their total income of $550,000).

B. Allocation of deductions

Under the present structure of deductions and its relationship to the composition of income, taxpayers are able to obtain a double benefit from items of excluded income and thereby significantly reduce their tax burdens. This situation occurs among those taxpayers who have appreciable amounts of excluded income together with personal deductions, and who thus escape a fair tax because their deductions are applied against only the taxable part of their income.

The unfairness of the present system is illustrated by the following case:

An individual had a total income of $1,284,718 of which $1,210,426 was in capital gains, the remaining $74,292 from wages, dividends, and interest. He excluded one-half of his capital gains, which he is allowed to do under present law, thereby reducing his present law (adjusted gross) income to $679,405 (after allowing for the $100 dividend exclusion). From this income he subtracted all his personal deductions, which amounted to $676,419 and which included $587,693 for interest on funds borrowed presumably for the purpose of purchasing the securities on which the capital gains were earned. As a result, after allowing $1,200 of personal exemptions his taxable income was reduced to $1,786 and he paid a tax of $274. His overall tax rate, therefore, was about two-hundredths of one percent.

Deductions which reduce taxable income are justified only to the extent that they are properly assignable to that income. When an individual receives income in forms that are excluded from taxation—such as the items discussed above in connection with the minimum tax—it is not consistent or proper to permit him to subtract all of his eligible deduction items from that part of his income which is subject to tax and ignore the excluded part.

The Treasury recommends that an individual's itemized deductions be allocated between his taxable income and his excluded income, with only the part allocable to the taxable income to be permitted as deductions in computing tax. The excluded income to be taken into account for this allocation is represented by the items that would be added to the tax base in applying the minimum tax. An exemption would be provided to insure that taxpayers with less than $5,000 of excluded income need not make this allocation.

The application of this allocation proposal to the example just cited would produce a taxable income for the individual of $319,094 rather than $1,786, and a tax of $208,856 rather than $274.[1]

In this case, the tax due after the allocation requirement is such that the individual would not be liable for the minimum tax. In other cases, however, the tax computed in accordance with the allocation rule may still be below the minimum tax. The individual would then pay the minimum tax rather than the tax computed by the allocation rule, but in computing the minimum tax the individual would be able to utilize all his deductions including those allocated to excluded income.

C. Correction of abuses by nonfarmers of farm tax rules

Farmers are permitted to apply liberal tax accounting rules for the computation of income and deductions associated with farming. These liberal departures from good accounting practices are permitted for

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[1] This is derived as follows: The adjusted gross income equals 53.09 percent of AGI after it is expanded to include the excluded half of capital gains less the special $5,000 exemption ($679,405 divided by the sum of $679,405 plus $605,213 minus $5,000 equals 53.09 percent); this percentage is applied to allocable personal deductions ($676,419) which gives the amount of deductions allowed against adjusted gross income ($359,111). This disallows $317,308 of deductions permitted under present law; thus taxable income is increased to $319,094 from $1,786 under present law.

farm operations in order to spare the ordinary farmer the bookkeeping chores associated with the taking of inventories and accrual accounting. Briefly these rules permit farmers:

To use the cash accounting method and ignore their yearend inventories of crops, cattle, etc.;

To depart from the normal treatment for capital expenditures, such as those associated with the development of breeding herds or of citrus groves, fruit orchards, vineyards, or similar ventures, and instead obtain current deductions for these expenditures.

Over the years more and more high-bracket taxpayers, whose primary economic activity is other than farming, have exploited these rules for the purpose of gaining tax advantages. 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.

In addition to creating these important escapes from the individual income tax, these practices are leading to a distortion of the farm economy and are harmful to the ordinary farmer who depends on the farm for his livelihood. 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.

There is, therefore, a clear need to prevent exploitation of the farm tax rules by taxpayers who were never intended to benefit from them.

The Treasury recommends that the deduction of "farm losses" against nonfarm income be limited to $15,000 in any taxable year (but with the opportunity to carry losses back for 3 years and forward for 5 years). This limitation would not apply in those cases where the net income from farming is computed by normal business methods of accounting with the use of inventories and proper capitalization of preparatory and development costs. These rules would apply to both individuals and corporations.

This proposal would affect fewer than 14,000 individual tax returns, and would have little or no effect on taxpayers with less than $15,000 of nonfarm income. About two-thirds of the revenue gain from the proposal would come from individuals with nonfarm income of more than $100,000.

D. Taxation of multiple trusts and accumulated income in trusts

One premise of our present tax system is a progressive rate scale for individuals. This 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 and to distribute that income with little or no additional tax even where the beneficiary is in a high tax bracket. In such a case, unwarranted tax reduction is achieved because the trust's income is taxed separately from the beneficiaries' to whom it is ultimately distributed. Present law contains the so-called "throwback" rule which taxes to the beneficiary the trust income earned in the 5 years preceding distribution. This rule, however, is subject to exceptions which have permitted abuse.

Moreover, in some cases, taxpayers are seeking to compound the abuse by creating multiple similar trusts with a view to dividing the total income among numerous taxpaying entities.

The Treasury recommends that the throwback rule be applied to all trust distributions without being limited to the last 5 years income and without the various exceptions now contained in the code. Some minor exceptions will be provided for administrative convenience. The effect of this change will be to treat all taxpayers receiving distributions from trusts as if they had received the income over the years it was earned. Credit would be given for taxes paid by the trust. Also, simplified methods of computation will be provided. To reach the special situation where, on the termination of a trust accumulating income, the property is to be returned to the grantor and the accumulated income distributed to his wife, the rules would provide that the grantor of the trust be taxed currently on all income accumulated for eventual distribution to his spouse. This is consistent with the present rule that income accumulated for eventual distribution to the grantor is taxed currently to him.

LIMITATION ON TAX BURDEN

Maximum individual income tax

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 true income includes substantial amounts of excluded 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 taxable income of $500,000 or more, about 29 percent would pay—after the other reforms included in the program—more than 50 percent of their true incomes in tax. 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.

The Treasury recommends, as a component of an overall program to improve the equity of the income tax at the higher brackets, that no individual be required to pay more than one-half of his total income (including presently taxable income plus the major sources of excluded income) in income tax to the Federal Government. This would be accomplished through the introduction of an optional, alternative *maximum* tax. In making this recommendation the Department stresses the concept of "total income," for the maximum tax approach is valid only if there is assurance that an individual's total receipts are realistically and fully taken into account in computing the tax.

This alternative *maximum* tax would be computed at the rate of 50 percent on the same concept of income proposed in connection with the minimum tax with the addition of the value of stock options at the time of their exercise. Taxpayers would have the option of paying this maximum tax if it were lower than their regular tax under present law.

It is necessary to emphasize that the establishment of such a maximum tax is feasible only in conjunction with the recommended treatment for the taxation of appreciated assets transferred at death or by gift. A high proportion of those who would benefit from the maximum tax proposal are also large holders of appreciated assets. They, therefore, now benefit from the permanent exclusion from income taxation of the appreciation on these assets, which is possible under present law. Unless this special tax benefit is removed, it would be unfair to provide additional benefits through any reduction in the tax rate applicable to annual dividends, interest, and other income mainly derived from those assets. Indeed, such treatment would be inconsistent with the concept of the maximum tax as setting a limit on total tax paid in relationship to total income including capital gains.

INCREASED SIMPLIFICATION AND EQUITY IN TREATMENT OF DEDUCTIONS

A number of the proposals are aimed at a restructuring of the treatment of deductions, primarily the itemized deductions, in order to achieve increased simplification in that treatment and to improve the equitable distribution of the tax burden.

A. Liberalization of the standard deduction

Under present law, an individual taxpayer is entitled to deduct certain personal outlays from his net income before he computes his tax liability. Included among these personal deductions are such items as nonbusiness interest, taxes, charitable contributions, medical expenses, and casualty losses. To obtain the benefit of personal deductions, the taxpayer may either itemize the actual amounts of his various deductions or claim the so-called "standard deduction." Present law allows the standard deduction in an amount equal to 10 percent of the taxpayer's income, with a maximum of $1,000 and a minimum of $200 plus $100 for each allowable personal exemption.

A careful reexamination of the policies underlying the present limits on the standard deduction and the relationship of the standard deduction to itemized deductions has suggested major changes in the present treatment of personal deductions.

The standard deduction is one of the most helpful and desirable features of our tax system for combining simplification with equity. It is used by almost 40 million people, or 57 percent of our individual taxpayers. 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—a boon to so many taxpayers—also 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.

The present limits on the standard deduction were established when typical income levels were lower and when personal deductions were much lower in relation to income than they are today. When established, the standard deduction was used by more than 80 percent of our individual taxpayers. It is time to bring the standard deduction closer into line with today's income levels and with today's relative cost and expenditure patterns for deduction items, and thereby to restore the coverage of the standard deduction to about the same percentage of taxpayers which eixsted at its adoption.

The Treasury recommends that the amount of the allowable standard deduction be increased from 10 to 14 percent of adjusted gross income, and the dollar limitation on the standard deduction be increased from \$1,000 to \$1,800.

B. Revision of charitable contribution deduction

1. Allowance of deduction in addition to standard deduction

The tax deduction for charitable gifts is designed to serve as an incentive to individuals to contribute to charitable organizations. When individuals utilize the standard deduction, they may not now separately claim a deduction for their charitable gifts. In a separate recommendation, the Treasury has proposed that the standard deduction allowance be liberalized. This, in itself, would significantly reduce the incentive effect of the charitable deduction since many additional taxpayers would no longer have sufficient other personal deductions to warrant itemization and thus will receive no tax benefit for their charitable contributions.

The Treasury recommends that those using the standard deduction be permitted also to claim a deduction for charitable contributions.

2. Charitable deduction threshold

Although it is desirable to remove the charitable contribution deduction from the scope of the standard deduction so that the incentive effect of the charitable deduction is not impaired, it is not possible to allow the deduction for all amounts. The complete extension of the charitable deduction to those claiming the standard deduction would result in virtually every individual income tax return claiming charitable deductions, many of them small in amount. Verification of these millions of small contributions would pose an unacceptable and costly, and indeed, impossible, enforcement problem. Moreover, the complete extension of the deduction would represent a move away from simplification and ease of compliance for the taxpayer.

The Treasury recommends, as a companion proposal to allowing the charitable deduction outside the standard deduction, that the charitable deduction be limited to those amounts in excess of 3 percent of adjusted gross income. The limitation would apply both to taxpayers using the standard deduction and those using itemized deductions.

The increase in the standard deduction and the adoption of the 3-percent threshold for the charitable contribution deduction will reduce significantly the number of returns requiring auditing for personal deduction items, while maintaining the tax incentive for more than routine charitable gifts. This will permit release and reallocation of revenue agents' time with a resulting increase in revenue to be expected.

3. Increase of deduction ceiling

The effect of permitting charitable deductions only to the extent they exceed a 3-percent threshold focuses the tax deduction where an incentive for charitable giving is meaningful—gifts of more than routine amounts. The incentive could be further strengthened by raising the existing 30-percent of income limitation on the maximum amount of charitable gifts which may be deducted.

The Treasury recommends that the present 30-percent limitation on deductible charitable contributions be increased to 50 percent.

4. Correction of certain charitable deduction abuses

a. Avoidance of percentage limitations.—Since the adoption of the original deduction for individual charitable contributions in 1917, Congress has maintained percentage limitations upon the ability of taxpayers to reduce their tax base by charitable gifts. These limits reflect a fundamental judgment that charitable contributions should not enable taxpayers to escape making a reasonable contribution to the costs of Government.

Two provisions of present law, however, conflict with these principles and permit avoidance of the general percentage limitations on the charitable contribution deduction.

One provision permits charitable deductions without limitation if certain conditions are met. This provision is used by less than 100 very-high-income individuals and grants them special tax savings of approximately $25 million each year.

The unlimited charitable deduction requirements ostensibly require that the donor give most if not all of his income to charity. Thus, it is often assumed that persons using the unlimited deduction are turning over their entire annual incomes to charity. In fact their contributions typically consist of greatly appreciated property for which deductions based on fair market values are claimed. In this way they retain their annual incomes untaxed, since the appreciation in value of the property contributed is not subject to tax.

The Treasury recommends that the unlimited charitable contribution deduction be repealed and that these taxpayers be made subject to the same percentage ceilings on charitable deductions as apply to other taxpayers. However, because present law requires a period of qualifying contributions before the benefits of the unlimited deduction become available, and some taxpayers have undertaken the actions necessary to qualify upon the assumption that the unlimited deduction would be in effect when their qualification is complete, a grace period of 10 years would be allowed before the repeal of the unlimited charitable contribution deduction becomes effective.

The second special provision, which permits avoidance of the percentage limitation, allows a person to establish a 2-year trust for the benefit of charity. He may thereby exclude the income from his tax base and donate it to charity without regard to the limitations that would have applied had he given the income directly.

The Treasury recommends that the special 2-year charitable trust provision be repealed.

b. Other charitable deduction abuses.—Several recommendations are included to correct other abuses of the charitable deduction provisions. The following are the principal areas of concern covered by these recommendations.

When property is transferred to a trust in which a charity has either an income or remainder interest, the contributor often receives a deduction for an amount considerably in excess of the amount that the charity ultimately realizes. This occurs because the method for valuing the charitable interest may have little relation to investment policy as regards income versus capital growth.

The Treasury recommends that for gifts in this form the charitable deduction be allowed only under arrangements which guarantee that the charity will actually receive an amount equivalent to the amount for which the deduction is allowed.

Persons owning appreciated property which would be taxed at ordinary income rates if sold, are able to realize a greater after-tax profit by contributing the property to charity than by selling the property and keeping the proceeds. Obviously, the charitable contribution deduction is not intended to generate tax savings detached from charitable motives.

The Treasury recommends that there be included in income the amount of ordinary income or short-term capital gain that would have resulted had property donated to charity been sold at fair market value. The full value of the property would continue to be deductible.

Significant tax savings can be effected by selling appreciated property to a charity for less than its value, for example, at an amount equal to its cost (tax basis). This allows the donor to obtain a tax-free recovery of his cost, and at the same time to secure a deduction for the full amount of the untaxed appreciation.

The Treasury recommends that in any case when property is sold to charity for less than its fair market value, a proportionate part of the appreciation be allocated to the sale element of the transaction and be subject to tax.

C. Repeal of gasoline tax deduction

State gasoline taxes paid as personal expenses are deductible in determining an individual's Federal income tax. Like the nondeductible Federal gasoline tax, the State gasoline tax is essentially a direct charge by the State for the highway facilities it provides to those on whom the tax is imposed. It's deductibility is inconsistent with the user charge character of the tax in that it serves to shift part of the cost from the highway user to the general taxpayer.

The Treasury recommends that State gasoline taxes paid as personal expenses no longer be deductible. However, gasoline taxes paid as a business expense would continue to be deductible.

D. Consistency of capital gain and loss rules

Under present law, net capital gain income is taxed at preferential rates, while net capital losses may be claimed as ordinary deductions against regular income subject to an annual limitation of $1,000. This inconsistent treatment affords an undue advantage to investors who are able to realize their gains and losses in alternate years since the gains are taxed at a maximum of 50 cents on the dollar while each dollar of loss offsets a dollar of fully taxable income.

The Treasury recommends that each dollar of net long-term capital loss be permitted to offset only 50 cents of ordinary taxable income, subject to the present $1,000 overall limitation on the amount deductible in any one year. If the total net long-term loss for a year exceeds

$2,000, a deduction of $1,000 would be permitted for the year in which the loss is realized and any excess over $2,000 may be carried over and treated as a long-term capital loss in the succeeding year.

In some instances, married couples pay the same amount of tax whether they file separate returns or a joint return. When this is the case, a couple may double its maximum capital loss deduction to $2,000 a year by filing separate returns instead of following the normal practice of filing a joint return.

The Treasury recommends that the annual limitation on the capital loss deduction be lowered to $500 in the case of a married person filing a separate return.

E. Liberalization of moving expense rules

An individual who moves his residence because of a change in the location of his employment may frequently incur substantial expenses. Under present law, in this situation, a tax deduction or exclusion is granted for the cost of transporting the employee, his immediate family, household goods, and personal effects. Some liberalization in the tax treatment of employee moving expenses is justified, particularly in view of the increasing mobility of our working force. However, since these expenses are both business and personal in nature, it is not appropriate to allow their deductability without limit.

The Treasury recommends that the tax allowance for moving expenses be liberalized to include—

The cost of house hunting trips;

The temporary living costs at a new location while awaiting permanent quarters; and

Certain costs incurred in selling a house;

But with all these items subject to a combined dollar limitation of $1,500.

In the future, all tax allowances for employee moving expenses would be in the form of a deduction from gross income.

REVISED TAX TREATMENT OF THE ELDERLY

The tax laws now contain a variety of complex income tax benefits for the elderly. Social security and railroad retirement benefits are excluded from income; a complex retirement income credit (at a maximum of 15 percent of the first $1,524 of eligible retirement income for a single person) is provided to grant somewhat comparable tax benefits to individuals with pension or investment income who are not covered or are only partially covered by the social security or railroad retirement programs; and all persons age 65 or over are accorded an extra $600 personal exemption and an additional $100 minimum standard deduction. Wage income is not eligible for the retirement income credit and, in addition, wage income reduces the amount of that credit available for investment and pension income.

These tax provisions are inequitable and inefficient in distributing financial aid to the elderly. They discriminate unfairly against those who need to continue working after reaching 65. The retirement income credit is so complicated on the tax return that many senior citizens do not understand it and therefore lose the benefits to which they are entitled. Finally the provisions are of greatest benefit to those with the highest incomes.

The Treasury recommends that the income tax treatment of the elderly be revised to eliminate these complex features of existing law and to provide, instead, a simple and uniform method of equitably taxing all aged taxpayers.

In place of the existing benefits, a special exemption of $2,500 would be allowed to all single taxpayers who have attained the age of 65 and a special exemption of $4,200 would be allowed to a married couple where both spouses are over the age of 65. In order to limit their applicability to situations which warrant financial help, these special exemptions would be reduced dollar for dollar for 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. 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 these benefits included in his income for tax purposes.

VOLUNTARY WITHHOLDING ON INDIVIDUALS

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 be voluntarily subjected to withholding even though the employee and employer desire it.

The Treasury recommends that the present system of withholding of income taxes be extended to those situations not covered by the mandatory system if both the employer and employee voluntarily agree.

CORPORATE INCOME TAX

Four of the recommendations relate particularly to corporations and involve situations where the existing provisions of the law produce unintended results.

ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS

The 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.

Contrary to the intent of the provision, a number of large businesses have taken advantage of the surtax exemption by organizing themselves in chains of separate corporations, each claiming to qualify for a separate surtax exemption. In this manner, large business enterprises seek to cover most if not all of their income under the 22-percent rate[1] and thus secure significant tax reduction. Congress in 1964 dealt particularly with this situation but the provisions have proved largely ineffective.

The Treasury recommends that these distortions of the fundamental purpose of the surtax exemption be eliminated by ultimately limiting each commonly controlled business enterprise to one surtax exemption. To accomplish this result in an orderly fashion, curing the worst abuses first, the number of permissible surtax exemptions available to a single controlled group of corporations would be reduced from 500 to one over a 7-year period. Similar limitations would be applied to limit the extent to which other small business provisions may be claimed by large corporate chains.

MINERAL PRODUCTION PAYMENTS

In recent years the use of mineral production payments has increased substantially, primarily for tax reasons. By the use of carved-out production payments, the limitation on the depletion allowance which Congress has provided has been distorted. Under present rules, the depletion deduction with respect to a mineral property is limited to 50 percent of the net income for the taxable year from that property. However, by the sale of a production payment, this limitation can be avoided since the seller of the payment takes the proceeds of the sale into account as depletable income in the year of the sale. The seller excludes from income amounts used to pay out the production payment, but nevertheless claims a deduction for the expenses relating to the production payment.

In ABC transactions, the production payment is used as a financing device. But the tax consequences of the transaction are distorted because the owner of the mineral interest excludes from income the amounts used to pay the production payment, but claims a deduction for the expenses attributable to the production payment.

In each case, there is a mismatching of income and expenses which distorts the tax liability of taxpayers in the extractive industries.

The Treasury recommends that these distortions be eliminated by in general treating production payments as loan transactions. The result will be that income and expenses relating to the production payments will be matched in the same taxable year and the abuses now being encountered will be corrected.

CURING OF DEFECT IN 1962 RULES REGARDING MUTUAL SAVINGS BANKS

There is a considerable degree of overlap in the functions performed by the various types of banks and savings institutions, and they often provide essentially similar services. In this situation it is particularly important that the tax laws do not unreasonably favor one type of institution over another.

In 1962, Congress took an important step in reforming the tax treatment of mutual thrift organizations. However, due to defects in the assumptions underlying the legislation passed at the time, one group

[1] In many of these cases, a 6-percent penalty rate applies, thus making the tax rate 28 percent.

of thrift institutions, the mutual savings banks, have been able to continue to conduct their operations so as to make tax-free additions to reserves of an amount which has permitted them to remain virtually exempt from tax. In other words, they are not paying the tax which Congress fully intended they should pay when action was taken in 1962.

The Treasury recommends elimination of the particular alternative (i.e., the 3-percent method) for computing bad debt deductions which has resulted in the current undertaxation of mutual savings banks. Also, the Treasury suggests that consideration might be given to adding flexibility to the other special formula for computing bad debt deductions for all mutual thrift organizations.

REVISION OF TREATMENT OF SUBCHAPTER S CORPORATIONS

In 1958, Congress enacted a new provision—commonly referred to as subchapter S—allowing small corporations to elect not to be subject to the regular corporate income tax. Instead, they can elect to have their income taxed directly to their shareholders in somewhat the same manner as a partnership. This special alternative has generally worked well over the 10 years it has been in the law. However, as with any new concept, experience has revealed certain difficulties which should be corrected. On the one hand, the somewhat complex rules have produced unintended hardships in certain areas—frequently because the shareholders were unfamiliar with one or another of the many provisions. On the other hand, these provisions have sometimes conferred unintended benefits on certain taxpayers.

The Treasury recommends a revision of subchapter S that would make the rules for these corporations and their shareholders conform more closely to the rules governing partnerships and partners, and make them easier and simpler to comply with. Certain of the tax benefits these corporations now receive would be conformed to those available to partnerships. For example, a shareholder-employee owning more than 10 percent of the corporation's stock would be taxable on contributions made to a pension plan on his behalf to the extent the contributions exceed those allowable to a partnership.

TAX-EXEMPT ORGANIZATIONS

Examination and review of the operation of organizations which qualify for tax exemption, indicate that certain of these organizations carry on activities which are incompatible with the purpose of their exemption. Three of the recommendations concern these situations.

PRIVATE FOUNDATIONS

Generous provisions for tax exemption of private foundations and for the tax deduction of contributions to such foundations have long been provided in the tax laws. However, since this tax treatment diverts amounts from the public treasury to private foundations, it is imperative that the tax laws insure that these private foundations put these funds to philanthropic purposes that benefit the public.

In order to determine if private foundations are indeed discharging the philanthropic obligations which justify their tax benefits, the

Treasury Department, at the request of the tax committees of the House and Senate, conducted a study into the operations of private foundations. This study revealed that the preponderant number of private foundations are performing their functions without tax abuse. However, the study also revealed that a minority of such organizations are being operated so as to bring private advantage to certain individuals, to delay passing on directly benefits to charity for extended periods of time, and to involve the foundation too greatly in the ownership and management of commercial enterprises. The study revealed that the restrictions in present law dealing with these problems have been difficult and expensive to administer, hard to enforce in litigation, and otherwise insufficient to prevent these abuses.

The Treasury Department submitted to the Congress in 1965 a report recommending action to deal with these foundation abuses. The Ways and Means committee of the House has already secured public comments upon the Treasury Department report and has published those comments.

The Treasury recommends that the Congress act on this report and its recommendations to eliminate the tax abuses in this area.

CURBING OF ABUSES IN DEBT-FINANCING OF ACQUISITIONS

The Supreme Court in 1965 approved capital gains treatment for persons who sold a business to a tax-exempt organization in an arrangement elaborately structured both to avoid payment of Federal income tax upon the earnings of the business and to immunize the exempt organization from any liability or risk of loss. By means of the arrangement, the exempt organization undertook to acquire ownership of the business entirely without investment of its own funds.

The availability of tax exemption for use in transactions following this pattern creates serious problems. First, where the purchase price of a business or other income-producing property is to be financed from the future earnings of the property, tax-exempt organizations are uniquely situated to pay a considerably higher price than other purchasers can afford—their exemption makes it possible for them, in effect, to pay to the former owners of the business the money which a taxable purchaser would have to pay to the Government in taxes. This advantage to exempt organizations creates a strong incentive for the sale of businesses to them.

Second, use of the exemption in transactions of this type permits exempt organizations to grow independent of the amount of contributions or membership fees which they receive from the public.

The Ways and Means Committee in 1966 held hearings on legislative proposals, developed by the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation, which were addressed to these problems. Bills reflecting further study of those proposals have been introduced subsequently.

The Treasury recommends that the Congress adopt the pending bills.

EXPANSION OF TAXATION OF INCOME FROM UNRELATED BUSINESS AND FROM INVESTMENTS OF CERTAIN ORGANIZATIONS

Prior to 1950, it became general knowledge that some tax-exempt organizations were engaging in businesses unrelated to their exempt purposes. If tax exemption were available to shield the income from these unrelated commercial activities, organizations could enjoy, vis-a-vis their taxpaying competitors, substantial competitive advantages such as the ability to charge lower prices and to expand their business operations out of earnings undiminished by taxation. Congress responded to this problem of unfair competition by the passage, in 1950, of the unrelated business income tax. Under these provisions, with certain exceptions, income tax is imposed upon the income derived by exempt organizations from the regular conduct of an unrelated trade or business.

However, the unrelated business income tax under present law does not apply to certain tax-exempt organizations, including churches, social welfare organizations, social clubs and fraternal beneficiary societies. Organizations of this type are presently engaged in unrelated business activities and are otherwise earning tax-free income from sources incompatible with the proper scope of their tax exemption.

The Treasury recommends that:

(1) The existing provisions of the unrelated business income tax be extended to churches and to social welfare organizations.

(2) The tax exemption for social clubs be limited to income from dues, fees, or other amounts paid by members for providing to such members or their guests goods, facilities, or services constituting the basis for the tax exemption. Thus, income from sources outside the membership generated in any manner, and income from the membership generated other than in exchange for goods, facilities, or services consistent with the club's exempt functions would be subject to the unrelated business income tax. Moreover, the present exceptions to the unrelated business income tax for investment income would be inapplicable to social clubs, to eliminate the unwarranted benefit now available to members in these clubs resulting from the fact that pleasure and recreational facilities are provided them out of the untaxed investment income of these clubs.

(3) Fraternal beneficiary societies be taxed in the same manner as social clubs, but with an additional exemption for income from property permanently committed to providing life, sick, accident or other benefits to the membership or their dependents.

The possibility of unfair competition resulting from the inapplicability of the unrelated business income tax may exist in classes of tax-exempt organizations other than those dealt with under this proposal. Furthermore, unwarranted benefits to members from nonmember income, similar to those encountered in connection with social clubs and fraternal beneficiary societies, may also exist in other classes of tax-exempt organizations (including social welfare organizations). Finally, special problems are raised by the relationship between the unrelated business income tax and the insurance, banking, retirement or other business oriented functions of several exempt organizations (including the insurance function of fraternal beneficiary societies). The question of the proper tax treatment in all of these cases is under review and study by the Treasury Department. At a later date, when this study has been completed, the Treasury may have further recommendations to offer in this area.

Estate and Gift Taxes

Taxes on property left by an individual to his heirs is one of the oldest and most widely accepted forms of taxation. Although the revenue yield of the estate tax is not large in relation to the income tax, the tax does play an important role in our tax system. Since gifts during life are an alternative to gifts at death, taxation of gifts by the living is a natural companion to taxation of gifts at death.

While the past 8 years have seen major reforms enacted in the corporate and individual income tax structure and the repeal or reduction of most of the excise taxes, our estate and gift taxes have not been thoroughly reexamined or revised since 1942. It is widely recognized that a complete revision is long overdue. Various provisions of the law produce complexities in estate planning, encourage dispositions of assets contrary to the best interests of taxpayers, beneficiaries, and the economy, and work gross inequities among taxpayers. Considerable information for such a revision is available through substantial studies that have been conducted recently by the Brookings Institution and the American Law Institute Federal estate and gift tax project.

The following proposals combine to produce this needed complete overhaul of these taxes.

TAXATION OF APPRECIATION OF ASSETS TRANSFERRED AT DEATH OR BY GIFT

Associated with the needed revision of the taxation of transfers of wealth at death or by gift is a much needed revision of the income tax treatment of appreciated property so transferred. Under present law, accumulation of wealth from ordinary income—wages, salaries, dividends, business profits—is subject to the income tax as the wealth is accumulated. Similarly, when a taxpayer sells a capital asset which has appreciated, the gain is subject to income tax. On the other hand, if a taxpayer holds an appreciated asset until he dies, the appreciation is not subject to the income tax.

As a result of this situation, there is obvious and gross inequality in the income tax treatment of people who accumulate their estates by means of untaxed appreciation or value as compared to those who accumulate out of currently taxable income. Vast portions of capital gains—$15 billion a year—fall completely outside the income tax system.

When tax liability is allowed to depend on whether or not an appreciated asset is sold or kept until death, not only is there a serious inequity in the tax law, but, particularly in the case of older people, assets become immobilized. Investors become "locked in" by the prospect of avoiding income tax completely if they hold appreciated assets until death rather than selling them. This freezing of investment positions curtails the essential mobility of capital in our economy and deprives it of the fruits of an unencumbered flow of capital toward areas of enterprise promising the largest rewards.

The Treasury recommends taxation under the income tax, in a manner similar to that of other capital gains, of the appreciation in the value of assets transferred at death or by gift. To assure equitable application of the tax, it is recommended that—

Only appreciation occurring after the date of enactment be subject to tax to remove any semblance of unfairness toward those who already hold appreciated assets in anticipation of tax-free transfer at death;

The tax on appreciation of transferred assets be allowed as a deduction for estate tax purposes;

Taxpayers be allowed a minimum basis of $60,000 with the result that no tax at all would be imposed on gains when the total value of assets transferred is $60,000 or less;

Complete exemptions be allowed for transfers between spouses or to charity;

Limited exemptions be allowed for transfers to orphan children and transfers of ordinary personal and household effects;

Net unrealized losses on business or investment property be allowed as an offset against capital gain and, subject to appropriate limitations, against ordinary income for the 3 taxable years preceding the decedent's final income tax return;

Gains on transferred assets be eligible for averaging.

The adoption of this recommendation to tax appreciation on assets transferred at death or by gift is essential to permit the reduction in estate tax rates and the removal of the limit on tax-free transfers between husband and wife which the Treasury is also recommending.

Imposition of an income tax on appreciated capital assets at death would not result in a doubling up of death taxation. A tax on the appreciation would be due under the income tax, but the amount of such tax would not enter the estate of the decedent. The base of the estate tax would thus be net of the income tax paid, as is the case for those who accumulate their estates out of ordinary income or out of capital gains realized prior to death.

TAX-FREE TRANSFERS BETWEEN HUSBAND AND WIFE

Present law permits a husband to leave up to half his property to his wife free of estate or gift tax. The 50-percent limitation upon this so-called marital deduction is undesirable as transfers of property between husband and wife are not appropriate occasions for imposing tax. An especially difficult burden may be imposed by the tax when property passes to a widow with minor children. Instead, when the surviving spouse dies, the transfer tax can be properly imposed as the property passes to the heirs.

Furthermore, the distinctions drawn by existing law between transfers which qualify for the marital deduction and those which do not have generated drafting complexities, artificial limitations upon dispositions, and considerable litigation.

The Treasury recommends that the present limit on the marital deduction be removed. As part of this recommendation, the present restrictions upon the types of interests which qualify for the marital deduction would be liberalized. Finally, to add further flexibility to the planning of transfers between spouses, the spouses would be given power to determine the extent to which they wish the marital deduction to apply and the extent to which, therefore, the transferred property would be subject to tax upon subsequent disposition by the transferee.

ORPHAN CHILDREN'S DEDUCTION

A need for special relief must be recognized when a decedent has no surviving spouse but leaves minor children.

The Treasury recommends that an appropriate deduction be provided for parents' transfers to their orphan children.

UNIFICATION OF THE ESTATE AND GIFT TAXES

At present, the estate and gift taxes are applied as two separate taxes. This dual tax structure permits very large differences in tax liabilities to arise among estates of equal size. The individual who is fortunate enough to hold his wealth in forms which lend themselves to distribution by gift during life rather than at death may employ a number of major advantages available through the gift tax system. He can take advantage of liberal gift-tax exemptions. For gifts in excess of the exemption, gift tax rates are much lower than estate tax rates. Then, after a lifetime of giving at rates that do go higher and higher, the taxation of the individual's remaining estate starts over with a new set of exemptions and with a whole new rate schedule starting at low rates.

Further, the gift tax rates are applied only to the net amount of the gift, so that the amount used to pay the gift tax does not enter the base; the estate tax, however, is levied on the full value of the estate which includes whatever amount is needed to pay the tax. These among other things, bring about significant reduction in the taxes which such an individual's property should bear. Other persons—possessed of estates too modest to permit large lifetime gifts or owning interests which cannot be disposed of conveniently or prudently during life—are unable to make use of the special preferences inherent in the present system.

The discrepancies in tax treatment can be great. For example:

> A father dies and leaves an estate of $713,385 to his two children and four grandchildren. The estate tax liability is $213,385 leaving $500,000 for his heirs. However, under present law, had the father been in a position to make gifts to his heirs while he was alive—which many taxpayers are not in a position to do—he could have given $500,000 to his children and grandchildren entirely tax free. To accomplish this he could have given $6,000 per year to each recipient for a period of 14 years.
>
> The transfer at death of an amount equal, after tax, to $1 million involves a tax liabilty at least 75 percent greater than if the family were wealthy enough to accomplish the transfer half by lifetime gift and half by a bequest at death.
>
> The advantages of lifetime giving over bequests at death are more valuable the greater the amount of wealth involved. By splitting $1 million worth of property between lifetime gifts and bequests at death, the heirs will receive about 15 percent more than if the property were passed entirely in the estate at death. But splitting property worth $5 million between lifetime gifts and bequests at death will increase the amount available to the heirs by as much as 37 percent.

A further unfortunate result of our present dual-transfer-tax system is the spawning of complexity and controversy. The separation of the gift tax from the estate tax has necessitated the creation of elaborate rules for determining which tax should apply to situations in which a donor transfers property during his lifetime, but retains some interest in it or some opportunity to recover it. Slight differences in the form of such transfers often lead to substantial differences in the amount of tax which must be paid.

The Treasury recommends full unification of the estate and gift taxes into a single-transfer tax to accomplish the dual objectives of fairness and reduced complexity. Under this unified transfer tax—

Lifetime gifts and transfers at death would be added together to determine the total wealth subject to transfer taxation;

A single exemption and a single rate schedule would be made applicable to that total;

The base of the gift tax would be grossed up to include the amount of tax, parallel to the treatment for estate taxes;

Appropriate rules would be provided to accomplish an orderly and equitable transition to the new system.

ARRANGEMENTS FOR GENERATION SKIPPING

Present law encourages the establishment of complex arrangements under which property is left in trust for succeeding generations. The objective of these arrangements is to avoid estate tax by skipping its application to the succeeding generation in the wealth-transfer sequence. Under even more elaborate arrangements, trusts may be established to provide incomes for children and then for grandchildren, and so on, with the trust property ultimately going to great-grandchildren, or beyond. Thus, estate taxation can be skipped for two or more entire generations. The enjoyment of the property by each successive generation is not skipped—it is only the estate tax that is being skipped.

The special tax advantages of this estate tax generation skipping have several undesirable features. First, they are available to some, but certainly not to all families. The wealthier the family, the greater the opportunity for arrangements of this character. Evidence from a recent study indicates that the use of generation skipping trusts is about 10 times as great among those leaving gross estates of $1 million or more than it is among those leaving estates of $300,000 or less. For those leaving estates of $2 million or more, almost all the family trusts were of the generation-skipping type.

The availability of this tax avoidance device creates an artificial incentive for dispositions of a kind which would not otherwise be chosen—frequently restraining the free transfer of property for a considerable number of years. Finally, generation-skipping conflicts with the fundamental principle of estate and gift taxation that wealth should be taxed as it passes from one generation to the next.

The Treasury recommends the imposition of a substitute tax upon arrangements accomplishing the avoidance of transfer taxation for one generation or more. This tax would be imposed at the time enjoyment of the transferred wealth actually passes to each succeeding generation. The tax would not be applicable to transfers—whether direct or in trust—which have heretofore become irrevocable.

RATE REDUCTION

Two of the major structural changes recommended—the taxation of appreciation of assets transferred as a gift or at death, and the unification of the transfer taxes—will, over time, produce substantial revenue yields under the rate schedules existing today.

The Treasury recommends that these revenue effects be counterbalanced by a scheduled reduction of the transfer tax rates to take place in month-by-month steps over a period of 10 years. After the transition, the top transfer tax rate would be 65 percent compared to the 77-percent rate for the present estate tax. The remainder of the rate schedule (except for the very low rates—starting at 3 percent—at the beginning of the scale) would be reduced commensurately by about 20 percent of the present net Federal estate tax rates. The credit allowed for State death taxes would not be changed from present law.

EXEMPTIONS

Under present law there is a lifetime gift tax exemption of $30,000 plus an estate tax exemption of $60,000.

The Treasury recommends that an overall exemption of $60,000 be provided under the unified transfer tax. Although this single exemption is numerically smaller than the present combined $90,000 exemption, this is more than offset by the recommendation for a complete exemption of transfers between spouses which will result in a considerably more liberal overall exemption structure than the present general exemptions.

Present law contains an annual $3,000 per donee exclusion intended to permit relatively small gifts (e.g., Christmas and birthday gifts) to be made free of tax. This exemption applies on an annual basis with respect to each donee, regardless of the number of donees. This $3,000 limitation should be retained to facilitate lifetime giving of small gifts.

The Treasury recommends continuing the annual per donee exclusion, at the present level of $3,000.

LIBERALIZATION OF PAYMENT RULES

In certain situations the nature of the assets comprising an estate presents special impediments to the prompt discharge of the estate's tax liability. Estates consisting largely or entirely of interests in closely held businesses or farms are particularly likely to encounter these difficulties when the decedent's heirs wish to maintain ownership of the business. Present law affords insufficient relief for these situations. The proposed rate reductions and the proposed full exemption of transfers to a spouse will do much to reduce or eliminate these problems. Still, difficulties may remain in some cases.

The Treasury recommends that special provisions be adopted to provide liberalized rules for deferred payment of death tax liabilities in cases in which payment problems are present.

III. CONCISE SUMMARY OF PROPOSALS AND SUMMARY TABLES

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III. CONCISE SUMMARY OF PROPOSALS AND SUMMARY TABLES

Individual Income Tax

RELIEF FOR PERSONS IN POVERTY

Liberalization of minimum standard deduction

Under existing law, each taxpayer is entitled to a minimum standard deduction of $200 plus $100 for each exemption, subject to an overall limitation of $1,000. This would be raised to $600 plus $100 for each exemption, still subject to the same overall $1,000 limit.

This change will reduce taxes principally for taxpayers earning under $5,000 a year. It will eliminate all income tax liability for a majority of taxpayers with poverty level incomes and materially reduce the tax burden of the remainder.

Revenue loss.—The annual revenue loss would be $1.1 billion.

ELIMINATION OF UNACCEPTABLE TAX ABUSES

A. Minimum individual income tax

A minimum income tax would be adopted applicable to taxpayers with significant amounts of excluded income. Individuals who receive a substantial portion of their income from tax-exempt sources would be required to pay a tax under a graduated minimum tax rate schedule applied to their "expanded income base" if that minimum tax exceeded their liability under present law.

The "expanded income base" for minimum tax purposes would be the present taxable income expanded to include the following excluded items: the excluded one-half of long term capital gains, State and local bond interest, percentage depletion in excess of the cost of the property, and appreciation in property donated to charity for which a tax deduction is allowed.

Generally, the minimum tax rates would result in a tax equal to the tax under the normal rates on one-half as much income. Thus, the minimum tax will not generally apply unless the individual's excluded income exceeds his presently includible income. In no case would it apply to an individual whose "expanded income base" is less than $10,000.

About 40,000 taxpayers in the higher income groups would pay minimum tax.

Revenue gain.—The minimum tax provision would increase revenues by $420 million per year.

B. Allocation of deductions

An individual's nonbusiness itemized deductions would be allocated between his taxable income and his major items of excluded income with only the part allocable to the taxable income to be allowed as deductions. The excluded items to be taken into account in this computation are the same as those in the "expanded income base" under the minimum tax: the excluded one-half of long term capital gains, State and local bond interest, percentage depletion in excess of the cost of the property, and appreciation in property which is donated to charity and for which a tax deduction is allowed.

Allocation would not be required unless the taxpayer had at least $5,000 of the above-excluded items. Moreover, the standard deduction would always be allowed without allocation.

This proposal would affect approximately 400,000 taxpayers, most of whom have total income in excess of $20,000.

Revenue gain.—The proposal would increase revenues by $405 million per year.

C. Correction of abuses of farm tax rules by nonfarmers

The deduction of "farm losses" against nonfarm income would be limited to $15,000 in any taxable year (but with the opportunity for carrybacks and carryforwards of any excess to avoid imposing the restriction where a large isolated loss is incurred in one year). The limitation would be applicable to individually operated farms and to farms operated by a corporation or a partnership. This limitation would not apply, however, in those cases where normal business methods of accrual accounting and proper capitalization of preparatory and development costs are used by the taxpayer.

This proposal would affect about 14,000 taxpayers and would have little or no effect on taxpayers earning less than $15,000 of nonfarm income.

Revenue gain.—The proposal would increase revenues by $145 million per year.

D. Taxation of multiple trusts and accumulated income in trusts

The existing "throwback" rule regarding the accumulated income of trusts would be applied to all trust distributions without being limited to the last 5 years' income and without the various exceptions now contained in the code. Some minor exceptions would be provided for administrative convenience. The effect of this change would be to treat all taxpayers receiving distributions from income accumulated by trusts as if they had received the income over the years it was earned. Credit would be given for taxes paid by the trust. Also, simplified methods of computation would be provided. Where a trust is established to accumulate income for eventual distribution to the grantor's spouse, the trust's income would be taxed currently to the grantor.

Revenue gain.—These provisions would produce a gain of $70 million per year.

LIMITATION ON TAX BURDEN

Maximum individual income tax

A maximum tax would be introduced under which a ceiling would be placed on the total tax imposed on the total income of individuals. Under this maximum tax, the income tax could not exceed 50 percent of a taxpayer's total income, measured generally in accordance with the same expanded income base as is used under the minimum tax. A taxpayer would have the option of paying this maximum tax if it were lower than his regular tax under present law.

The maximum tax would not go into effect so long as the temporary 10-percent surcharge is in effect. It is estimated that the maximum tax would be used by about 12,000 high-income taxpayers.

Revenue loss.—The maximum tax proposal would result in an annual revenue loss of $205 million.

INCREASED EQUITY AND SIMPLIFICATION IN TREATMENT OF DEDUCTIONS

A. Liberalization of general standard deduction

At present the standard deduction is 10 percent of adjusted gross income with a ceiling of $1,000. It would be raised to 14 percent of adjusted gross income with a ceiling of $1,800.

The change would result in about 80 percent of taxpayers using the standard deduction rather than itemizing their deductions. It would principally benefit taxpayers in the $5,000- to $15,000-income range.

Revenue loss.—This provision involves an annual revenue loss of $1.4 billion.

B. Revision of charitable contribution deduction

1. Allowance of deduction in addition to standard deduction

The charitable contribution deduction is presently an itemized deduction which is not available if the standard deduction is claimed. Under the proposal the charitable contribution deduction would be allowed to be claimed even if the standard deduction were used.

Revenue loss.—The allowance of charitable contribution deductions outside the standard deduction would involve an annual revenue loss of about $440 million and affect 18.5 million taxpayers after the proposed liberalization of the standard deduction, minimum standard deduction, and the proposed application of a 3-percent threshold (discussed below).

2. Charitable deduction threshold

A limitation on deductibility would be imposed so that only those contributions in excess of 3 percent of adjusted gross income would be deductible outside the standard deduction. This threshold of 3 percent would also apply to taxpayers electing to itemize all personal deductions and not taking the standard deduction.

Revenue gain.—The disallowance of deductions under the 3-percent level would increase revenues by $1.5 billion and affect 21.6 million itemizers remaining after the proposed liberalization of the standard deduction and minimum standard deduction.

3. Increase of deduction ceiling

Under present law, the maximum limitation on the charitable contribution deduction is 30 or 20 percent of adjusted gross income, depending on the recipient. The general 30 percent limitation on the charitable deduction would be increased to 50 percent.

Revenue loss.—The effect of the proposal will be a $20 million revenue loss and would generally benefit upper-income taxpayers who make large amounts of charitable gifts, including those who would lose the unlimited charitable contribution deduction discussed below.

4. Correction of certain charitable deduction abuses

(*a*) *Avoidance of percentage limitations.*—Under present law, the maximum limitation on the charitable contribution deduction does not apply for the very small number of taxpayers who qualify for the unlimited charitable contribution deduction. Also, the percentage limitations may be avoided under a special provision which permits the creation of a 2-year trust for the benefit of charity resulting in the exclusion of the trust's income from the donor's taxable income.

The unlimited charitable deduction option and the special 2-year trust rule would be repealed (the former after a 10-year transition period). These taxpayers would be subject to the proposed 50-percent limitation.

Revenue gain.—Repeal of the unlimited charitable contribution deduction would gain $25 million after the 10-year-grace period has expired. The revenue gain after repeal of the trust rule would be small. Repeal of the two special exemptions to the percentage limitation rules would affect a limited number of wealthy taxpayers.

(*b*) *Other charitable deduction abuses.*

1. The charitable contribution deduction for a trust interest given to a charity is based on an assumed actuarial calculation made at the time the trust is created. Management of the trust property, however, can be conducted with a view to favoring the interests of the noncharitable beneficiaries and giving charity less than was assumed in calculating the deduction. The proposal would restrict the deduction to the amount that the charity actually receives.

2. With certain limited exceptions, a taxpayer can deduct the value of appreciated property donated to charity without payment of the tax that would be due had he sold it. In cases where the gain realized on sale would be taxed as *ordinary income* (such as in the case of inventory or section 306 preferred stock), the result for high bracket taxpayers is that they can realize more after-tax income by giving the property to charity than by selling it and keeping the after-tax income for their own use. This would be corrected by including in income the amount of ordinary income which would have resulted on a sale of the property at its market value.

3. Significant tax savings can be effected by selling appreciated property to a charity for an amount equal to its cost (tax basis). This permits the tax-free recovery of cost, and at the same time a deduction for the appreciation in value without the payment of tax on the appreciation. To correct this abuse, special rules for the allocation of basis on these "bargain sale" transactions would be prescribed.

These changes would affect only high bracket taxpayers. The revenue increase is under $5 million.

D. Repeal of gasoline tax deduction

Under existing law, taxpayers may deduct State gasoline taxes but not the Federal gasoline tax. State gasoline taxes like the Federal gasoline tax are essentially charges for the use of highways and therefore are more like a personal expense for automobile travel (such as tolls, etc.) than a tax. This proposal would eliminate this deduction. Such repeal would affect most taxpayers who itemize their deductions.

Revenue gain.—This provision involves an annual increase in revenues of $310 million.

E. Consistency of capital gain and loss rules

Under present law, only 50 percent of net long-term capital gains is required to be included in income (subject to a maximum alternative tax equal to 25 percent of the gain). On the other hand, net long-term capital losses may be deducted in full against ordinary income, up to $1,000 per year, and the excess over $1,000 may be carried forward in full and treated as a long-term capital loss. To make the rules applicable to long-term capital losses consistent and parallel with those governing long-term capital gains, a change is proposed under which each $1 of net long-term capital loss would offset only 50 cents of ordinary taxable income, subject to the present $1,000 overall limitation on the amount deductible in any 1 year.

If the total net loss for a year does not exceed $2,000, 50 percent of it would be deductible against ordinary income, with no carryover. If the total net 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 could be carried over and treated as a long-term capital loss in the succeeding year.

In addition, the annual $1,000 capital loss limitation would be lowered to $500 in the case of a married person filing a separate return.

Revenue gain.—The proposal would increase revenues an estimated $60 million in the first year. As the backlog of existing capital loss carryovers is absorbed under the new rule, the annual revenue gain would increase to an ultimate level of about $100 million (at 1969 income levels) within about 6 years.

F. Liberalization of moving expense rules

A tax deduction for employee moving expenses would be extended to cover the cost of house-hunting trips, temporary living costs at the new location, and the commission for selling the house at the old location. All of these items would be subject to a combined dollar limitation of $1,500. At present, only the direct transportation costs incurred in a job-related move may be deducted or excluded.

Revenue loss.—This provision involves a revenue loss of $85 million per year.

TAX TREATMENT OF THE ELDERLY

A special exemption would replace the various tax benefits now available to the elderly (retirement income credit, exclusion of social security benefits, additional $600 exemption) and their attendant complexity. This special exemption would be available to all lower and middle-income elderly regardless of their source of income, but would not be available to higher income individuals where there is no need for tax relief because of age.

The dollar amount of the special exemption for single persons would be $2,500. For married couples, the special exemption would be $4,200. (Each aged person would continue to receive the regular $600 exemption.) The income level at which the special exemption begins to phase out would be $6,500 for single people and $11,500 for a married couple. An additional special deduction would be provided for those receiving railroad retirement benefits.

Of the approximately 4.8 million elderly individuals who now pay income tax, almost 3.6 million would be either completely exempted from tax or would receive tax reductions. The remainder—in the middle and upper brackets—would realize tax increases.

Revenue loss.—This proposal would result in an annual revenue loss of $80 million.

VOLUNTARY WITHHOLDING ON INDIVIDUALS

There are frequently situations where an employer and his employees may desire to institute income tax withholding on wages but are prevented from doing so by the technical provisions of present law. To correct this situation, wage withholding would be permitted in those situations not now covered by the law (such as agricultural labor) if both the employer and employee agree to such withholding.

CORPORATE INCOME TAX

CORRECTION OF ABUSE OF MULTIPLE SURTAX EXEMPTIONS

Corporations pay a tax of 22 percent on their first $25,000 of income and 48 percent on income over this amount. This exemption of the first $25,000 of income from the general corporate rate is known as a "surtax exemption."

The proposal would eliminate the ability of a controlled group or chain of corporations to claim more than a single surtax exemption. This result would be achieved over a 7-year transition period which would allow the corporations ample time to adjust their affairs to the new system.

The transition to this rule would be accomplished by a sliding scale of maximum limits on the number of surtax exemptions that may be claimed by any controlled group of corporations. For the first year the maximum would be 500 exemptions; for the second year, 250; for the third year, 100; for the fourth year, 50; for the fifth year, 25; for the sixth year, 10; and for the seventh year, 5. Thereafter, no more than one surtax exemption could be claimed by a controlled group.

Revenue gain.—This provision would increase annual revenues by $235 million when the transition is fully effected.

CORRECTION OF ABUSE OF MINERAL PRODUCTION PAYMENTS

The tax treatment of the extractive industries may be distorted under present law by use of mineral production payments. Where the owner of a mineral interest sells a carved-out production payment, he takes the proceeds of the sale into account as depletable income in the year of the sale. By this device, the limitation on the deduction for depletion may be avoided. Further distortion may occur because the owner of the working interest excludes from income amounts used to pay off the production payment, but claims a deduction for the expenses attributable to the production payment. In ABC transactions, the production payment is used as a financing transaction, but its tax consequences are distorted because the owner of the working interest excludes from income the amount used to pay off the production payment, but claims a deduction for the expenses attributable to the production payment. In both cases there is a mismatching of income and expenses which distorts the tax treatment of the extractive industries.

The proposal generally would treat mineral production payments as loan transactions. As a result the owner of a mineral interest subject to a production payment will take the income and expenses with respect to the production payment into account in the same taxable year.

Revenue gain.—This provision would increase annual revenue by $200 million.

CORRECTION OF TREATMENT OF MUTUAL SAVINGS BANKS

To correct the fact that mutual savings banks are not paying the tax which Congress intended they should pay as a result of the 1962 reform of the tax treatment of mutual thrift organizations, mutual savings banks would no longer be permitted to use the so-called 3-percent method of creating tax-free reserves. Instead, their additions to these reserves would have to be on the basis of actual experience or on the basis of 60 percent of taxable income. Moreover, it would seem advisable to revise this 60-percent method of computing additions to reserves for all thrift institutions in a manner which would merely reduce (instead of eliminate as under present rules) the tax benefits involved, to the extent that the institution fails to maintain a specified level of investment in residential mortgages, while at the same time not interfering with the institution's investment flexibility.

Revenue gain.—This provision would increase revenues by $40 million per year.

SIMPLIFICATION OF TREATMENT OF SUBCHAPTER S CORPORATIONS

The provisions relating to so-called subchapter S corporations would be revised so that the tax rules for these corporations and their shareholders conform more closely to the rules governing partnerships and partners and to make them easier and simpler to comply with. Consistent with this goal of parallel treatment to partnerships, some of the tax benefits now available to subchapter S corporations would be limited to those available to partnerships—for example, the nontaxable contributions that may be made to pension plans on behalf of shareholder-employers owning more than 10 percent of the business would be limited to the amount of such contributions that may be made to self-employed pension plans on behalf of the owners.

TAX-EXEMPT ORGANIZATIONS

CORRECTION OF ABUSES IN PRIVATE FOUNDATIONS

Approximately 3 years ago, the Treasury Department submitted a report to the Congress concerning private foundations. The report contained a series of recommendations to correct abuses which were revealed in a thorough study of this area. The recommendations in the report are designed principally to prevent the creator of a private foundation from utilizing the foundation's property for his personal benefit, to require that property transferred to a private foundation be devoted to charitable use within a reasonably prompt period of time, and to divorce the philanthropic aspects of foundations from their control and management of business. The proposals endorse these recommendations. These proposals affect only a minority of private foundations and have no significant overall revenue effect.

CURBING OF ABUSES IN DEBT FINANCING OF ACQUISITIONS

Charitable organizations are acquiring business enterprises under a technique which has very favorable tax aspects for the parties concerned. The exempt organization purchases the business, its obligation to pay being limited to a specified percentage of future profits.

Since the profits generated by the business are not subject to tax in the charity's hands, it is able to pay an inflated price for the business. The sellers realize capital gain on their profit, a result which has been upheld by the Supreme Court in the *Clay Brown* case. In accord with bills considered in 1966 in public hearings by the Ways and Means Committee, and reintroduced in revised form in 1967, a tax would be imposed on the unrelated debt-financed income of exempt organizations to curb this practice. Although this would not have any immediate significant overall revenue effect, it would prevent substantial future revenue losses.

EXPANSION OF TAXATION OF INCOME FROM UNRELATED BUSINESSES AND FROM INVESTMENTS OF CERTAIN EXEMPT ORGANIZATIONS

A. Unrelated business income

Most types of exempt organizations are subject to income tax on income from businesses unrelated to their exempt activities. This proposal would extend this tax to certain exempt organizations to which it does not now apply—churches, social welfare groups, civic leagues, social clubs, and fraternal beneficiary associations. This tax would not apply to income from businesses related to the organization's exempt function, such as an insurance business run by a fraternal beneficiary association.

B. Investment income

The interest, dividends, rents, and royalties received by exempt organizations are, for the most part, not subject to income taxes. This exclusion is appropriate to those organizations which are exempt because they are rendering some service to the community as a whole. There are certain classes of exempt organizations, however, which are exempt on a theory of mutuality. Organizations such as social clubs are operated solely for the benefit of members and any "profit" derived from rendering services to members is used by the club for the benefit of members and therefore represents merely a reduction to the member of the cost of services rendered to him because the services in fact cost less than the original charge. Where, however, a social club has income from interest, dividends, rents, or royalties, this income inevitably reduces the member's cost below the actual cost of providing the purely personal facilities made available by the organization. The proposal would tax social clubs and certain other membership organizations on all income other than that derived from rendering services to members.

Revenue gain.—These proposals would increase annual revenue receipts by an undeterminable amount.

Estate and Gift Taxes[1]

TAXATION OF APPRECIATED PROPERTY TRANSFERRED AT DEATH OR BY GIFT

Under existing law, appreciated property may be transferred at death without the imposition of a capital gains tax on the increase in value. Additionally, the recipient of the property takes its market value at death as his tax basis. Thus, the appreciation forever escapes income taxation.

[1] Revenue effects of the various proposals are discussed at p. 44.

It is proposed that a capital gains tax be imposed on the appreciation in assets transferred at death or by gift, with certain exemptions and exclusions. The tax would apply, however, only as to appreciation occurring after the date of enactment. Since every taxpayer would be presumed to have a minimum basis in property transferred at death of $60,000, only those with significant amounts of assets would be affected by this proposal.

TAX-FREE TRANSFERS BETWEEN HUSBAND AND WIFE

Presently, there is a 50 percent limitation on the amount of property which can pass tax free from a husband to his wife at death, with a similar limitation on gifts. This limitation would be removed so that up to 100 percent of property could be transferred between spouses free of estate or gift tax. Additionally, the rules concerning the types of interest in property which may qualify for the marital deduction would be liberalized and simplified.

These revisions will be of benefit to smaller and medium-sized estates and will be a considerable benefit to estates lacking liquidity.

ORPHAN CHILDREN'S DEDUCTION

A deduction for property left to orphans of the decedent would be provided, which would be $3,000 for each year of the orphan's age below 21.

UNIFICATION OF GIFT AND ESTATE TAXES

Under present law, there are separate progressive rate schedules and separate exemptions applicable to the gift tax and to the estate tax. A more equitable and uniform system of transfer taxation is proposed. The gift and estate taxes would be combined into one single transfer tax with a single rate schedule and a single exemption. The gift tax rates are presently 25 percent lower than the estate tax rates. The unified transfer tax would further equate lifetime and deathtime transfers by providing rules for computing the tax on lifetime transfers so that, in effect, the tax is paid out of the property transferred, as is the case with transfers at death. Thus, the proposal provides for computation of the tax on lifetime transfers by valuing the gift ("grossing-up" the gift) so as to include the amount of the tax within the amount of the gift upon which the tax is computed.

Unification would generally increase the total transfer tax burden for those taxpayers with accumulated wealth at levels sufficient to induce them to make large amounts of lifetime gifts.

TAXATION OF GENERATION SKIPPING ARRANGEMENTS

By means of complex legal arrangements, property can now be passed through to subsequent generations without the imposition of a transfer tax in each generation. This procedure is commonly referred to as "generation skipping," and can be indulged in only by those possessing considerable wealth. A special tax would be imposed on "generation skipping" transfers of property which would serve as a substitute tax for the tax that would have applied if the property had paid estate tax successively through each generation.

EXEMPTIONS

Under present law an individual may give $3,000 of property to a donee each year without this either being counted as a gift or using up any of the $30,000 lifetime exemption. A married person may double these amounts. In addition, there is a separate $60,000 exemption under the estate tax.

Whether a particular transfer to a relative is a gift or a discharge of a support obligation is also a complex issue that comes out differently under one State law as compared to another.

The proposal would introduce a uniform Federal rule to designate which kinds of property transfers are gifts and which are support arrangements. The present separate exemptions for gift taxes and estate taxes would be combined into one $60,000 exemption under the unified transfer tax. The present $3,000 per donee exclusion would be retained.

RATE REDUCTIONS

To counterbalance those aspects of the estate and gift tax reforms which increase revenues, significant reductions in the present estate tax rates would be implemented in month-to-month steps over a 10-year period. When the transition has been fully effected, the top rate would have been reduced from 77 percent to 65 percent, with most other rates reduced by approximately 20 percent.

LIBERALIZATION OF PAYMENT RULES

The Internal Revenue Code presently has special provisions which permit deferring the payment of estate taxes in cases in which the decedent owns a closely held business. These rules would be liberalized to make their use more readily available to estates which encounter difficulty in immediately raising the funds necessary to satisfy estate tax liabilities. These special rules would also be made applicable where a capital gains tax is imposed at death on the appreciation in closely held business interests.

This would help owners of small businesses and farms who desire to leave the enterprise in family control.

REVENUE EFFECT OF ESTATE AND GIFT TAX PROPOSAL

Most of the estate and gift tax recommendations will have revenue effects that would change considerably over a long transition period. Over this period the estate and gift tax revenues would rise considerably even if there was no change in the law. The most meaningful way to describe the revenue effects of these changes, therefore, is to express them as percentages of the expected revenue yield of the present law estate and gift tax:

The unlimited marital deduction would initially cause a revenue loss of about 13 percent of the present estate and gift taxes. This loss would decline after 10 years to about 10 percent.

Unification of estate and gift taxes would initially cause a revenue loss, due to the new start for the gift tax, of about 1 percent of the present estate and gift tax revenues, and after 10 years this would be converted into a 5-percent revenue gain.

The generation skipping substitute tax would initially increase the present estate and gift tax revenues by 2 percent. After 10 years this increase would be 4 percent.

The taxation of capital gains on transfer of appreciated property by death or gift would initially cause a revenue gain equal to 6 percent of present estate and gift tax revenues and rise toward 23 percent after 10 years (as the prescribed valuation date becomes less significant).

The estate and gift tax rate changes would after 10 years reduce present revenues by 17 percent.

The other substantive changes would approximately cancel out and would have no effect on present revenues.

The overall combined changes would reduce taxes on estate and gift tax returns filed for 1970 decedents by about 7 percent and increase these taxes for 1980 decedents by about 5 percent. Due to the long period for filing estate tax returns, the revenue loss in fiscal year 1971 would be below $100 million. It would be about a $260 million loss in fiscal year 1972.

OVERALL EFFECTS OF REFORM PROGRAM

Table 1 (pt. 1) attached hereto indicates that the aggregate effect of all the proposals, other than those dealing with estate and gift taxes, would yield an annual net revenue gain of about $155 million. The estate and gift tax proposals as shown in table 1 (pt. 2) involve early annual net revenue losses of about $260 million. However, in the 10th year after enactment the estate and gift tax proposals would produce a revenue gain of about $360 million.

For individuals, the proposed income tax reform will go a long way toward simplifying the problem of filling out the 78 million tax returns each year. About 3.5 million filers will be taken completely off the tax rolls. More than 18 million filers will switch to the standard deduction and will no longer find necessary the recordkeeping and detailed accounting required by itemized deductions. This will increase the percentage of filers using the simple standard deduction from 57 percent to 80 percent.

The proposed reform will also go a long way toward removing the Federal income tax burden on families in poverty. Of the 2.2 million poverty families paying tax under present law, 1.2 million would become nontaxable, and the other 1 million families would have their tax reduced.

In addition, the proposed reform program will go a long way toward making the tax system more fair and equitable by removing tax abuses and defects. As a result there will be taxpayers with tax increases as well as taxpayers with tax decreases. Overall, among the 78 million filers, 44 million, or 56 percent, will have tax decreases; 21 million, or 27 percent, will have tax increases; and 13 million, or 17 percent, will show no net change.

Summary Tables

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TABLE 1 (PT. 1).—SUMMARY REVENUE ESTIMATES FOR INCOME TAX PROVISIONS

[In millions of dollars]

	Revenue change, 1969 levels
INDIVIDUAL INCOME-TAX CHANGES	
Relief for persons in poverty: Liberalization of minimum standard deduction	−1,130
Elimination of unacceptable tax abuses:	
Minimum individual income tax	+420
Allocation of deductions	+405
Correction of abuses by nonfarmers of farm tax rules	+145
Taxation of multiple trusts and accumulated income in trusts	+70
Limitation on tax burden: Maximum individual income tax	−205
Increased simplification and equity in treatment of deductions:	
Liberalization of limits of general standard deduction:	
Increase percentage of adjusted gross income limit to 14 percent	−215
Increase dollar limit to $1,800	−1,190
Revision of charitable contributions deduction:	
Allowance of deduction outside the standard deduction	−440
Disallowance of deduction under the 3-percent threshold	+1,470
Disallowance of unlimited deduction [1]	+25
Increase deduction ceiling to 50 percent	−20
Repeal of gasoline tax deduction	+310
Consistency of capital gain and loss rules [2]	+100
Liberalization of moving expense rules	−85
Revised tax treatment of elderly	−80
Total individual income tax changes	−420
CORPORATE TAX CHANGES	
Correction of tax abuses and defects:	
Multiple surtax exemptions [2]	+235
Mineral production payments [2]	+200
Tax-free reserves of mutual savings banks	+40
Total corporate tax changes	+475
Allowance for improved administration through reduction in number of itemizers and changes in charitable deduction	+100
Net revenue change for income tax provisions	+155

[1] Although the provision would not be eliminated until 10 years after enactment of the reform program, the revenue gain from its elimination is shown at 1969 levels.
[2] This is the expected revenue when the transition is fully accomplished.

TABLE 1 (PT. 2).—SUMMARY REVENUE ESTIMATES FOR TRANSFER TAX PROVISIONS

	Year of death	
	1970	1980
	Percent of tax that would be due under present law	
Unlimited marital deduction	−13	−10
Unification	−1	5
Substitute tax (for generation skipping)	2	4
(Other substantive estate provisions approximately cancel out.)		
Estate and gift tax rate changes	0	−17
Total estate and gift tax	−13	−18
Capital gains on transfer by death or gift	6	23
Total transfer tax changes	−7	+5

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

REVENUE COLLECTIONS

	Fiscal year 1971	Fiscal year 1972	Fiscal year 1976	Fiscal year 1980
Expected yield, present law (billions)	$4.3	$4.6	$6.0	$8.7
Percentage change, in fiscal year revenues	−1.6	−5.7	+1.0	+4.2
Revenue change (millions)	−$70	−$260	+$60	+$370

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

TABLE 2.—OVERALL EFFECTS OF THE INDIVIDUAL INCOME TAX REFORM PROPOSAL (1969 LEVELS)

[Dollar amounts in millions]

AGI (in thousands of dollars)	Present law tax	Tax change	Percentage tax change	Present law AGI [1]	Tax change as percent of AGI
0 to 3	$1,159	$−415	−35.8	$18,952	−2.2
3 to 5	3,177	−495	−15.6	36,766	−1.3
5 to 7	5,439	−393	−7.2	57,388	−.7
7 to 10	13,925	−432	−3.1	139,762	−.3
10 t.o 15	18,916	−478	−2.5	157,751	−.3
15 to 20	7,550	+79	+1.0	53,418	+.1
20 to 50	12,795	+503	+3.9	67,323	+.7
50 to 100	6,326	+385	+6.1	21,404	+1.8
100 to 500	4,666	+403	+8.6	12,141	+3.3
500 to 1,000	645	+113	+17.5	1,510	+7.5
1,000 and over	891	+200	+22.4	2,091	+9.6
Total	75,490	[2] −530	−.7	568,506	−.1

[1] Taxable returns.
[2] The overall revenue loss of $530,000,000 differs from the $420,000,000 loss on table 1 by the $40,000,000 difference between the 1969 and long-run effect of the capital loss limitation provision and the $70,000,000 gain from current taxation of individuals of income accumulated in certain trusts.

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TABLE 3.—REVENUE EFFECT OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 1 OF 2 PARTS

[In millions]

AGI class (in thousands of dollars)	Liberalization of standard deduction: $600 plus $100 minimum standard deduction	Liberalization of standard deduction: 14 percent standard deduction	Liberalization of standard deduction: $1,800 standard deduction ceiling	Changes in itemized deductions: Disallow State gas tax deduction	Changes in itemized deductions: Contributions: 3-percent floor	Changes in itemized deductions: Contributions: Allow outside standard deduction	Changes in itemized deductions: Contributions: 50-percent ceiling	Changes in itemized deductions: Contributions: Disallow unlimited deduction
0 to 3	−$415			+$1	+$2	−$15	(1)	
3 to 5	−420			+10	+15	−35	(1)	
5 to 7	−200	−$70		+30	+65	−55	(1)	
7 to 10	−95	−145	−$265	+90	+205	−105	(1)	
10 to 15			−695	+95	+270	−135	(1)	
15 to 20			−145	+35	+155	−50	(1)	
20 to 50			−80	+35	+370	−40	(1)	
50 to 100			−5	+10	+205	−5	−$1	
100 to 500			−1	+3	+142	(1)	−11	+$2
500 to 1,000				(1)	+20	(1)	−3	+2
1,000 and over				(1)	+23	(1)	−4	+21
Total	−1,130	−215	−1,190	+310	+1,470	−440	−20	+25

1 Less than $500,000.

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

TABLE 3.—REVENUE EFFECT OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 2 OF 2 PARTS

[In millions]

AGI class (in thousands of dollars)	Deduction allocation	Minimum tax	Maximum tax	Capital loss limitation[2]	Increasing moving expense deduction	Farm loss disallowance	Revised treatment elderly relief	Total revenue effect
0 to 3	(1)	+$12	----------------	+$6	−$2	----------------	−$3	−$415
3 to 5	(1)	(1)	----------------	+4	−6	----------------	−63	−485
5 to 7	+$1	(1)	----------------	+6	−13	----------------	−157	−393
7 to 10	+1	(1)	----------------	+10	−22	----------------	−106	−432
10 to 15	+3	+8	----------------	+17	−25	----------------	−16	−478
15 to 20	+5	+2	----------------	+7	−9	+$1	+78	+79
20 to 50	+50	+30	----------------	+9	−7	+10	+126	+503
50 to 100	+90	+6	−$2	+1	−1	+43	+44	+385
100 to 500	+160	+105	−93	(1)	(1)	+79	+17	+403
500 to 1,000	+35	+90	−40	(1)	----------------	+9	(1)	+113
1,000 and over	+60	+167	−70	(1)	----------------	+3	(1)	+200
Total	+405	+420	−205	+60	−85	+145	−80	−530

[1] Less than $500,000.

[2] Effect in 1969. The overall revenue loss of $530,000,000 differs from the $420,000,000 loss on table 1 by the $40,000,000 difference between the 1969 and the long-run effect of the capital loss limitation and the $70,000,000 gain from current taxation of individuals of income accumulated in certain trusts.

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

TABLE 4.—TAX CHANGE AS PERCENT OF TAX LIABILITY UNDER PRESENT LAW OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 1 OF 2 PARTS

AGI class (in thousands of dollars)	Liberalization of standard deduction			Changes in itemized deductions				
					Contributions			
	$600 plus $100 minimum standard deduction	14-percent standard deduction	$1,800 standard deduction ceiling	Disallow State gas tax deduction	3-percent floor	Allow outside standard deduction	50-percent ceiling	Disallow unlimited deduction
0 to 3	−35.8			+0.1	+0.2	−1.3	(1)	
3 to 5	−13.2			+.3	+.5	−1.1	(1)	
5 to 7	−3.7	−1.3		+.6	+1.2	−1.0	(1)	
7 to 10	−.7	−1.0	−1.9	+.6	+1.5	−.8	(1)	
10 to 15			−3.7	+.5	+1.4	−.7	(1)	
15 to 20			−1.9	+.5	+2.1	−.7	(1)	
20 to 50			−.6	+.3	+2.9	−.3	(1)	
50 to 100			−.1	+.2	+3.2	−.1	(1)	
100 to 500			(1)	+.1	+3.0	(1)	−0.2	(1)
500 to 1,000				(1)	+3.1	(1)	−.5	+0.3
1,000 and over				(1)	+2.6	(1)	−.4	+2.4
Total	−1.5	−.3	−1.6	+.4	+1.9	−.6	(1)	(1)

1 Less than .05 percent.

TABLE 4.—TAX CHANGE AS PERCENT OF TAX LIABILITY UNDER PRESENT LAW OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 2 OF 2 PARTS

AGI class (in thousands of dollars)	Deduction allocation	Minimum tax	Maximum tax	Capital loss limitation [1]	Increasing moving expense deduction	Farm loss disallowance	Revised tax treatment of the elderly	Total revenue effect
0 to 3	(2)	+1.0	----------	+0.5	−0.2	----------	−0.3	−35.8
3 to 5	(2)	(2)	----------	+.1	−.2	----------	−2.0	−15.6
5 to 7	(2)	(2)	----------	+.1	−.2	----------	−2.9	−7.2
7 to 10	(2)	(2)	----------	+.1	−.2	----------	−.8	−3.1
10 to 15	(2)	(2)	----------	+.1	−.1	----------	−.1	−2.5
15 to 20	+.1	(2)	----------	+.1	−.1	(2)	+1.0	+1.0
20 to 50	+.4	+.2	----------	+.1	−.1	+.1	+1.0	+3.9
50 to 100	+1.4	+.1	(2)	(2)	(2)	+.7	−.7	+6.1
100 to 500	+3.4	+2.2	−2.0	(2)	(2)	+1.7	+.4	+8.6
500 to 1,000	+5.4	+14.0	−6.2	(2)	----------	+1.4	(2)	+17.5
1,000 and over	+6.7	+18.7	−7.9	(2)	----------	+.3	(2)	+22.4
Total	+.5	+.6	−.3	+.1	−.1	+.2	−.1	−.7

[1] Effect in 1969.

[2] Less than .5 percent.

TABLE 5.—PERCENTAGE DISTRIBUTION OF TAX CHANGE BY INCOME CLASS OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 1 OF 2 PARTS

AGI class (in thousands of dollars)	Liberalization of standard deduction			Changes in itemized deductions				
					Contributions			
	$600 plus $100 minimum standard deduction	14-percent standard deduction	$1,800 standard deduction ceiling	Disallow State gas tax deduction	3-percent floor	Allow outside standard deduction	50-percent ceiling	Disallow unlimited deduction
0 to 3	37	-	-	(1)	(1)	3	(1)	-
3 to 5	37	-	-	3	1	8	(1)	-
5 to 7	18	33	-	10	4	12	(1)	-
7 to 10	8	67	22	29	14	24	(1)	-
10 to 15	-	-	58	31	18	31	(1)	-
15 to 20	-	-	12	11	11	11	(1)	-
20 to 50	-	-	7	11	25	9	(1)	-
50 to 100	-	-	1	3	14	1	5	-
100 to 500	-	-	-	1	10	(1)	55	8
500 to 1,000	-	-	-	(1)	1	(1)	15	8
1,000 and over	-	-	-	(1)	1	(1)	20	84
Total	100	100	100	100	100	100	100	100

[1] Less than .5 percent.

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

TABLE 5.—PERCENTAGE DISTRIBUTION OF TAX CHANGE BY INCOME CLASS OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 2 OF 2 PARTS

AGI class (in thousands of dollars)	Deduction allocation	Minimum tax	Maximum tax	Capital loss limitation [1]	Increasing moving expense deduction	Farm loss disallowance
0 to 3	(2)	3	----------------	10	2	----------------
3 to 5	(2)	(2)	----------------	7	7	----------------
5 to 7	(2)	(2)	----------------	10	15	----------------
7 to 10	(2)	(2)	----------------	17	26	----------------
10 to 15	1	2	----------------	28	31	----------------
15 to 20	1	(2)	----------------	12	11	1
20 to 50	12	7	----------------	15	8	7
50 to 100	22	1	1	2	1	30
100 to 500	40	25	45	(2)	----------------	54
500 to 1,000	9	21	20	(2)	----------------	6
1,000 and over	15	40	34	(2)	----------------	2
Total	100	100	100	100	100	100

[1] Effect in 1969.

[2] Less than .5 percent.

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

TABLE 6.—NUMBER AND PERCENT OF TAX RETURNS AFFECTED BY INDIVIDUAL INCOME TAX PROVISIONS OF THE REFORM PROGRAM (1969 LEVELS)

[Number of returns in thousands]

AGI (in thousands of dollars)	Number of returns (taxable and nontaxable)	Number of returns			Percent of returns		
		With no change	With tax increase	With tax decrease	With no change	With tax increase	With tax decrease
0 to 3	21,640	11,590	285	9,765	54	1	40
3 to 5	10,285	1,025	995	8,265	10	10	80
5 to 7	9,916	346	2,645	6,925	3	27	75
7 to 10	16,875	110	6,860	9,905	1	41	58
10 to 15	13,340	55	5,935	7,350	(1)	44	55
15 to 20	3,151	21	1,945	1,185	1	62	37
20 to 50	2,363	15	1,913	435	1	81	18
50 to 100	329	1	301	27	(1)	91	8
100 to 500	75	(1)	66	9	(1)	88	12
500 to 1,000	2	(1)	1.4	.6	(1)	70	30
1,000 and over	1	(1)	.7	.3	(1)	70	30
Total	77,977	13,162	20,945	43,870	17	27	56

[1] Less than 50 returns or .5 percent.

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

TABLE 7.—GAINERS (TAX DECREASE) AND LOSERS (TAX INCREASE) FROM INDIVIDUAL INCOME TAX PROVISIONS OF THE REFORM PROGRAM BY FILING STATUS AND DEDUCTION STATUS UNDER PRESENT LAW (1969 LEVELS)

[Number of returns in thousands]

	Present standard and itemized returns						Present itemized returns						Present standard returns					
	All returns		Joint returns		Other returns		All returns		Joint returns		Other returns		All returns		Joint returns		Other returns	
AGI (thousands of dollars)	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose	Gain	Lose
0 to 3	9,765	285	935	80	8,830	205	685	225	175	65	510	160	9,080	60	760	15	8,320	45
3 to 5	8,265	995	2,780	485	5,485	510	1,505	960	780	470	725	490	6.760	35	2,000	15	4,760	20
5 to 7	6,925	2,645	3,480	1,615	3,445	1,030	1,995	2,615	1,230	1,600	765	1,015	4,930	30	2,250	15	2,680	15
7 to 10	9,905	6,860	7,935	6,125	1,970	735	2,995	6,770	2,625	6,110	370	660	6,910	90	5,310	15	1,600	75
10 to 15	7,350	5,935	6,700	5,535	650	400	3,590	5,825	3,390	5,475	200	350	3,760	110	3,310	60	450	50
15 to 20	1,185	1,945	1,095	1,840	90	105	725	1,915	675	1,820	50	95	460	30	420	20	40	10
20 to 50	435	1,913	395	1,780	60	133	250	1,890	235	1,760	15	130	185	23	160	20	25	3
50 to 100	27	301	22	276	5	25	19	300	15	275	4	25	8	1	7	1	1	(1)
100 and over	10	68	7	61	3	7	9	68	6	61	3	7	1	(1)	1	(1)	(1)	(1)
Total	43,870	20,945	23,355	17,795	20,515	3,150	11,775	20,565	9,135	17,635	2,640	2,930	32,095	380	14,220	160	17,875	218

[1] Less than 500 returns.

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

TABLE 8.—TAX INCREASE AND TAX DECREASE FROM INDIVIDUAL INCOME TAX PROVISIONS OF THE REFORM PROGRAM, BY FILING STATUS UNDER PRESENT LAW (1969 LEVELS), PRESENT STANDARD AND ITEMIZED DEDUCTION RETURNS COMBINED

[In millions]

AGI (in thousands of dollars)	All returns			Joint returns			Other returns		
	Net tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease
0 to 3	—$415	$13	$427	—$34	$8	$42	—$380	$5	$385
3 to 5	—495	23	518	—142	11	153	—353	12	365
5 to 7	—393	81	474	—197	48	245	—196	33	229
7 to 10	—432	288	720	—317	240	557	—115	48	163
10 to 15	—478	387	865	—431	328	759	—47	59	106
15 to 20	+79	256	177	+74	230	156	+5	26	21
20 to 50	+503	595	93	+453	533	80	+49	62	13
50 to 100	+385	393	8	+346	352	6	+39	41	2
100 and over	+716	864	148	+648	723	75	+68	141	73
Total	—530	2,900	3,430	+400	2,473	2,073	—930	427	1,357

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

TABLE 9.—TAX INCREASE AND TAX DECREASE FROM INDIVIDUAL INCOME TAX PROVISIONS OF THE REFORM PROGRAM, BY FILING STATUS AND DEDUCTION STATUS UNDER PRESENT LAW (1969 LEVELS), PRESENT ITEMIZED DEDUCTION RETURNS

[In millions]

AGI (in thousands of dollars)	All returns			Joint returns			Other returns		
	Tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease
0 to 3	−$12	$12	$24	+$3	$8	$5	−$15	$4	$19
3 to 5	−65	21	86	−26	10	36	−39	11	50
5 to 7	−62	79	141	−40	47	87	−22	32	54
7 to 10	+88	282	194	+69	239	170	+19	43	24
10 to 15	+71	379	308	+34	324	290	+37	55	18
15 to 20	+179	249	70	+161	224	63	+18	25	7
20 to 50	+547	584	37	+489	523	34	+58	61	3
50 to 100	+386	390	4	+346	349	3	+40	41	1
100 and over	+714	861	147	+647	721	74	+67	140	73
Total	+1,846	2,857	1,011	+1,683	2,445	762	+163	412	249

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

TABLE 10.—TAX INCREASE AND TAX DECREASE FROM INDIVIDUAL INCOME TAX PROVISIONS OF THE REFORM PROGRAM BY FILING STATUS AND DEDUCTION STATUS UNDER PRESENT LAW (1969 LEVELS), PRESENT STANDARD DEDUCTION RETURNS

[In millions]

AGI (in thousands of dollars)	All returns			Joint returns			Other returns		
	Net tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease	Net tax change	Tax increase	Tax decrease
0 to 3	−$402	$1	$403	−$37	[1]	$37	−$365	$1	$366
3 to 5	−430	2	432	−116	$1	117	−314	1	315
5 to 7	−331	2	333	−157	1	158	−174	1	175
7 to 10	−520	6	526	−386	1	387	−134	5	139
10 to 15	−549	8	557	−465	4	469	−84	4	88
15 to 20	−100	7	107	−87	6	93	−13	1	14
20 to 50	−45	11	56	−36	10	46	−9	1	10
50 to 100	−1	3	4	----------	3	3	−1	[1]	1
100 and over	+2	3	1	+1	2	1	+1	1	[1]
Total	−2,376	43	2,419	−1,283	28	1,311	−1,093	15	1,108

[1] Less than $500,000.

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

TABLE 11.—TAX STATUS CHANGE IN TAXABLE AND NONTAXABLE RETURNS UNDER THE REFORM PROGRAM (1969 LEVELS)

[Number of returns in thousands]

AGI (in thousands of dollars)	Nontaxable under present law	Taxable made nontaxable by reform program	Nontaxable made taxable by reform program	Nontaxable under reform program
0 to 3	11,632	2,535	40	14,127
3 to 5	1,062	835	40	1,857
5 to 7	279	105	30	354
7 to 10	94	10	30	74
10 to 15	32	5	5	32
15 to 20	7		2	5
20 to 50	4		2	2
50 to 100	.7		.3	.4
100 plus	.5		.3	.2
Total	13,111	3,490	150	16,451

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

TABLE 12.—NUMBER OF RETURNS AFFECTED BY MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 1 OF 2 PARTS

[Number of returns in thousands]

AGI class (in thousands of dollars)	Liberalization of standard deduction			Changes in itemized deductions					
				Disallow State gas tax deduction	Contributions				
	$600 plus $100 minimum standard deduction	14-percent standard deduction	$1,800 standard deduction ceiling		3-percent floor	Allow outside standard deduction	50-percent ceiling	Disallow unlimited deduction
0 to 3	9,760			190	250	3,480	20	(1)
3 to 5	7,870			1,050	1,230	3,640	10	(1)
5 to 7	5,940	3,390		2,840	3,030	3,030	5	(1)
7 to 10	4,330	5,230	6,250	7,060	6,970	4,080	3	(1)
10 to 15			6,900	5,900	5,820	3,160	2	(1)
15 to 20			1,070	1,850	1,960	750	3	(1)
20 to 50			400	1,580	1,910	310	2	(1)
50 to 100			20	230	305	15	1	(1)
100 to 500			2	50	72	(1)	1	(1)
500 to 1,000				(1)	2		(1)	(1)
1,000 and over				(1)	1		(1)	(1)
Total	27,900	8,620	14,642	20,750	21,550	18,465	48	(1)

[1] Less than 500 returns.

Note: The same return may be affected by more than one provision and is counted under each provision affecting it. Details may not add to totals because of rounding.

TABLE 12.—NUMBER OF RETURNS AFFECTED BY MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 2 OF 2 PARTS

[Number of returns in thousands]

AGI class (in thousands of dollars)	Deduction allocation	Minimum tax	Maximum tax	Capital loss limitation [2]	Increasing moving expense deduction	Farm loss disallowance	Revised treatment of elderly relief
0 to 3	16		------	85	15	------	265
3 to 5	(1)	23	------	55	70	------	940
5 to 7	1		------	70	120	------	825
7 to 10	1		------	135	160	------	720
10 to 15	30	4	------	200	145	------	510
15 to 20	35	3	------	75	30	1	195
20 to 50	140	3	------	55	10	5	245
50 to 100	120	(1)	2	5	(1)	4	60
100 to 500	52	4	9	(1)	(1)	2	20
500 to 1,000	2	1	1	(1)	------	(1)	(1)
1,000 and over	1	(1)	(1)	(1)	------	(1)	(1)
Total	395	40	12	680	550	12	3,780

[1] Less than 500 returns.
[2] Effect in 1969.

Note: The same return may be affected by more than 1 provision and is counted under each provision affecting it. Details may not add to totals because of rounding.

TABLE 13.—NUMBER OF ITEMIZERS SHIFTING TO STANDARD DEDUCTION UNDER REFORM PROGRAM (1969 LEVELS)

[Number of returns in thousands]

AGI class (in thousands of dollars)	Total number of returns (taxable and nontaxable)	Present law				Shifting to standard deduction		Reform program			
		Nonitemizers		Itemizers				Nonitemizers		Itemizers	
		Number	Percent of total	Number	Percent of total	Number	Percent of present law itemizers	Number	Percent of total	Number	Percent of total
0 to 3	21,640	19,740	91	1,900	9	1,550	82	21,290	98	350	2
3 to 5	10,285	7,547	73	2,738	27	1,950	71	9,497	92	788	8
5 to 7	9,916	5,212	53	4,704	47	2,645	56	7,857	79	2,059	21
7 to 10	16,875	7,037	42	9,838	58	4,680	48	11,717	69	5,158	31
10 to 15	13,340	3,877	29	9,463	71	5,420	57	9,297	70	4,043	30
15 to 20	3,151	492	16	2,659	84	1,215	46	1,707	54	1,444	46
20 to 50	2,363	213	9	2,150	91	555	26	768	32	1,595	68
50 to 100	329	9	3	320	97	35	11	44	13	285	87
100 and over	78	1	1	77	99	3	4	4	5	74	95
Total	77,977	44,128	57	33,849	43	18,053	53	62,181	80	15,796	20

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

TABLE 14.—NUMBER OF ITEMIZERS SWITCHING TO THE STANDARD DEDUCTION AS A RESULT OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 1 OF 2 PARTS

[Number of returns in thousands]

AGI class (in thousands of dollars)	Liberalization of standard deduction			Changes in itemized deductions				
				Disallow State gas tax deduction	Contributions			
	$600 plus $100 minimum standard deduction	14-percent standard deduction	$1,800 standard deduction ceiling		3-percent floor	Allow outside standard deduction	50-percent ceiling	Disallow unlimited deduction
0 to 3	870			30	485	65		
3 to 5	1,120			140	270	135		
5 to 7	980	220		275	670	425		
7 to 10	400	460	1,255	550	1,445	570		
10 to 15			3,035	500	1,415	470		
15 to 20			585	95	385	160		
20 to 50			195	20	265	75		
50 to 100			10	(1)	20	5		
100 to 500			1	(1)	2	(1)		
500 to 1,000						(1)		
1,000 and over								
Total	3,370	680	5,080	1,600	4,960	1,905		

TABLE 14.—NUMBER OF ITEMIZERS SWITCHING TO THE STANDARD DEDUCTION AS A RESULT OF MAJOR PARTS OF THE REFORM PROGRAM RELATED TO INDIVIDUAL INCOME TAX (1969 LEVELS)

PART 2 OF 2 PARTS

[Number of returns in thousands]

AGI class (in thousands of dollars)	Deduction allocation	Minimum tax	Maximum tax	Capital loss limitation	Increasing moving expense deduction	Farm loss disallowance	Revised treatment of elderly relief	Total returns switching to the standard deduction
0 to 3	(1)						100	1,550
3 to 5	(1)						285	1,950
5 to 7	(1)						75	2,645
7 to 10	(1)							4,680
10 to 15	(1)							5,420
15 to 20								1,215
20 to 50								555
50 to 100								35
100 to 500								3
500 to 1,000								(1)
1,000 and over								(1)
Total	(1)						460	18,053

1 Less than 500 returns.

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

TABLE 15.—NUMBER OF TAXABLE INDIVIDUAL INCOME TAX RETURNS, ADJUSTED GROSS INCOME, TAXABLE INCOME, AND TAX LIABILITIES BY ADJUSTED GROSS INCOME CLASSES AT CALENDAR YEAR 1969 LEVELS OF INCOME—PRESENT LAW

[Dollar amounts in millions]

Adjusted gross income class (in thousands of dollars)	Number of taxable returns (thousands)	Adjusted gross income	Taxable income [1]	Present law tax [2]
0 to 3	10,007	$18,952	$8,070	$1,159
3 to 5	9,223	36,766	20,337	3,177
5 to 7	9,637	57,388	33,376	5,439
7 to 10	16,781	139,762	83,894	13,925
10 to 15	13,308	157,751	108,900	18,916
15 to 20	3,144	53,418	38,963	7,550
20 to 50	2,358	67,323	52,602	12,795
50 to 100	328	21,404	16,880	6,326
100 and over	78	15,743	7,998	6,202
Total	64,866	568,507	369,019	75,490

[1] Excludes capital gains subject to the 25-percent alternative rate.
[2] Tax after credits.

Note: Figures do not necessarily add to totals due to rounding.

TABLE 16.—NUMBER OF NONTAXABLE INDIVIDUAL INCOME TAX RETURNS AND ADJUSTED GROSS INCOME, PRESENT LAW, 1969 LEVELS

Adjusted gross income class (in thousands of dollars)	Number of nontaxable returns (thousands)	Adjusted gross income (millions)
0 to 3	11,633	$9,370
3 to 5	1,062	4,032
5 to 7	279	1,586
7 to 10	94	764
10 to 15	32	374
15 to 20	7	118
20 to 50	5	121
50 to 100	1	49
100 and over	(1)	241
Total	13,111	16,655

[1] Less than 500 returns.

Note: Figures do not necessarily add to totals due to rounding.

TABLE 17.—NUMBER OF RETURNS (TAXABLE AND NONTAXABLE COMBINED) BY FILING STATUS AND DEDUCTION STATUS UNDER PRESENT LAW, 1969 LEVELS

[Number of returns in thousands]

AGI (in thousands of dollars)	Standard and itemized			Present itemized returns			Present standard returns		
	All	Joint	Other	All	Joint	Other	All	Joint	Other
0 to 3	21,640	4,130	17,510	1,900	804	1,096	19,740	3,326	16,414
3 to 5	10,285	4,082	6,203	2,738	1,468	1,270	7,547	2,615	4,932
5 to 7	9,916	5,379	4,537	4,704	2,889	1,815	5,212	2,490	2,722
7 to 10	16,875	14,161	2,714	9,839	8,797	1,042	7,037	5,364	1,673
10 to 15	13,340	12,269	1,071	9,463	8,897	567	3,877	3,372	505
15 to 20	3,151	2,949	202	2,659	2,506	153	492	443	49
20 to 50	2,363	2,187	176	2,150	2,001	149	213	186	27
50 to 100	329	299	30	319	291	28	9	8	1
100 and over	78	68	10	78	68	10	1.0	0.7	0.3
Total	77,977	45,524	32,453	33,849	27,719	6,130	44,128	17,804	26,32

TABLE 18.—NUMBER OF TAXABLE RETURNS, BY FILING STATUS AND DEDUCTION STATUS UNDER PRESENT LAW, 1969 LEVELS

[Number of returns in thousands]

AGI (in thousands of dollars)	Standard and itemized			Present itemized returns			Present standard returns		
	All	Joint	Other	All	Joint	Other	All	Joint	Other
0 to 3	10,007	990	9,017	875	219	656	9,132	771	8,361
3 to 5	9,223	3,229	5,994	2,424	1,209	1,215	6,800	2,020	4,780
5 to 7	9,637	5,139	4,498	4,610	2,817	1,793	5,027	2,322	2,705
7 to 10	16,781	14,073	2,708	9,772	8,735	1,037	7,010	5,338	1,672
10 to 15	13,308	12,244	1,064	9,439	8,879	560	3,869	3,366	503
15 to 20	3,144	2,942	202	2,654	2,501	153	490	441	49
20 to 50	2,358	2,183	175	2,146	1,999	147	212	185	27
50 to 100	328	298	30	318	290	28	9	8	1
100 and over	78	68	10	77	68	10	1.0	0.7	0.3
Total	64,866	41,167	23,700	32,316	26,717	5,600	32,550	14,451	18,099

TABLE 19.—ESTIMATED CHANGES IN EFFECTIVE RATES OF TRANSFER TAX UNDER THE PROPOSED PROGRAM, BY SIZE OF GROSS TRANSFERS DURING LIFE AND AT DEATH; MARRIED TRANSFERORS [1]

[Percent of gross transfers]

Size of gross transfers during life and at death (in thousands of dollars)	Effective tax rate under present law	Combined effects of proposed program [2]	Changes in effective transfer tax rates due to proposal to—								
			Reduce rates	Accomplish structural revisions				Increase future transfer taxes			
				Total	Provide unlimited marital deduction [3]	Tax on appreciated transfers at death	Unify transfer taxes	Total discounted to date of taxpayer's death	Incurred by surviving spouse due to— [3]		Substitute tax on generation skipping transfers
									Increased inheritance	Tax on appreciated transfers	
Below 100	0.3	+0.6	(4)	−0.1	−0.2	+0.1	(4)	+0.7	+0.2	+1.3	(4)
100 to 200	2.1	+.2	−0.2	−1.0	−1.6	+.4	+0.2	+1.4	+.8	+2.0	(4)
200 to 400	7.4	−1.9	−.6	−3.7	−4.8	+.7	+.4	+2.4	+2.7	+2.0	+0.2
400 to 600	11.8	−1.3	−1.2	−4.6	−6.2	+.8	+.8	+4.5	+6.0	+2.2	+.8
600 to 1,000	14.6	−.8	−1.6	−4.3	−6.4	+.9	+1.2	+5.1	+6.0	+2.5	+1.8
1,000 to 2,000	17.2	+.1	−2.2	−3.7	−6.5	+1.2	+1.6	+6.0	+7.3	+2.7	+2.0
2,000 to 3,000	20.6	+.4	−2.9	−2.4	−5.8	+1.5	+1.9	+5.7	+6.9	+2.4	+2.2
3,000 to 5,000	22.3	+1.6	−3.2	−1.3	−5.3	+1.8	+2.2	+6.1	+6.9	+2.4	+3.0
5,000 and over	22.2	+2.6	−3.3	+.4	−4.0	+1.9	+2.5	+5.5	+6.0	+1.8	+3.2

[1] The estimates in this table relate to the cases of married taxpayers survived by their spouses. To facilitate a comparison of the proposed program with present law, tax liabilities are evaluated at the time of the taxpayer's death and relate only to the transfers made by him during his life and at his death.

[2] These estimates reflect the full force of all the proposals. During the transition which has been recommended for reducing transfer tax rates, the indicated increases would nevertheless be smaller, the indicated decreases larger, due to the exclusion of all prior lifetime gifts from the unified transfer tax base and the design designation of date of enactment as the basis date for valuing appreciation of property transferred at death.

[3] These estimates represent the saving to decedents who have utilized the unlimited marital deduction in order to maximize the wealth holdings of their surviving spouses, averaged among all married decedents. The saving in this column is achieved at the death of the 1st spouse, and since it is implicit in this wealth devolution pattern that the 2 spouses regard the family wealth as a unitary estate for their joint and common support, the subsequent increase in transfer tax which occurs on the death of the 2d spouse is shown separately as a future effect of the proposed program.

[4] Less than 0.05 percent.

TABLE 20.—ESTIMATED CHANGES IN EFFECTIVE RATES OF TRANSFER TAX UNDER THE PROPOSED PROGRAM BY SIZE OF GROSS TRANSFERS DURING LIFE AND AT DEATH; NON-MARRIED TRANSFERORS [1]

[Percent of gross transfers]

Size of gross transfers during life and at death (In thousands of dollars)	Effective tax rate under present law	Combined effects of proposed program	Changes in effective transfer tax rates due to proposal to:						
			Reduce rates	Accomplish structural revisions:					
				Total	Provide unlimited marital deduction [2]	Tax on appreciated transfers at death	Unify transfer taxes	Include substitute tax on generation skipping transfers	
								Discounted	When paid
Below 100	1.1	+1.4	−0.1	+1.5	(3)	+1.4	+0.1	(3)	(3)
100 to 200	8.8	+1.0	−2.4	+3.1	−0.2	+2.4	+0.9	+0.3	+0.7
200 to 400	16.7	+0.1	−4.2	+3.5	−0.3	+2.7	+1.1	+0.8	+1.7
400 to 600	21.9	+0.8	−4.4	+3.9	−0.4	+3.0	+1.3	+1.3	+2.6
600 to 1,000	24.0	+1.3	−4.8	+4.7	−0.5	+3.4	+1.8	+1.4	+2.9
1,000 to 2,000	26.4	+2.4	−4.9	+5.5	−0.5	+3.8	+2.2	+1.8	+3.7
2,000 to 3,000	28.4	+3.2	−4.9	+5.8	−0.6	+3.9	+2.5	+2.3	+4.6
3,000 to 5,000	33.0	+4.1	−5.4	+6.9	−0.7	+4.2	+3.4	+2.6	+5.3
5,000 and over	39.7	+3.4	−6.6	+6.5	−0.8	+3.7	+3.6	+3.5	+7.0

[1] The estimates in this table relate to unmarried taxpayers as well as to widows and widowers. To facilitate a comparison of the proposed program with present law, tax liabilities are evaluated at the time of the taxpayer's death and relate only to the transfers made by him during his life and at his death.

[2] These estimates represent the saving attained by widows and widowers who have utilized the unlimited marital deduction for interspousal transfers to divide the family wealth into two separately taxed estates, averaged among all decedents included in this table. This saving attributed to the second spouse is put within reach of those spouses who regard the family wealth primarily as a fund to benefit heirs other than themselves by the unlimited marital deduction which enables them to insure that their combined wealth will be taxed at the lowest possible marginal transfer tax rates thereby maximizing the net inheritances of their successors.

[3] Less than 0.05 percent.

IV. THE CASE FOR AND DIMENSION OF TAX REFORM

IV-A. THE CASE FOR AND DIMENSION OF TAX REFORM: INDIVIDUAL INCOME TAX

Introduction—The Goals of Tax Reform

Our individual income tax system has developed great disparity and unfairness in the total tax treatment of individuals in lower, middle, and upper income ranges. This statement describes both the general nature and extent of these disparities and inequities and also some of the major reform proposals which help to correct specific problem situations.

The disparities and inequities that have developed under the income tax involve many problems: Among low incomes there is the problem of burdens being imposed on people in poverty. Among middle incomes there is the problem of a steadily increasing number of taxpayers being thrown into the complexity of itemization and of growing disparity of effective tax rates due to extreme variations in the ratio of personal deductions to income. Among high-income taxpayers there is the problem of the disparities and the unfairness that has developed because of excluded items of income and also the combination of such items with extraordinary personal deductions.

Tax reform is designed to promote four general goals: (1) keeping tax burdens in line with the ability to pay taxes, (2) equity of tax burdens among similar taxpayers and between dissimilar taxpayers, (3) tax simplicity, and (4) neutrality of the tax system in economic decisions.

The ability-to-pay objective is basic to our tax system. Factors which are generally accepted as influencing taxpayers' ability to pay taxes are income, family size, and to some extent personal and business expenses including those related to the earning of income.

The equity objective is twofold: taxpayers similarly situated should pay equal amounts of tax and dissimilar taxpayers should pay unequal amounts of tax according to their different abilities to pay. And, in keeping with the general progressive nature of our tax structure, high-income individuals should pay a larger share of their incomes in tax than is required of lower income individuals.

Tax simplicity is encouraged in instances where complex provisions are apt to produce undesirable taxpayer errors which lead to incorrect allocations of tax burdens, where the vast majority of taxpayers can be spared computational and recordkeeping tasks without the sacrifice of fairness, and where tax administration can be made more efficient.

Neutrality of the tax system is an objective because it is generally undesirable for special provisions of the income tax to influence the outcome of economic decisions of taxpayers, since otherwise investment resources are misallocated where tax savings through special preferences are considered.

I. Low-Income Taxpayers

A. THE IMPOSITION OF TAX ON THOSE IN POVERTY

A major problem of the individual income tax is that tax is imposed on some people whose incomes fall below the poverty line. Since the poverty line is established to measure levels of income (according to family size) which are barely sufficient to provide the necessities of life which every American family should enjoy, it is questionable whether individuals having incomes below this line have the ability to pay any income tax. Table 1 provides some data on the relation of incomes now subject to tax and poverty levels of income, including estimates of the number of families in poverty who are now subject to income tax.

The additional hardship that the income tax imposes on people in poverty is particularly severe for single individuals and for families with less than seven members. Table 1 indicates that about one-fourth of all single individuals with incomes under the poverty line pay some income tax. The structure of the minimum standard deduction (MSD) gradually reduces this taxable fraction as family size increases; however, it is not until families exceed six persons that the MSD affects a virtual elimination of 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	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

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

Admittedly, the definition of any poverty line is arbitrary. The widespread use of the HEW estimates which are cited in table 1 reflects a very general opinion that these are living standards below which people ought not to have to live and, implicitly, it reflects an opinion that imposing an income tax below these levels is harsh.

It is important to note that the poverty income definition is in terms of total income, so that a single person with $1,000 of adjusted gross income for tax purposes could well have other nontaxable income, such as social security benefits, that put him above the poverty level. Nevertheless, there are many people below the poverty line whose only income is from work, and therefore taxable, and for whom income tax is a serious hardship.

B. PROPOSED RELIEF TO LOW INCOMES: INCREASE IN THE MINIMUM STANDARD DEDUCTION

It is proposed to increase the minimum standard deduction from $200 plus $100 for each exemption to $600 plus $100 for each exemption. The provision of existing law which limits the deduction to

$1,000 would be retained. The effect of this proposal would be to make an additional 2.4 million returns nontaxable. Due to other proposals, another 1.1 million people will be made nontaxable. The details of numbers becoming nontaxable are shown in table 1A. Of the 2.2 million poverty families paying tax under present law, 1.2 million would become nontaxable. An additional 1 million families in poverty would have their tax reduced although not completely eliminated.

TABLE 1A.—NUMBER OF RETURNS MADE NONTAXABLE BY MAJOR TAX REFORM PROPOSALS

[Thousands of returns]

AGI class (in thousands of dollars)	(1) Minimum standard deduction changes	(2) Standard deduction changes	(3) Charitable contributions deduction outside of the standard deduction	(4) Revised tax treatment of the elderly	(5) Total (all) proposals[1]
0 to 3	2,025		385	126	2,535
3 to 5	320		109	406	835
5 to 7	15	(2)	4	84	105
7 to 10		(2)	8		10
10 to 15		5			5
Total (all classes)	2,360	5	506	616	3,490

[1] Other deduction changes such as the liberalization of the moving expense deduction and the increased ceiling applicable to the charitable contribution deduction eliminate tax for a small number of returns. Returns whose tax status is affected by these miscellaneous provisions are too few to separately show but are included in the total column.

[2] Less than 500 returns.

Note: Totals may not equal sums due to rounding.

II. Middle-Income Taxpayers

A. THE EROSION OF TAX SIMPLICITY

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. It meant that for the great mass of taxpayers the recordkeeping and general complexity of itemized deductions for personal expenses—such as interest, taxes, medical expenses, charitable contributions, casualty losses—would be avoided; also, to the extent of something like average personal deductions, the variations in deductions between otherwise similar taxpayers wouldn't count in changing the tax. For most taxpayers only personal expense deductions over the average would change the tax.

Two things have happened since: In the first place, average deductions have risen, with higher State and local taxes and greater home ownership. 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 2, with an attendant increase in the actual complexity of taxpayer compliance, and a greater spread in effective tax rates for similarly situated taxpayers.

TABLE 2.—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	41.2	58.8
1969 (estimated)	78.0	43.0	57.0

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

Table 3 shows that, for taxpayers above the poverty levels up to the middle-high brackets, there is now a considerable range of effective tax rates due to variations in the ratio of itemized deductions to adjusted gross income (AGI). In the income ranges around $10,000 to $20,000, the bulk of taxpayers are distributed over a range in which the effective rate on the most favored is half the effective rate on the least favored.

TABLE 3.—PERCENTAGE DISTRIBUTION OF RETURNS BY EFFECTIVE TAX RATE CLASSES: PRESENT LAW TAX AS A PERCENT OF ADJUSTED GROSS INCOME, BY SELECTED AGI CLASSES, 1969 LEVELS

[4-person families] [1]

AGI	Effective tax rate classes													
	0 to 3	3 to 5	5 to 7	7 to 10	10 to 12	12 to 14	14 to 16	16 to 18	18 to 20	20 to 22	22 to 24	24 to 26	26 to 28	28 to 30
$900 to $1,000	[2] 100.0													
$1,685 to $1,785	[2] 100.0													
$3,485 to $3,585 [3]	[4] 100.0													
$3,950 to $4,050	21.8	78.2												
$4,900 to $5,100	11.3	24.9	63.8											
$7,400 to $7,600	.4	2.7	20.2	76.7										
$9,400 to $9,600 [5]	.6		3.0	58.4	38.1									
$9,900 to $10,100		.4	5.0	39.6	55.0									
$11,900 to $12,100		.6	1.8	15.4	51.7	30.4								
$14,900 to $15,100				5.3	28.8	51.0	14.9							
$15,500 to $16,000				.9	19.6	60.8	18.6							
$17,000 to $17,500				6.1	19.8	37.9	36.2							
$18,500 to $19,000				4.8	9.6	35.2	38.4	12.1						
$20,000 to $20,500				6.4		9.6	51.4	32.5						
$21,500 to $22,000					3.7	7.4	55.5	33.4						

[1] Joint returns, 4 personal exemptions, nonaged.
[2] Nontaxables are 100 percent.
[3] Projected 1969 poverty income level is $3,535.
[4] Nontaxables are 11.2 percent.
[5] Median income at 1969 levels is $9,500.

Table 3 presents the distribution of effective rates on adjusted gross income for a family of four persons, at various income levels. The same pattern would appear for other size families or for single persons. If all taxpayers were lumped together in these calculations, the spread of effective rates would, of course, be quite wide. We consider, however, that family size and income level are appropriate reasons for variation in effective rates.[1] Table 3 therefore was constructed to show a selected group of similarly situated taxpayers who, based on income and family size alone, ought to be paying about the same rate of tax. Similar results would appear if we selected other family sizes and other income levels.

These variations in rates arise due to itemized personal deductions. These deductions are also a source of complication on the tax return. Whether any taxpayer computes his correct tax depends upon his accuracy in recordkeeping and reporting, as well as upon his sophistication in knowing what is deductible. Further, the itemized deductions reflect at least some problems of tax policy. The homeowner gets the advantage of deducting the interest on his housing investment and his property tax, while the same expenses are borne by the tenant in his rent without their being deductible. Without arguing that particular itemized deductions should or should not be allowed, they should not make so much difference in tax liabilities for people at the same income level as the present variations in effective tax rates reflect.

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[1] This means that we consider personal exemptions and income splitting as appropriate causes for variation in effective tax rates among people with similar incomes, even though income splitting accounts for wide effective rate differences between single and married people at middle-income levels. Our view is based on the "ability-to-pay" criterion. If our approach were otherwise, then income splitting would represent, as some contend, an important tax preference to married couples, particularly at the middle-income range.

B. PROPOSED RESTORATION OF THE EFFECTIVENESS OF THE STANDARD DEDUCTION

Because the standard deduction no longer properly serves its intended purpose—to simplify the tax system for most taxpayers who have average levels of deductions—and because this failure creates unwarranted tax inequities between taxpayers who are able to itemize their personal deductions and those who are not able to separately itemize their deductions, it is proposed to expand the standard deduction and thereby restore it to its former relative position.

The proposed standard deduction would be equal to 14 percent of AGI subject to a maximum of $1,800, compared to a 10-percent deduction subject to a $1,000 ceiling under present law. The larger percent is in recognition that personal deductions have increased as a fraction of income since the institution of the present standard deduction. The higher limitation reflects some of the increase in incomes which has occurred since the present standard deduction was introduced.

As a result of this proposal, about 80 percent of all taxpayers would again be using the simplified standard deduction. (This compares with 82 percent who used the standard deduction when it was introduced in 1944 and with 57 percent who would use it in 1969 in the absence of this proposal.) This means that for the vast majority of taxpayers changes in tax liabilities resulting solely from variations in the level of personal expenses will be eliminated for all but those with extraordinary deductions above the general average.

III. HIGH-INCOME TAXPAYERS

A. UNFAIRNESS DUE TO DIFFERENCES IN EFFECTIVE TAX RATES

1. General

Extreme variations in tax burdens exist among high-income taxpayers because of variations in the tax treatment of income according to its source. As a result, many high-income taxpayers are paying far less than their intended share of the income tax burden, and others are paying tax currently at very high rates.

TABLE 4.—PERCENTAGE DISTRIBUTION OF RETURNS BY EFFECTIVE TAX RATE CLASSES: PRESENT LAW TAX AS A PERCENT OF AMENDED TAXABLE INCOME,[1] BY AGI CLASSES, 1969 LEVELS

AGI (in thousands of dollars)	Effective tax rate classes													
	0 to 5	5 to 10	10 to 15	15 to 20	20 to 25	25 to 30	30 to 35	35 to 40	40 to 45	45 to 50	50 to 55	55 to 60	60 to 65	65 to 70
0 to 3	[2] 68.0	0.5	1.5	6.0	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
3 to 5	14.2	2.5	11.0	63.0	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
5 to 7	3.6	2.1	22.5	71.5	(3)	(3)	(3)	(3)	-	-	-	(3)	-	(3)
7 to 10	.9	1.1	22.4	70.2	5.3	-	-	-	-	-	-	-	-	-
10 to 15	.5	.8	6.2	85.5	6.7	.4	-	-	-	-	-	-	-	-
15 to 20	.5	.7	4.2	72.2	20.1	2.3	-	-	-	-	-	-	-	-
20 to 50	.4	.7	3.9	27.5	48.6	14.6	3.3	.7	.2	-	-	-	-	(4)
50 to 100	.3	.4	1.2	4.9	11.9	22.3	34.5	18.5	4.4	1.3	.3	-	-	(4)
100 to 500	1.0	.4	.5	1.6	14.1	15.5	11.2	15.3	19.4	12.2	5.6	2.6	.5	(4)
500 to 1,000	1.8	.6	.6	.6	24.6	30.0	4.7	5.0	3.5	2.6	4.9	7.9	12.7	.8
1,000 and over	4.0	.2	.2	.2	31.0	27.2	5.2	1.8	2.4	4.0	1.8	2.7	12.3	6.9
All classes	21.5	1.1	10.9	52.7	8.4	2.0	.9	.5	.3	.2	.2	.1	.1	1.0

[1] Amended taxable income is taxable income after deduction changes plus excluded capital gains, tax-exempt interest, and excess of percentage over cost depletion. Amended taxable income is used to maintain a common base for the effective rate computation under present law and under the reform program.

[2] Nontaxable are 67.6 percent.

[3] The percentages in these effective rate classes are not very meaningful because they reflect present law tax divided by a small amount of amended taxable income under the reform program. Amended taxable income for these taxpayers is much smaller than present law taxable income primarily because of the higher MSD under the reform program.

[4] Less than .05 percent.

The implication of the treatment of various income sources for creating disparities and unfairness is brought out in table 4. This indicates for various AGI levels the distribution of taxpayers by the effective rate of tax paid in terms of amended taxable income. The table shows for taxpayers in various brackets of adjusted gross income the proportions having various percentages of tax to "amended taxable income,"—defined for purposes of this table as taxable income (i.e., after the personal deductions) increased by the exempt part of capital gains, exempt interest, and excess percentage depletion. Tax as a percent of amended taxable income is referred to as the "effective tax rate."

Effective tax rates calculated in the above manner are more meaningful than "effective tax rates" superficially calculated on either present law taxable income or adjusted gross income. Both taxable income and adjusted gross income are terms which are incorporated into the tax law. But so far as both exclude income from certain sources, neither represents an income base which reflects a taxpayer's true economic position or his ability to pay taxes.

TABLE 5.—RETURNS WITH TAXABLE INCOME, 1966: MARGINAL AND EFFECTIVE TAX RATES

(1)	(2)	(3)	(4)	(5)	(6)
Adjusted gross income class (thousands)	Average marginal rate [1]	Effective rate on taxable income [2]	Effective rate on adjusted gross income [3]	Effective rate on amended taxable income [4]	Effective rate on amended adjusted gross income [5]
0 to $5	16.0	15.3	7.5	15.0	7.4
$5 to $10	18.4	16.4	9.4	16.2	9.4
$10 to $20	21.5	18.1	12.3	17.8	12.2
$20 to $50	32.8	24.0	18.8	22.8	18.0
$50 to $100	51.1	35.8	29.5	32.6	27.3
$100 to $200	57.3	45.6	37.3	37.8	31.9
$200 to $500		52.3	41.7	37.9	32.0
$500 to $1,000	58.2	55.3	44.1	35.8	30.7
$1,000 and over	58.2	55.5	44.3	32.7	28.4

[1] Average rate applicable to top dollar of income taxable at normal and surtax rates.
[2] Statutory taxable income; adjusted gross income less exemptions and deductions.
[3] Statutory adjusted gross income.
[4] Statutory taxable income increased by items of excluded income. (Only excluded long-term capital gains, the largest single item of excluded income, are included in this computation; therefore the rates shown are slightly overstated as compared to table 4 where estimates are made as to other excluded items.)
[5] Statutory adjusted gross income increased by items of excluded income. (Only excluded long-term capital gains, the largest single item of excluded income, are included in this computation; therefore the rates shown are slightly overstated as compared to table 4 where estimates are made as to other excluded items.)

The relationship between effective tax rates calculated on amended taxable income and those calculated on other bases is shown in table 5. From these data it is evident that for taxpayers with AGI greater than $100,000, "effective tax rates" calculated on bases which exclude various income items seriously overstate the proportion of income paid in tax. For high-income individuals the meaningful effective tax rates are those calculated with respect to amended taxable income and amended adjusted gross income. Since effective tax rates based on amended adjusted gross income do not take account of personal deductions, which commonly influence the ability to pay taxes among high incomes, effective tax rates shown in table 4 are based on amended taxable income.

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A second drawback to the usual discussions of "effective tax rates" is evident upon comparing the average effective tax rates computed for each income class (col. 5, table 5) with the effective tax rates computed on the same base in table 4. Table 4 is considerably more useful because it shows not one effective tax rate figure for an entire income class but a range of effective rates and the percent of taxpayers in each income class who pay rates within this range. These figures are necessary for examining tax inequities within a single income class as well as inequities between classes.

It will be seen from table 4 that for incomes up to $100,000 there is a clear central tendency. For each bracket there is a generally common rate and some variation above and below depending on special circumstances. In the $50,000 to $100,000 bracket this clustering of rates begins to flatten out.

Above the income level of $100,000, however, two patterns emerge. A highly taxed class shows a grouping of high effective tax rates which rise above 50 percent. For the highly taxed in the income groups above $500,000, the effective tax rate is most commonly in the range of 60 to 65 percent.

There is also a low effective rate group among the high-income group who pay tax rates which are less on the average than the rates paid by people in the income bracket from $50,000 to $100,000. In this high-income group the typical effective rate is 20 to 30 percent.

2. *Excluded income which operates to reduce effective tax rates*

Items of excluded income which work to reduce tax rates for high incomes generally are, in order of importance, the excluded half of long-term capital gains realized, interest on State and local bonds, deductions for unlimited charitable contributions (largely unrealized capital appreciation), farm "tax losses," depletion in excess of basis, the excess of deductions for intangible drilling expenses over depreciations of oil wells, and income excluded for the aged. Table 6 shows how these factors combine to produce low rates of tax *for the aggregate of high-income taxpayers*. Table 6 has some omissions because of the difficulties of obtaining data on the distribution of the excluded income: Among the omissions are accelerated depreciation on buildings; interest on life insurance savings; and employee fringe benefits such as pension plans.

TABLE 6.—FACTORS REDUCING TAXES FOR TAXPAYERS WITH HIGH ADJUSTED GROSS INCOME OF $100,000 OR OVER, 1967 LEVEL

[Dollar amounts in millions]

	All over $100,000	$100,000 to $500,000	$500,000 to $1,000,000	$1,000,000 and over
Amended adjusted gross income [1]	$16,720	$12,205	$1,875	$2,640
Less personal deductions (taxes, interest, charitable contributions, etc.) but not including the unlimited charitable contribution	2,350	1,800	260	290
Amended taxable income	[2] 14,370	[3] 10,406	[4] 1,616	[5] 2,350
Less ½ of capital gains on assets actually sold	3,775	2,260	575	940
Less exempt interest on State and local bonds	440	330	70	40
Less deduction for unlimited charitable contribution	105	15	15	75
Less farm "tax losses"	70	55	10	5
Less excess percentage depletion [6]	60	25	25	10
Taxable income	9,870	7,700	905	1,265
Tax [7]	4,715	3,563	490	662
Tax as percent of taxable income	47.8	46.3	54.1	52.3
Tax as percent of amended taxable income	32.8	34.2	30.3	28.2
Tax as percent of total income	28.2	29.2	26.1	25.1

[1] After deductions for proper business expenses.

[2] Includes $45,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells and $5,000,000 of tax exclusions for the aged.

[3] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells and $5,000,000 of tax exclusions for the aged.

[4] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells. Tax exclusions for the aged are negligible in the aggregate for this group.

[5] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells. Tax exclusions for the aged are negligible in the aggregate for this group.

[6] Although the figures shown in the table are total depletion, they approximate the amount of excess percentage depletion since the bulk of claimed depletion is in excess of the recovery of basis.

[7] This tax figure reflects the lower alternative rate applicable to realized capital gains, the retirement income credit, and other credits.

TABLE 7.—*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 (millions)
Amended adjusted gross income [3]	$658
(Including dividends of	134)
(Including wages and salaries of	60)
Less ½ of capital gains excluded from AGI	182
Excess percentage depletion [4]	59
Net farm losses over gains	15
Contributions [5]	78
Other personal deductions	111
Total adjustments	440
Less unused adjustments	8
Taxable income	210
Tax before credits	102
Credits	4
Tax after credits	98
Effective rate on amended AGI (percent)	15
Effective rate on amended taxable income [6] (percent)	21

[1] The effective rate used for selection was the tax over amended adjusted gross income.

[2] Based on a 1 in 15 sample.

[3] Amended adjusted gross income is adjusted gross income plus the excluded part of net long term capital gains, the exclusion due to 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 the bulk of 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.

[6] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution.

Table 7 provides more detail on *the high income group which pays little or no tax*. It is based on a 1 in 15 random sample of tax returns in 1964 showing effective tax rates below 22 percent, where effective rate is defined for selection purposes with a base of adjusted gross income, adding the excluded part of capital gains and excess depletion but not allowing personal deductions.[1]

Since the data in table 7 are taken from actual tax returns, no information is available on exempt items of income other than the exempt half of long-term capital gains and excess depletion. Thus the computation of effective rates and the following analysis is limited to an income base which includes only income from taxable sources and these two items of exempt income. Of these remaining items of income it is clear that the largest item in this picture is capital gains.

For the group as a whole, capital gains constitute about 55 percent of the amended adjusted gross income. The part of income which does not consist of capital gains is virtually offset by deductions (treating excluded percentage depletion income as a deduction) and, therefore, the tax actually paid is substantially the tax paid at the alternative capital gains rate of 25 percent. This works out to an average rate of 15 percent on the total amended adjusted gross income because of the 25-percent rate on the capital gains portion and the near zero rate on the balance. On the effective rate definition used in table 4, that is, allowing personal deductions, this average rate would be 21 percent. Table 7 presents a reasonably good picture of the large segment of the high-income population shown in table 4 as falling in the 20- to 25-percent effective-rate bracket.

It can be seen at this point that there are two kinds of problems underlying the disparities in effective tax rates: (1) As table 7 brings out, great disparity arises because some kinds of income are subject to low tax-rates; and (2) personal deductions taken on high-income returns with large amounts of excluded income contribute to the bulk of very-high-income taxpayers having very low rates.

In table 7 it can be seen that the effective tax rate on income after deductions for the low-rate, high-income taxpayers is only 21 percent. The tax rate on the basis of amended adjusted gross income before deductions is even lower—15 percent—which is the rate paid by most people in the $15,000 to $20,000 bracket.

3. The interrelationship of personal deductions and excluded income

In the following analyses, further consideration is given to the relationship between personal deductions and excluded income, especially the particular deductions for charitable contributions and interest.

a. Personal deductions in general.—Table 7, discussed previously, indicates the general problem. Broadly, the personal deductions offset about 28 percent of the amended AGI. But out of the amended AGI, about 40 percent was protected from tax because it was covered by farm losses or excess percentage depletion, or was one-half of net long-term capital gains. Thus, the personal deductions in fact were used

[1] The fact that these returns were selected on a criterion that makes no allowance for personal deductions is not a drawback since we are at this point interested in the income characteristics of these people.

against the taxable 60 percent of amended AGI. Thus, 40 percent of amended AGI was taxed at a zero rate (that covered by percentage depletion, net farm losses, and personal deductions), and the remainder of amended AGI ($364 million) was capital gains taxed at a 25-percent rate. (We could expect that there was also some tax-exempt interest not shown in these data.) This use of personal deductions against the more highly taxed income explains why the effective tax rate on these returns was less than the 25 percent alternative tax rate on net long-term capital gains.

b. The unlimited charitable contribution deduction.—A particular problem of personal deductions is the provision in present law which limits the charitable deduction to 30 percent of AGI for most taxpayers, but permits an unlimited charitable contribution deduction to a handful of high-income taxpayers. Table 8 describes the situation of 50 high-income returns in 1964 that had this privilege. (The total number of eligibles was about 70, about one ten-thousandth of 1 percent of taxpayers.)

TABLE 8.—*Data on 50 returns with AGI over $200,000 and charitable contributions over 30 percent of AGI*

[Dollar amount in millions]

Amended AGI [1]	$107
Including dividends	73
Less excluded one-half of capital gains	17
Contribution deductions	86
Other personal deductions	8
Taxable income	2.9
Tax before credits	1.9
Credits	.2
Tax after credits	1.8
Effective tax rate on amended AGI .... percent	1.7
Effective tax rate on amended taxable income [2] .... do	1.8

[1] Amended gross income is adjusted gross income plus the excluded part of net long-term capital gains, the exclusion due to percentage depletion, and for the group as a whole the excess of farm losses over farm gains.

[2] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

The amended AGI of these taxpayers was $107 million for which $33 million was capital gains and $73 million was dividends. The contributions deduction itself was $86 million and the tax about 1½ percent of amended AGI. Again the dividend figure is striking. The stock which generated $73 million of dividends would presumably increase in value in a typical year by $146 million, and this suggests a total income of $220 million (after deducting the $33 million of realized gain already included). The amount given away in contributions, which on the basis of prior analysis of unlimited contribution returns was mostly in the form of appreciated securities, was about 39 percent of the wealth increase of these donors. (It is clearly appropriate to count appreciation in assets held because the contribution deduction counts appreciation in assets given away.) In substance the unlimited contribution deduction provision works out to be a special device for using the charitable deduction exclusively against the taxable portion of income. The group as a whole enjoyed $107 million in realized income from their holdings and an additional amount of about $113 million of increase in wealth—or a total of $220 million. By giving away $86 million of their property, they almost completely escape tax on the $107 million of realized income and still have a net wealth increase of $27 million in addition to the untaxed realized income.

TABLE 9.—*Data on 50 returns with AGI over $200,000 and interest deductions over 30 percent of AGI*

[Dollar amount in millions]

Amended AGI [1]	$21.0
Including dividends	7.4
Wages and salaries	3.6
Less excluded half of capital gains	4.5
Interest deduction	8.3
Other personal deductions	2.6
Taxable income	4.8
Tax before credits	2.2
Credits	.1
Tax after credits	2.1
Effective tax rate on amended AGI ... percent	10
Effective tax rate on amended taxable income [2] ... do	20

[1] Amended adjusted gross income is adjusted gross income plus the excluded part of net long-term capital gains, the exclusion due to percentage depletion and for the group as a whole the excess of farm losses over farm gains.
[2] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

c. The interest deduction.—Another case of extreme tax savings from deductions is suggested by the data in table 9 which shows information on 50 high-income returns that had an interest deduction of over 30 percent of AGI. These returns had amended AGI of $21 million, of which $7 million was dividends. Again realized gains were modest, only $9 million when their stock alone presumably increased in value by about $15 million a year. These returns showed $8.3 million of interest deductions, however. This, along with other personal deductions of $3.6 million, offset entirely the ordinary income items. The taxpayers were, in effect, using most of their borrowings to finance the holding of assets for appreciation and they paid tax only on the nearly half of their income which was realized as capital gain, and that at only a 25 percent rate. Their effective rate on realized income was thus brought down to 10 percent.

4. *The aspect of unrealized appreciation in wealth*

The 1 in 15 sample discussed earlier suggested that in addition to a number of low effective rate returns there were also about 1,000 returns of AGI over $200,000 that paid effective rates of over 50 percent. The results for this group are summarized in table 10.[1]

TABLE 10.—*Characteristics of an estimated 1,000 tax returns in 1964 with AGI over $200,000 and effective tax rates over 50 percent* [1 2]

[Dollar amount in millions]

Amended adjusted gross income [3]	$367
(Including dividends	184)
(Including wages and salaries	56)

[1] Based on a 1 in 15 sample.
[2] The effective rate used for selection was tax over amended adjusted gross income.
[3] Amended adjusted gross income is adjusted gross income plus the excluded part of net long-term capital gains, the exclusion due to percentage depletion and for the group as a whole the excess of farm losses over farm gains.

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[1] Again table 10 uses an effective tax rate definition on amended AGI, i.e., not allowing for personal deductions. Since personal deductions for this group are trivial the table would be little changed if the selection had been based on taxpayers with high effective rates on amended taxable income, i.e., after personal deductions.

TABLE 10.—*Characteristics of an estimated 1,000 tax returns in 1964 with AGI over $200,000 and effective tax rates over 50 percent*—Continued

[Dollar amount in millions]

Less excluded ½ of capital gains		$4
Excess percentage depletion		0
Net farm losses over gains		16
Contributions		16
Other personal deductions		20
Taxable income		324
Tax before credits		215
Less credits		3
Tax after credits		212
Effective rate on amended AGI	percent	58
Effective rate on amended taxable income [4]	do	64

[4] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

Ostensibly this group of high-taxpaying, high-income taxpayers paid an average rate of 58 percent on amended AGI, and 64 percent on amended taxable income, the measure used in table 4.

Table 10, however, reveals a striking feature about these high-taxpaying individuals. Half of their AGI is from dividends, but remarkably little is realized as capital gains. Any cross section of stocks held in recent years would have shown almost twice as much appreciation in value as dividends for an average year.

If it is assumed that this group had an average collection of stocks, their total increase in wealth in a year like 1964, taking into account stock appreciation, alone would have been about $723 million rather than $367 million, and their effective tax rate on amended AGI would fall to 29 or 31 percent on amended taxable income.

Since another quarter of the income of this group was from business sources, it could well be anticipated that there was additional appreciation associated with these business property holdings (including proprietorships, partnership interests, and interests in real estate and farms). It could also be expected that there was some tax-exempt interest. The total wealth addition of this group could have been near $1 billion, and the effective rate as low as 21 percent.

5. The stability of income patterns and effective tax rates

Section 1 of this analysis dealing with high incomes described the income situation of 1 year. Experience indicates that high-income taxpayers tend to show consistent income patterns, and thus consistent effective tax rates year after year. Thus, the analysis in section 1 can be taken as a picture of the behavior of high-income taxpayers who are consistently either high taxpaying or low taxpaying.

The returns of a group of 50 taxpayers with high tax rates in 1959 and a group of 50 with low rates in 1959 were collected along with their returns for the years 1958–61. All the taxpayers had AGI over $150,000 in 1959. Ninety-four returns are classified in table 11 according to both their adjusted gross incomes and effective rates of tax.[1] Each row within an AGI class grouping represents a single taxpayer, with the digits 1–4 designating the years 1958 through 1961, respectively; thus variations in effective tax rates over time are shown when a given taxpayer falls into more than one effective tax rate column.

[1] Taxpayers for whom records were not available for all 4 years of the sample period were omitted from this analysis. Presumably missing records were due to taxpayer deaths. Out of the high-rate group records for two taxpayers were not complete. Out of the low-rate group records for four taxpayers were not complete.

TABLE 11.—EFFECTIVE RATES OF TAX PAID BY A SAMPLE OF HIGH-INCOME TAXPAYERS FOR THE YEARS 1958 THROUGH 1961—TAX AS A PERCENT OF AMENDED AGI [1] 1959 AGI CLASS

Tax as a Percent of Amended AGI 1/ Low Effective Tax Rate Group 2/								1959 AGI Class ($000)	Tax as a Percent of Amended AGI 1/ High Effective Tax Rate Group 3/							
0%	0-5%	5-10%	10-15%	15-20%	20-25%	25-30%	30%+		0%	0-10%	10-20%	20-30%	30-40%	40-50%	50-60%	60%+
1234															342	1
4	23				1									34	12	
	2			3	1		4					4		1	23	
	34	12						$150								
	23		14					to	3						124	
	3	24	1					$250						1	234	
		2	13		4										1234	
			3	4	12			I						1	24	3
	3	24	1												124	3
			1234												1234	
	2	3		4		1								4	13	2
1	23	4												4	3	12
															1234	
	1	23			4			$250					4	1	23	
1	3	2		4				to						3	124	
	1	2	34					$500				4	3		12	
			2	13	4										1234	
			2	1	3		4	II					4		123	
			24	1	3										3	124
		134		2											4	123
234				1									3	4	12	
	2				134							34			2	1
														3	24	1
	34	12						$500	4			3	1		2	
		12	3	4				to							1	234
		3	2	1	4			$1,000					1		4	23
															34	12
			23	4	1										134	2
				1234				III								1234
				1234												1234
1234														34	12	
		1	34	2											4	123
34				12											1234	
				24	13			$1,000							1234	
			1	23	4			to							34	12
		4		23	1			$2,500								1234
				123	4									3	4	12
				23	14										134	2
				24	13			IV								1234
				24		13										1234
1234													1	34	2	
			34	12											1234	
				2	14	3								3	124	
				2	34	1		$2,500							12	34
								and						1	234	
					123		4	over							1234	
			13		24										2	134
134					2									3	12	4
	1			4	23			V								
4	3		1		2											1234

[1] Amended AGI for this analysis consists only of AGI plus the excluded half of long-term capital gains. Other forms of excluded income which should be included in amended AGI were not available from these returns, hence effective tax rates are slightly overstated for some returns.

[2] Returns in this group had an effective tax rate in 1959 which was less than 25 percent of amended AGI. Each row within a grouping represents a single taxpayer, with the digits 1 to 4 designating tax years 1958 through 1961, respectively.

[3] Returns in this group had an effective tax rate in 1959 which was greater than 50 percent of amended AGI. Each row within a grouping represents a single taxpayer, with the digits 1 to 4 designating tax years 1958 through 1961, respectively.

Among the high-rate group, there were 192 possible observations (48 taxpayers for 4 years each). Only 33 observations showed effective tax rates on amended AGI below 50 percent. Only 14 observations fell below 40 percent, only 7 below 30 percent, and only 2 below 20 percent.

Among the low-rate taxpayers, out of 184 possible observations only 3 were above 30 percent and only 44 were above 20 percent.

This analysis properly does not take account specifically of particular taxpayers who in 1 year suffered a drastic decline in income (and therefore in tax rate). The question at issue here is the adequacy of the tax system in the way that it handles people with high incomes. The data indicate that if people with high incomes are in the high- or low-rate bracket in 1 year, they are apt to remain there in other years.

6. Specific cases of high-income, low-rate taxpayers

Cases 1 through 11 attached are drawn from actual tax returns and were chosen to make more concrete the implications of the aggregate data reflected in the previous tables.

Cases 1 through 4 are taxpayers with total income from $6 million to over $10 million each, who paid no income tax as a result of the unlimited charitable contribution deduction. In cases 1 and 2 the income was almost entirely from dividends and their dividend income made it clear that each taxpayer must have had a very large amount of unrealized appreciation. It would have been normal tax practice in both cases to use unrealized appreciation as a means of making the charitable contribution so that each of the taxpayers should have been in a position to use every dollar of the dividend income for personal expenses. In cases 3 and 4 the taxpayers had a considerable amount of realized capital gain and in each case were able to completely avoid tax by giving away far less than their full income.

Cases 5, 6, and 7 are all taxpayers with large amounts of capital gain plus large itemized deductions. In each case they were able to take advantage of using the deductions against the included part of their income so that their effective tax rate on total income was less than the relative capital gains rate. This was carried to an extreme in case 7 where about 90 percent of the taxpayer's income came from capital gain, and his total deductions were about half of the income, so he virtually wiped out his tax, reducing it to three one-hundredths of 1 percent of total income. In the particular case the deductions were primarily interest deductions which were the cost of carrying assets on which capital gains income was realized. Even though the interest cost was only half of the total capital gain income, for tax purposes, he is permitted to use the interest deduction to wipe out the half of capital gains which is included.

Cases 8 and 9 indicate taxpayers with large percentage depletion deductions. In case 8 the percentage depletion deduction by itself virtually wiped out tax on a $1 million dividend income. In case 9 the taxpayer's income sources were from oil and gas operations plus capital gains. At the same time the taxpayer reported a "loss" of almost $1 million from farming. It would seem most likely that the farm loss represented an extensive investment in farm assets which under the applicable tax rules could be written off as current expenses.

Case 10 indicates that the successful real estate operator has significant sources of income from other endeavors and is able to shelter it from tax by excess real estate deductions. Later the real estate operated at a "tax loss" is sold, and the resulting gain is subject to tax only at capital gain rates.

Case 11 reveals the typical farm loss. The loss is great enough to insulate other income from tax while capital gains on farm assets, in this case over 75 percent on breeding cattle, indicate that the farm loss is not an economic loss. Rather, it is an investment in an asset which by its very nature appreciates but is subject only to capital gain rates when sold.

CASE 1.—*Taxpayer with unlimited charitable contribution deduction*

Adjusted gross income	$10,822,622
Amended gross income [1]	10,829,028
Wages and salaries	0
Dividends	10,806,947
Interest	3,158
Capital gains (100 percent)	12,812
Other income (net)	6,111
Total deductions	10,950,354
Contributions [2]	10,506,414
Interest	7,073
Taxes	147,831
Medical	0
Other	289,036
Taxable income	0
Tax	0
Tax as a percent of amended gross income	0
Tax as a percent of amended taxable income [3]	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains and losses.
[2] Mostly appreciated property which represents an increase in wealth.
[3] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 2.—*Taxpayer with unlimited charitable contribution deduction*

Adjusted gross income	$5,907,596
Amended gross income [1]	5,932,512
Wages and salaries	0
Dividends	5,881,828
Interest	1,783
Capital gains (100 percent)	49,832
Other income (net) [2]	−931
Total deductions	5,953,366
Contributions [3]	5,323,510
Interest	205
Taxes	142,510
Medical	0
Other	487,441
Taxable income	0
Tax	0
Tax as a percent of amended gross income	0
Tax as a percent of amended taxable income [4]	0
Tax as a percent of income paid by single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains and losses.
[2] Partnership and rental loss.
[3] Mostly appreciated property which represents an increase in wealth.
[4] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 3.—*Taxpayer with unlimited charitable contribution deduction*

Adjusted gross income	$4,772,058
Amended gross income [1]	8,225,075
Wages and salaries	50,000
Dividends	1,231,771
Interest	34,594
Capital gains (100 percent)	6,906,034
Other income (net)	2,676
Total deductions	5,206,718
Contributions [2]	5,113,404
Interest	56,620
Taxes	11,820
Medical	1,369
Other	23,505
Taxable income	0
Tax	0
Tax as a percent of amended gross income	0
Tax as a percent of amended taxable income [3]	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains and losses.
[2] Mostly appreciated property which represents an increase in wealth.
[3] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 4.—*Taxpayer with unlimited charitable contribution deduction*

Adjusted gross income	$4,317,986
Amended gross income [1]	6,511,908
Wages and salaries	1,500
Dividends	2,080,133
Interest	746
Capital gains (100 percent)	4,387,834
Other income (net) [2]	41,690
Total deductions	4,575,682
Contributions [3]	4,080,614
Interest	0
Taxes	465,396
Medical	5,543
Other	24,129
Taxable income	0
Tax	0
Tax as a percent of amended gross income	0
Tax as a percent of amended taxable income [4]	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains and losses.
[2] Net partnership income of approximately $80,000, pension income of $12,000, and farm loss of $50,000.
[3] Mostly appreciated property which represents an increase in wealth.
[4] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

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

Adjusted gross income	$3,281,693
Amended 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
Taxable income	2,085,421
Tax after credits	1,031,218
Tax as a percent of amended gross income	19.3
Tax as a percent of amended taxable income[2]	24.9
Income level at which a single individual pays 19.3 percent of his income in tax	12,600

[1] Adjusted gross income plus the excluded part of net long-term capital gains.
[2] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 6.—*Taxpayer with high capital gains and large itemized deductions*

Adjusted gross income	$659,873
Amended 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 gross income	14.7
Tax as a percent of amended taxable income[2]	25.5
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.
[2] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 7.—*Taxpayer with high capital gains and large itemized deductions*

Adjusted gross income	$679,405
Amended 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 gross income	.03

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

Tax as a percent of amended taxable income [3]	.06
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains.
[2] Rental loss.
[3] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 8.—*Taxpayer with total income over $900,000 with more than $800,000 of excess percentage depletion*

Adjusted gross income	$49,220
Amended gross income [1]	924,722
Salary	50,000
Dividend	1,022,312
Interest	676
Capital gains (100 percent)	26,519
Farm profit	10,683
Oil and gas operations before excess percentage depletion [2]	−185,468
Excess percentage depletion	862,042
Total personal deductions	41,141
Contributions	9,964
Interest	0
Taxes	4,112
Medical	2,902
Other	24,163
Taxable income	3,980
Tax after credits	397
Tax as a percent of amended gross income	0.04
Tax as a percent of amended taxable income [3]	0.04
Income level at which a single individual would pay $397 in tax	3,400

[1] Adjusted gross income plus the excluded part of net long-term capital gains and excess of percentage over cost depletion.
[2] Income from oil and gas minus exploration ad development, intangible drilling, and other costs.
[3] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 9.—*Taxpayer with total income over $1.3 million with more than $860,000 of excess percentage depletion*

Adjusted gross income	$111,422
Amended gross income [1]	1,313,811
Salary	0
Dividend	42,823
Interest	26,280
Capital gains (100 percent)	673,390
Farm loss	−828,571
Other business and partnership	69,290
Oil and gas operations before excess percentage depletion [2]	1,469,179
Excess percentage depletion	865,644
Total personal deductions	178,401
Contributions	32,809
Interest	19,457
Taxes	95,306
Medical	0
Other	30,829
Taxable income	0
Tax after credits	0
Tax as a percent of amended gross income	0
Tax as a percent of amended taxable income [3]	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains and excess of percentage over cost depletion.
[2] Income from oil and gas minus exploration and development, intangible drilling, and other costs.
[3] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

CASE 10.—*Taxpayer with total income over $1.4 million with more than $860,000 of real estate deductions in excess of real estate income*

Adjusted gross income	−$3,000
Amended gross income [1]	560,000
Salary	30,000
Dividend	221,000
Interest	23,000
Capital gains (100 percent) [2]	1,150,000
Total income before excess real estate deductions	1,433,000
Real estate deductions in excess of real estate income	−864,000
Total personal deductions	41,400
Contributions	33,000
Interest	5,500
Taxes	1,200
Medical	1,700
Other	0
Taxable income	0
Tax after credits	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains.
[2] Nearly ⅔, or about $762,000, of these capital gains were attributable to sales of real estate.

CASE 11.—*Taxpayer With Total Income Over $700,000 With a Farm Loss of More Than $450,000*

Adjusted gross income	$38,937
Amended gross income [1]	288,119
Salary	0
Dividend	16,207
Interest	193,192
Capital gains (100 percent) [2]	498,365
Other business and partnership	30,340
Total Income before farm loss	738,203
Farm loss	−450,084
Total personal deductions	3,162
Contributions	3,162
Interest	0
Taxes	0
Medical	0
Other	0
Taxable income	35,175
Tax after credits	0
Tax as a percent of income paid by a single individual at the poverty level ($1,700)	6.9

[1] Adjusted gross income plus the excluded part of net long-term capital gains.
[2] Capital gains attributable to farm assets exceed the total capital gains just slightly because minor losses were reported on the sale of non-farm assets.

B. MAJOR PROPOSALS TO IMPROVE EQUITY AMONG HIGH-INCOME TAXPAYERS

1. *Minimum tax*

In recognition that high-income taxpayers with large portions of excluded income are not paying a fair share of tax, it is proposed to introduce a minimum tax under which those with more than half of their incomes from excluded sources would pay tax according to a graduated minimum tax rate schedule. 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. 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 the minimum tax would apply to any individual whose tax-exempt income exceeds his income from taxable sources and whose total income exceeds $10,000. The bulk of the tax increase under this provision comes from taxpayers with more than $1 million of income each year. The total number of returns involved would be 40,000.

2. Allocation of deductions

Taxpayers with excluded income enjoy an unwarranted double benefit from that income: No tax is paid on the excluded income and personal deductions are used to offset income from taxable sources. To remedy this it is proposed to require taxpayers to allocate their nonbusiness personal deductions between income from taxable sources and income from nontaxable sources. This proposal would affect about 400,000 taxpayers, although it would rarely affect any returns with adjusted gross income of less than $50,000.

3. Removal of the unlimited charitable contribution deduction

It is proposed that the unlimited charitable contribution deduction be repealed after allowing a 10-year grace period out of consideration for those who have relied on the present law provision. This affects only about 100 taxpayers.

4. Maximum tax

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 items of excluded income) in income tax to the Federal Government. This would be accomplished by the introduction of an optional, alternative maximum tax. About 12,000 high-income, high-rate taxpayers would be affected.

5. Taxation of appreciated assets transferred at death

It is proposed to revise the tax treatment of the transfer of appreciated property at death by making such transfers subject to the income tax. Since this proposal concerns transfers of property at death, it is related to proposals in the estate and gift tax area and is discussed in the Case for and the Dimensions of Tax Reform: Estate and Gift Tax.

IV. Overall Effects of Proposals

The accompanying charts illustrate in summary fashion both the equity problems associated with our present tax law and the overall effects of the reform program on tax equity.

Chart 1 shows the present distribution of persons paying various different effective rates of tax for income classes above $5,000. For this presentation taxpayers are classified according to their "amended adjusted gross incomes"—adjusted gross income plus certain items of income excluded from tax; and effective rates of tax are defined as tax paid as a percent of "amended taxable income"—amended adjusted gross income less all deductions allowable under the reform program.[1]

Two facts are clearly illustrated by this chart. First, individuals similarly situated in income often pay strikingly dissimilar rates of

[1] This income classification and effective rate base have been selected so that chart 1 will be consistent with chart 2. Items of excluded income which are added to AGI to produce amended adjusted gross income are one-half of long-term capital gains, percentage depletion claimed after full recovery of basis, unrealized appreciation of property donated to charity, and tax-exempt interest. Deductions allowed under the reform program exclude the deduction for gasoline tax and, for certain taxpayers, exclude those deductions allocated to exempt income. Allowed deductions include the expanded standard deduction.

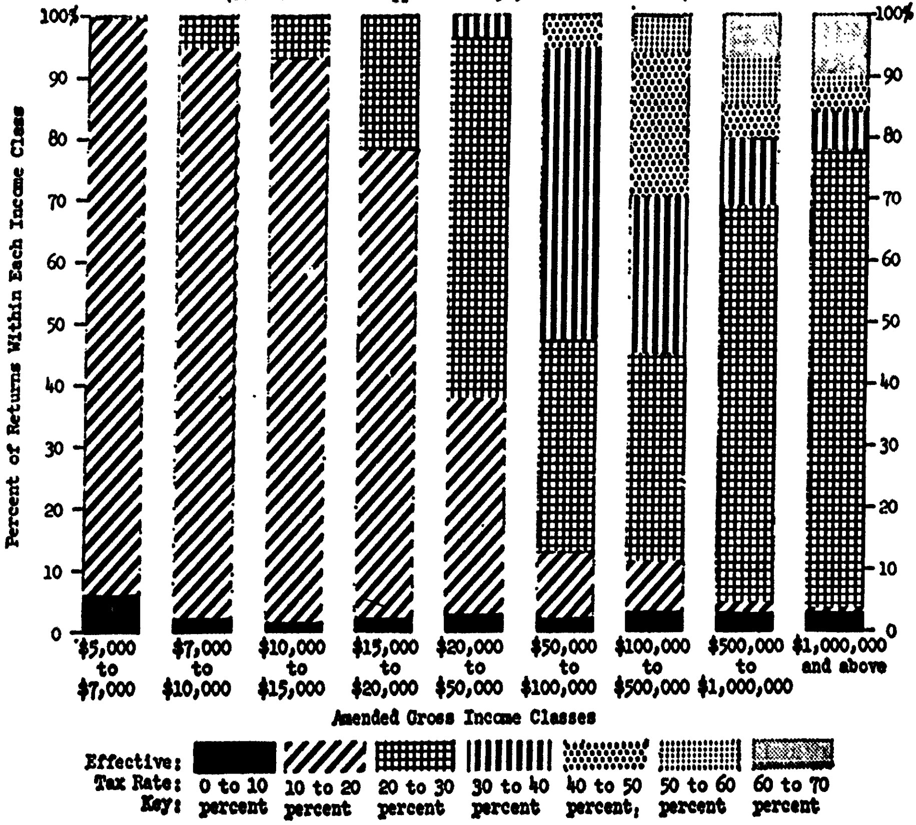
tax. For example, while almost two-thirds of those with incomes in the $500,000 to $1 million class pay an effective rate of tax between 20 percent and 30 percent, a significant number (about 5 percent) pay rates less than 20 percent, and a larger fraction (about 7 percent) pay rates in excess of 60 percent. The remaining one-fourth of the returns in this income class pay rates ranging from 30 percent to 60 percent. Although some of this rate disparity is expected due to the range of income represented within the class limits, the significant number of returns falling into high and low rate extremes is not an expected result of the present law marginal tax rate schedule, which is constructed so that similar rates apply to roughly similar levels of income.

The observed variations of rates within income classes are due both to variations in the amount of income excluded from tax and to variations in the amount of personal deductions claimed, although rate differences resulting from variations in deductions do not appear as severe as they would if rates were computed on an income base which did not already exclude deductions.

A second problem underscored by this chart is the fact that equal rates of tax are often paid by taxpayers with marked differences in income. For example, most taxpayers with incomes in the $20,000 to $50,000 income class pay rates between 20 percent and 30 percent. Most taxpayers with incomes between $500,000 and $1 million also pay rates of 20 percent to 30 percent; however, the latter group has, on the average, about 20 times the income of the former group.

TAX INEQUITIES: ILLUSTRATED BY THE PERCENT OF RETURNS IN EACH INCOME CLASS PAYING VARIOUS DIFFERENT RATES OF TAX

(Present tax law applied to 1969 levels of income)



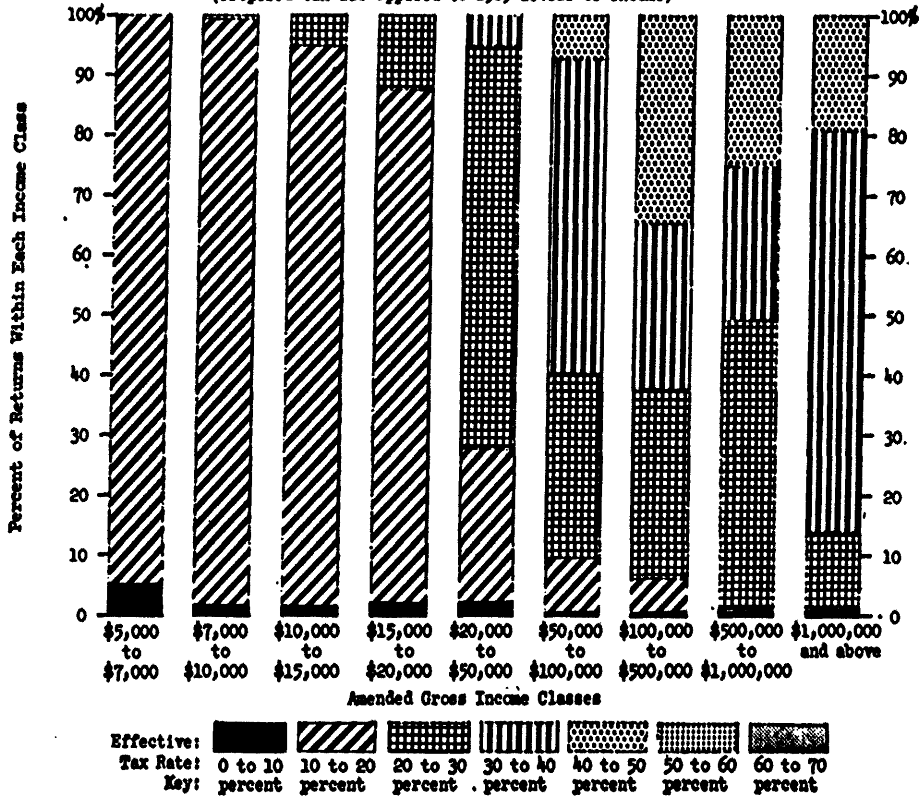
Another way of examining the favorable treatment of certain higher income returns is to observe that almost 5 of every 10 returns with income ranging from $50,000 to $500,000 pays an effective rate of tax less than 30 percent, while almost 7 out of every 10 returns with income from $500,000 to $1 million and about 8 out of 10 returns with income in excess of $1 million pay an average rate of tax lower than 30 percent. This is clearly contrary to the expected results of a tax rate schedule which is nominally progressive.

The proposals—although not *all* specifically aimed at altering effective rate inequities—taken together have major effects on both horizontal inequities (unequal tax treatment of like incomes) and vertical inequities (equal or perverse tax treatment of unequal incomes). The degree to which the proposals improve overall tax equity can be measured by comparing chart 2, which shows the distribution of effective rates of tax by income classes after the proposals, with chart 1. Because the proposals are *not* designed (1) to eliminate any specific class of deductions (other than the gasoline tax deduction) or (2) to apply regular rates of tax to income currently exempt from tax, some apparent inequities still exist. However, by achieving the goals of each specific proposal—namely to correct major abuses—the overall picture of tax equity is greatly improved.

Primarily because of the expanded standard deduction and the institution of the charitable deduction outside of the standard deduction, the rates paid by lower middle income taxpayers would be more nearly homogeneous; taxpayers paying rates greater than 20 percent

TAX INEQUITIES: ILLUSTRATED BY THE PERCENT OF RETURNS IN EACH INCOME CLASS PAYING VARIOUS DIFFERENT RATES OF TAX

(Proposed tax law applied to 1969 levels of income)



are fewer under the reform program than under present law for income classes up to $20,000. At the same time those with higher incomes who pay rates as low as 20 percent are substantially reduced in number.

The dramatic increase under present law in the proportion of those paying less than 30-percent tax rates as income rises is eliminated by the proposals. Although the proportion of those with incomes between $500,000 and $1 million and who pay rates less than 30 percent is still somewhat higher than the same proportion in the $50,000 to $500,000 range, it is nevertheless sharply down from the present law situation (approximately 5 out of every 10 taxpayers compared to 7 out of 10). And, more important, the trend no longer continues into the highest income: the ratio of somewhat more than 1 out of 10 individuals earning more than $1 million and paying tax rates of less than 30 percent compares favorably with the 8 out of 10 ratio under present law.

Although a few high-income individuals continue to pay extremely low rates (those with little or no excluded income and large itemized deductions), no taxpayers have an effective rate greater than 50 percent. This reduction in the incidence of extreme rates, both high and low, considerably improves the overall picture of horizontal equity—fairness among those with like incomes. And the reduction in the low-rate incidence for high incomes and the high-rate incidence for low incomes similarly improves vertical equity—fairness between those with unequal incomes.

IV–B. THE CASE FOR AND DIMENSION OF TAX REFORM: CORPORATE INCOME TAX

The corporate income tax is generally described as requiring that corporations pay taxes at a 48-percent rate on their total net income as net income is usually defined for business purposes. (We leave out of account the temporary 10-percent surcharge.) This is what would happen if there were no surtax exemption, no special capital gains rate, no special deductions or exclusions and no investment credit. Table 1 provides estimates of the effective tax rates *actually paid* by corporations, as a group and for several industries. The table recognizes the regular corporate rate of 48 percent in the first column.

With the allowance of a surtax exemption for the first $25,000 of income but with corporate chains prevented from obtaining multiple surtax exemptions, the effective rate of all corporations would be 45.8 percent, as shown in the second column. The third column shows that with allowance of the investment credit the effective rate would be 43.4 percent. This rate may then be compared with the lower tax rates on total net income that are actually being paid, shown in the fourth column of table 1.

TABLE 1.—TAX RATES ON CORPORATE TAXABLE INCOME COMPARED WITH ACTUAL TAX RATES ON TOTAL NET INCOME FOR CERTAIN CLASSES OF CORPORATIONS, 1965 DATA

[In percent]

	Tax without surtax exemption and without investment credit	Tax with surtax exemption and without investment credit	Tax with surtax exemption and with investment credit	Actual tax on taxable income	Actual tax on total net income
All industries	48	45.8	43.4	42.3	37.5
Petroleum	48	47.8	44.8	43.7	21.1
Other mineral industries	48	46.4	42.7	40.5	24.3
Lumber	48	45.1	41.2	29.6	29.5
Commercial banks	48	45.0	43.4	42.2	24.4
Mutual savings banks	48	43.8	42.4	34.1	5.3
Savings and loan associations	48	41.0	40.4	39.7	14.5
Other manufacturing	48	47.2	44.9	44.4	43.3

The reduction in the effective rate from 43.4 percent for all corporations to the actual rates in the fifth column is due to special provisions for computing taxable income which make taxable income less than total net income for the industries and activities benefited. The following are the principal special provisions involved, and their average effect on tax rates for all corporations combined:

	Percent
Effective tax rate on total net income allowing only the appropriate surtax exemption and investment credit	43.4
Reduction in effective rate due to—	
Excess percentage depletion	2.2
Excess exploration and development cost	.4
Tax-exempt interest	.9
Capital gain rate and definition	.8
Excess bad debt deduction of financial institutions	.6
Multiple surtax exemptions	.8
Excess depreciation on buildings	.5
Western Hemisphere Trade Corporation deduction	.2
Total reduction	5.9
Actual effective tax rate on total net income	37.5

The analysis is based on 1965 data, the latest for which tax return data are available. It might be noted that at 1968 profit levels a change of 1 point in the effective rate means $800 million of revenue and a change of 0.1 point means $80 million. More detailed information basic to table 1 is given in table 2, which also indicates the effect of various provisions for some industry groups. The issues raised by these special provisions are best explained by some discussion of individual industries.

TABLE 2.—FACTORS REDUCING THE TAX LIABILITIES OF CORPORATIONS, 1965 DATA

[Dollar amounts in millions]

	All industries	Selected industries: Petroleum	Other mineral industries	Lumber	Commercial banks	Mutual banks	Savings and loan associations	Other manufacturing[1]
Total net income	$79,792	$6,861	$952	$542	$3,808	$155	$867	$37,531
Less:								
Excess percentage depletion deductions[2]	4,038	2,858	305		1			527
Tax-exempt interest	1,751	4	2	1	1,096	12	9	75
Excess bad debt deductions[3]	1,167				507	119	541	
Excess depreciation on buildings	950	10						190
Excess exploration and development costs[4]	700	540	20					25
Western Hemisphere trade deduction	346	141	54					116
Equals taxable income as reported	70,840	3,308	571	541	2,204	24	317	36,598
Tax that would be paid except for preferential treatment of capital gains and multiple surtax exemptions	30,745	1,481	244	223	957	10	128	16,445
Deduct:								
Benefits from taxation of capital gains at preferential rate	572	35	13	63	26	2	2	158
Benefit from multiple surtax exemptions	225							25
Equals actual tax paid to United States and foreign governments	29,948	1,446	231	160	931	8	126	16,262
Computed tax rates:								
As percent of taxable income as reported: Actual tax paid to United States and foreign governments	42.3	43.7	40.5	29.6	42.2	34.1	39.7	44.4
As percent of total net income: Actual tax paid to United States and foreign governments	37.5	21.1	24.3	29.5	24.4	5.3	14.5	43.3

[1] Total manufacturing excluding petroleum refining and lumber.

[2] 90 percent of depletion deduction assumed to be in excess of cost-basis depletion. In the long run this could be less as owners of new mines and wells would have lower current deductions and thus more unrecovered cost for cost depletion.

[3] Excess estimated only commercial banks, mutual banks, and savings and loan associations.

[4] 50 percent of exploration and development expenditures assumed to be in excess of depreciation.

1. Extractive Industries

Companies doing several kinds of business have to be put in one industry classification representing their principal business activity, as indicated in the tabulations of corporate tax return data on which tables 1 and 2 are based. Companies classified in the petroleum business (oil and natural gas) report 60 percent of the depletion claimed on corporate returns. Firms characterized as mining other than oil and natural gas report less than 10 percent of the depletion, and about 30 percent is claimed by corporations in other industry classifications.

The effective tax rate for the petroleum industry is 21.1 percent, as shown in tables 1 and 2. For mining companies other than petroleum and natural gas, the effective tax rate is slightly higher, at 24.3 percent. These effective rates are not always fully descriptive when it is recognized that the tax returns from which they are drawn include both extractive and nonextractive operations and, in general, do not indicate the appropriate allocation between the two activities. It is possible, for example, for an integrated company to earn income equally from extraction and processing and pay effective tax rates of zero and 46 percent respectively, and show an overall effective rate of 23 percent.

The overwhelming bulk of the special tax advantage for companies engaged in mineral extraction arises from percentage depletion, which is properly called a special deduction because it results in receipt of nontaxable income after the investor has fully recovered his cost. In the petroleum area it appears generally that 90 percent of the percentage depletion deduction allowed is in excess of what would be allowed as cost depletion. The revenue loss due to the excess of percentage over cost depletion for all extractive industries is $1.3 billion, of which $1.1 billion is due to corporations and $0.2 billion to individuals. (The revenue effect would be larger during a transition period.)

The tax treatment of certain capital costs to bring a mineral deposit into production is also significant. These costs may be deducted as current expenses in calculating taxable income rather than spread over the useful life of the property. These costs include the intangible drilling costs for gas and oil and the costs of developing other mineral properties. Under present law, these costs are deductible without affecting or limiting the percentage depletion deductions. Under cost depletion, the expensing of intangible drilling costs would reduce the amount to be recovered through cost depletion. The revenue cost of expensing intangible drilling costs is $300 million a year, of which $240 million is due to corporations and $60 million to individuals. In money terms about 80 percent of the tax relief for extractive industries goes to the oil and gas industry, and the other 20 percent to all other minerals.

A Treasury study on the taxation of extractive industries is going forward and should be available during the next session of Congress.

2. Timber

Timber growers are permitted to claim capital gains treatment on the portion of their income which can be attributed to the increase in value of trees while the trees are growing and before they are cut. As a result of this special provision, companies in the lumber and wood products industry (excluding furniture) have in the aggregate "capital gains" which amount to about half of their net income.[1] (The ratio for corporations as a whole is below 5 percent.) This benefit alone would reduce the tax of lumber companies about one-half if all of the income arose from the increased value of trees; the reduction would be one-fourth if half of the income came from appreciation of tree values and half from logging, sawing, and distribution. The final effective tax rate of 29.6 percent comes out about two-thirds of that paid by other manufacturing corporations.

The capital gains and thus the tax savings are concentrated in a small number of large companies. In 1965, the last year for which tax return data are available, the 16 largest corporations in the lumber, plywood and paper industries with assets over $250 million reported 64.8 percent of the long-term capital gains reported on all the 13,251 corporate returns in these industries. Five companies alone reported 51.3 percent of all these long-term gains, of which one company reported $108 million of capital gains, or 24.4 percent of the total claimed by the entire industry.

The estimated revenue loss of this capital gain treatment is $125 million a year, of which $100 million is for corporations and $25 million for individuals.

A Treasury study on the taxation of timber is going forward and should be available during the next session of Congress.

3. Financial Institutions

Three special features reduce the effective tax rates for commercial banks, saving and loan associations, and mutual savings banks. In the first place, each category of financial institutions has a special bad debt reserve provision quite unrelated to its actual loss experience. The ratio of allowed bad debt reserves to actual losses is considerably larger for savings and loan associations and mutual savings banks than it is for commercial banks, although the amount of the allowed deduction is large in absolute terms for commercial banks. The revenue loss due to the current bad debt reserve provisions is $600 million, of which $250 million goes to commercial banks.

Another feature that reduces the effective tax rates of banks is the fact that they can take full deductions for the cost of obtaining deposits which in effect are borrowed funds, but they then invest some of those funds in assets which are excluded from corporate taxable income. Interest on tax-exempt securities is fully excluded, while dividends on corporate stocks are largely excluded under the corporate dividends received deduction provision. With respect to these investments the banks thus obtain a double benefit. This feature is important for both commercial banks and mutual banks. The revenue cost is about $600 million.

These financial institutions also receive preferential treatment on long-term capital gains and losses on securities. They receive capital gains treatment on net gains, as do other taxpayers, but may treat net losses on securities as deductions from ordinary income, a treatment not available to other investors in securities. The revenue loss due

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[1] Some gains from the special tax treatment of timber go also to firms in the paper industry.

to the non-parallel treatment of these gains and losses, based on the experience of 1961 to 1966, averages $50 million.

A Treasury study on the taxation of financial institutions is going forward and should be available during the next session of Congress.

4. Real Estate

Present law provides considerable, but not easily measured, benefits for corporations owning real estate. The benefit arises because tax depreciation deductions for real estate are excessive in relation to actual depreciation and also because a large portion of the recovery of excessive depreciation at the time of sale is taxable as a capital gain. The revenue cost of the excess of accelerated depreciation over straight line depreciation is $750 million of which $500 million is for corporations and $250 million for individuals.

A Treasury study on the taxation of real estate is going forward and should be available during the next session of Congress.

5. Tax-Exempt Organizations

Another area of corporate tax reduction is that of exempt organizations and businesses owned by exempt organizations. There is no basis for a general revenue estimate here because the whole matter hinges on what organizations one thinks ought to be tax exempt and, if the organization is to be taxed, how funds secured by the organization and amounts accumulated or expended for the purpose of the organization are to be treated.

Some organizations whose overall purposes may justify exemption from income tax may operate businesses at a profit unrelated to their exempt purposes. In such cases, unless the tax exemption is retructed to the nonbusiness activities, tax revenues are reduced and taxpaying businesses are placed at a competitive disadvantage.

6. Foreign-Earned Business Income

Profits of foreign subsidiaries of U.S. corporations are generally not taxable in the United States until the profits are repatriated as dividends to U.S. parent corporations. Profits of foreign branches, however, are subject to U.S. taxes in the year earned, whether or not the branch profits are repatriated. Further, the special exemption from "gross up" in relation to the foreign tax credit for subsidiary dividends of companies in less developed countries provides a tax advantage to U.S. corporate parents of those companies in certain situations. In somewhat the same category are provisions which (1) reduce the tax of certain U.S. companies, primarily in the natural resource area, operating in the Western Hemisphere, or (2) deriving most of their income from U.S. possessions. These several provisions together reduce revenues by $320 million.

IV-C. THE CASE FOR AND DIMENSION OF TAX REFORM: DEATH AND GIFT TAXES

I. Description of Present Law

ESTATE TAX

The Federal estate tax is levied upon the transfer of property at death. In the normal case, the rate of tax is not affected by the amount of the transfers already made by the decedent during his lifetime. The tax is levied upon the total value of all the property in a decedent's gross estate. The gross estate includes, in general, the property owned by a decedent at the time of his death, plus certain property transferred during his life in which he retained an interest at the time of his death, and property transferred in contemplation of death. The tax is imposed upon the taxable estate; that is, the gross estate less allowable deductions and exemptions. The estate tax is progressive, because the tax rates increase as the size of the taxable estate becomes larger.

An estate tax return must be filed by the estate of every U.S. citizen or resident whose gross estate at the date of death exceeds $60,000. In general, the return (and any tax payable) are due within 15 months of the date of death, although an extension of time may be granted. If the estate consists largely of an interest in a farm or closely held business, the estate may elect to pay the tax attributable to that farm or business interest over a period of up to 10 years.

The executor or administrator of an estate may elect to value the property in the estate either as of the date of the decedent's death, or as of the "alternate valuation date" which is 1 year after death. However, the property sold prior to the alternate valuation date is valued at its sales price. The alternate valuation date provides relief to an estate which contains property that declines in value during the year subsequent to the date of death.

The deductions and exemptions allowed for estate tax purposes include an exemption in the amount of $60,000, and deductions for funeral expenses, administration expenses, claims against the estate, mortgages or indebtedness where the full value of the mortgaged or encumbered property is included in the gross estate, certain State and foreign taxes, losses, charitable transfers, and certain bequests to a surviving spouse. The $60,000 estate tax exemption insures that no one leaving an estate of $60,000 or less will be subject to estate taxation. In addition, if a decedent has taken full advantage of the availability of the marital deduction, no tax is due unless the estate exceeds $120,000. There are no percentage limitations on the charitable contribution deduction for estate tax purposes. However, the amount of the charitable contribution deduction may not exceed the value at which the donated property is included in the gross estate.

A marital deduction is allowed for property passing to the decedent's surviving spouse. This deduction is limited to 50 percent of the "adjusted gross estate," which is defined, in general, as the gross estate minus the allowable deductions (and after elimination of any community property included in the gross estate). The deduction for charitable transfers and the $60,000 exemption are not required to be taken into account in computing the adjusted gross estate.

Four credits are allowed against the estate tax liability. The most important of these is the credit for State death taxes. The maximum credit allowable for State death taxes is expressed as a percentage of the decedent's taxable estate in excess of $40,000. The effect of this credit is to permit the States to obtain substantial death tax revenues which would otherwise be collected by the Federal Government, without increasing the total death tax burden on their citizens.

Credit against the estate tax is allowed for gift taxes paid by the decedent on transfers which were made by him during his lifetime, but which were included in his gross estate because the transfer was incomplete or because it was made in contemplation of death. The amount of this credit is limited to the amount of the gift tax paid with respect to the property included in the gross estate, or the estate tax paid with respect to such property, whichever is smaller.

In order to prevent the imposition of successive estate taxes on the same property within a brief period, a credit is also allowed for all or part of the estate tax paid with respect to property transferred to a particular decedent, or his estate, from another decedent within 10 years before, or within 2 years after the particular decedent's death. This credit is a vanishing one, since it is reduced by 20 percent for each full 2 years separating the dates of death of the two decedents.

Finally, a credit is allowed for foreign death taxes with respect to property situated in a foreign country which is subject to both United States and foreign estate taxes. The credit is limited to the lesser of the United States or the foreign tax attributable to such propery.

GIFT TAX

Gifts during life are a natural alternative to gifts at death, especially for wealthy individuals who can afford to give away a substantial part of their property during their lifetime without impairing their standard of living or making use of funds needed for emergencies. Consequently, the taxation of gifts during life is a natural companion to the taxation of gifts at death. For this reason, Congress developed a system of Federal gift taxes shortly after the introduction of the Federal estate tax system.

Like the estate tax, the Federal gift tax is imposed upon transfers of property from one person to another. The tax is a liability of the person making the gift and is based upon the value of the transferred property. Unlike a gift at death, the amount of a taxable lifetime gift does not include the tax on that gift.

The existing tax on lifetime gifts is cumulative, that is, the applicable tax bracket is determined by taking into account the sum of all taxable gifts made since enactment of the law in 1932. The tax to be paid in any 1 year is equal to (1) the tax on the aggregate of all taxable gifts made since 1932 less (2) the amount of tax on the aggregate gifts made up to the beginning of the current taxable year. In determining (1) and (2), gift tax rates in effect in the current taxable year are applied. Consequently, the tax is determined by applying the current tax rate which is applicable to the donor's bracket to the gifts made during the year.

In computing the amount of "taxable gifts" in any 1 year, the first $3,000 of gifts to each recipient may be excluded, if the donee receives a present interest in the donated property. This is the so-called "per donee" exclusion. Where a spouse agrees to treat gifts made by the other spouse as having been made one-half by each, a maximum annual exclusion of $6,000 per donee is available.

In addition to the annual "per donee" exclusion, there is a specific exemption of $30,000 of total lifetime gifts to all donees. This exemption may be claimed in full in a single year or, at the taxpayer's option, over a number of years until the full $30,000 exemption is exhausted. A married person's specific exemption is increased to $60,000 if the other spouse agrees to treat gifts as having been made one-half by each.

Certain deductions are also allowed in computing the amount of taxable gifts. Gifts made to charitable organizations may be deducted in full. In addition, one-half of the value of gifts between a husband and wife may be made tax-free. This marital deduction corresponds roughly to that allowed for estate tax purposes.

II. General Background

The estate and gift taxes comprise a significant element in the progressivity of the overall Federal tax system. Estate and gift taxes combined constitute only 2 percent of Federal tax receipts, but they play a much larger part in the progressivity structure of the tax system. Roughly, the progressivity element of the individual income tax can be defined as the revenue raised by that portion of the rate schedules in excess of 20 percent. In 1965 this element was $5 billion, while total estate and gift tax liability was $2.7 billion. Studies of the association of wealth and income indicate that estate and gift taxes are involved almost exclusively with families with annual income of over $20,000. Thus the estate and gift taxes are probably responsible for about one-third of the net progressivity in the U.S. tax system.[1]

However, an analysis of the estate and gift tax system which has developed over the past 45 years reveals many features of the system which run counter to the basic functions of that system.

These features have produced erratic results in the sense that the burden of estate and gift taxes is much heavier on some forms of wealth holdings and on some forms of transfers than on others. The principal problem, therefore, in the present estate and gift tax system is horizontal equity, that is, the unequal treatment of wealth holdings of comparable size as the result of different patterns of transfer of those holdings. The different patterns are the consequence of differing fam-

[1] At the lower end of the income scale the income tax is progressive due to the personal exemptions. A number of studies, however, suggest that this progression in the income tax just about offsets the regressivity of sales and property taxes, leaving the overall tax system as a whole roughly proportional up to income of $10,000–$20,000. We can thus think of the upper income progressivity as the net progressivity.

The extent of the net progressivity contributed by the corporate tax is not fully clear, since this depends mostly on the extent to which the tax is shifted.

ily desires or needs as to the patterns of wealth accumulations and dispositions. As a result, a number of individual large estates have actual lower tax burdens than many middle size estates.

III. Specific Defects in the Present Transfer Tax System

A. NONTAXATION OF APPRECIATION OF ASSETS TRANSFERRED AT DEATH OR BY GIFT

The failure to see clearly that the estate and gift taxes are not substitutes for income taxes has led to adoption of rules with regard to property transferred at death which subverts the goal of income taxation. If a person accumulates income during life from taxable sources (wages, dividends, interest, rent, and unincorporated business profits) he pays a tax on the income as earned, and the balance of accumulated after-tax income may still bear an estate tax at the person's death if the accumulation is large enough. The estate tax and its companion gift tax are essentially separate levies which in the normal case fall on wealth accumulations after income tax.

With regard to capital assets the law has failed to recognize the necessarily separate character of estate taxation on the one hand and income (capital gains taxation) on the other. It has not treated the transfer of appreciated property at death as an occasion for imposing a capital gains tax, but then has given property, which has been transferred at death, credit for having been through the estate tax "mill" in the form of a stepped-up income tax basis which precludes any income tax on the appreciation in the hands of the testator.

Thus, a wealth holding that has grown to $1 million by appreciation in value has no income tax under present law, but only an estate tax. The same accumulation from wages and dividends would have paid both an income tax and an estate tax. Clearly, equity between various forms of wealth accumulation is not achieved under present law.

Data available readily indicate the scope and impact of this lack of equity in the present tax system. A 1 in 15 sample of high income taxpayers shows that there were about 1,000 returns with adjusted gross income (AGI) over $200,000 that paid effective tax rates of over 50 percent in 1964. The results for this group are summarized in table 1.[1]

[1] Table 1 uses, for sample selection purposes, an effective rate definition on amended AGI, that is, adjusted gross income plus major items of excluded income (other than appreciation in wealth). Since personal deductions for this group are trivial the table would be little changed if the selection had been based on taxpayers with high effective rates on amended taxable income, that is, after personal deductions.

TABLE 1.—*Characteristics of an estimated 1,000 tax returns in 1964 with AGI over $200,000 and effective tax rates over 50 percent* [1] [2]

[Dollar amounts in millions]

Amended adjusted gross income [3]	$367
(Including dividends	$184)
(Including wages and salaries	$50)
Less Excluded ½ of capital gains	$4
Excess percentage depletion	0
Net farm losses over gains	0
Contributions	$16
Other personal deductions	$20
Taxable income	$324
Tax before credits	$215
Less credits	$3
Tax after credits	$212
Effective rate on amended AGI (percent)	58
Effective rate on amended taxable income (percent) [4]	64

[1] Based on a 1 in 15 sample.
[2] The effective rate used for selection was tax over amended adjusted gross income.
[3] Amended adjusted gross income is adjusted gross income plus the excluded part of net capital gains, the exclusion due to excess percentage depletion, and for the group as a whole the excess of farm losses over farm gains. Tax exempt interest and appreciation of property donated to charity should also be included in this income but were not available from these sample data.
[4] Amended taxable income equals amended AGI less deductions.

Ostensibly this group of high-taxpaying, high-income taxpayers paid an effective tax rate of 58 percent on amended AGI, and 64 percent on amended taxable income.

Table 1, however, reveals a striking feature about these high-taxpaying individuals. Half of their AGI is from dividends, but remarkably little is realized as capital gains. Any cross section of stocks held in recent years would have shown almost twice as much appreciation in value as dividends for an average year. (Dividend rates have been around 3 percent while appreciation in value in the 1960's has been at a rate of about 6 percent. A 6-percent appreciation increase is expectable in the aggregate because ultimately common stock is a claim on corporate profits, and these profits in the aggregate grow at the rate of money GNP, about 5 percent to 6 percent a year.)

If it is assumed that this group had an average collection of stocks, their total increase in wealth in a year like 1964, taking into account stock appreciation alone would have been about $723 million rather than $367 million, and their effective tax rate on true income would fall to 29 percent or 31 percent on income after deductions. (In 1964, as a matter of fact, appreciation in value was about five times dividends. This was a year of unusual stock price movement, however. Therefore, to avoid distortion an assumption of appreciation equal to two times dividends is used. Realized gains are subtracted from this appreciation to get the appropriate adjustment to find the total wealth increase. It also would be reasonable to assume that taxpayers facing marginal rates of 60 to 70 percent on dividends would have tried to select stocks with higher than average appreciation to dividend ratios. No explicit allowance is made for this last factor.)

Since another quarter of the income of this group was from business sources, it could well be anticipated that there was additional appreciation associated with these business property holdings (including proprietorships, partnership interests, and interests in real estate and farms). It could also be expected that there was some tax-exempt interest. The total wealth addition of this group could have been near $1 billion, and the effective tax rate as low as 21 percent.

It is typical for returns that show high or low effective tax rates in one year to have a similarly high or low rate in other years. It could be expected, therefore, that those taxpayers who have high income from dividends and do not realize gains follow this investment strategy year after year, and depend upon unrealized gains as a way of building wealth. Thus, most of these high tax rate cases have in fact relatively low rates, since under present law such capital appreciation at death forever escapes income tax. (It is irrelevant that this wealth may be subject to estate tax, since the estate tax also falls on income accumulated after income tax.)

These people cannot be regarded as paying at relatively high tax rates unless steps are taken to close the escape of appreciation in value at death. The apparently highly taxed group includes a number of salary earners who presumably have untaxed fringe benefits not included in these figures which would further reduce effective rates.

Turning to statistics for the aggregate of high-income taxpayers, an alternative estimate of appreciation in assets over realized gains is appropriate. This estimate is based on aggregate data which indicate total appreciation tends to be about three times realized gains, and thus the excess of appreciation in 1 year over total realized gains in that year is about twice the realized gain itself. Table 2 uses this estimate by assuming that for each income class the annual addition to unrealized appreciation is twice the volume of realized gains for each class. (It should be noted that while this technique provides the best overall estimate of excess appreciation for the aggregate of high-income taxpayers, it is clearly inappropriate for estimating excess appreciation for the special group of taxpayers included in table 1 who report disproportionately small amounts of capital gain and hence pay superficially high effective rates of tax.)

Estimates of other income exclusions for the aggregate of high-income taxpayers are also included in table 2. It will be seen that these inclusions bring the effective tax rate to the area of 15 percent for all returns over $100,000 AGI and to about 10 percent to 11 percent for the returns with AGI over $1 million. In each class the unrealized appreciation is about equal to all other income sources put together.

TABLE 2.—FACTORS REDUCING TAXES FOR TAXPAYERS WITH HIGH ADJUSTED GROSS INCOME OF $100,000 OR OVER, 1967 LEVEL

[Dollar amounts in millions]

	All over $100,000	$100,000 to $500,000	$500,000 to $1,000,000	$1,000,000 and over
Total income—broadest definition [1]	$31,820	$21,245	$4,175	$6,400
Less personal deductions (taxes, interest, charitable contributions, etc.) but not including the unlimited charitable contribution	2,350	1,800	260	290
Available total income (including appreciation in wealth)	29,470	19,445	3,915	6,110
Less average annual appreciation on capital assets (in excess of gains realized) that will not be sold during lifetime	15,100	9,040	2,300	3,760
Amended taxable income	14,370	10,405	1,615	2,350
Less one-half of capital gains on assets actually sold	3,775	2,260	575	940
Less exempt interest on State and local bonds	440	330	70	40
Less deduction for unlimited charitable contribution	105	15	15	75
Less farm "tax losses"	70	55	10	5
Less excess percentage depletion [2]	60	25	25	10
Less excess of deduction for intangible petroleum drilling expenses over depreciation of oil wells	45	15	15	15
Less exclusions for the aged	5	5	(3)	(3)
Taxable income	9,870	7,700	905	1,265
Tax [4]	4,715	3,563	490	662
Tax as percent of taxable income	47.8	46.3	54.1	52.3
Tax as percent of available total income	16.0	18.3	12.5	10.8
Tax as percent of total income	14.8	16.8	11.7	10.3

[1] After deduction for proper business expenses but including unrealized appreciation in wealth.
[2] Although the figures shown in the table are total depletion, they approximate the amount of excess percentage depletion since the bulk of claimed depletion is in excess of the recovery of basis.
[3] Negligible.
[4] This tax figure reflects the lower alternative rate applicable to realized capital gains, the retirement income credit, and other credits.

Table 2 included as income the increase in wealth arising from the increase in value of securities, since, if one individual increases his wealth by earning wages and using the proceeds to buy securities, and another by having the value of his securities rise, they both could end up with the same securities. The wealth increase from appreciation can hardly be a different kind of thing than a wealth increase from wages if they can end up in the same investment. Whether or not it would be a practical scheme to tax gains as they accrue, it is still a useful indicator of the burden of taxes in relation to wealth increases to show the tax actually paid in relation to total income including accrued gains.

It is apparent that the present system of not taxing appreciation on assets transferred at death has serious defects:

> The present system is grossly inequitable and substantially impairs the progressivity of the tax structure.
>
> At least $15 billion a year of capital gains fall completely outside the income tax system.
>
> From an economic standpoint this inconsistent income tax treatment may produce unnatural holding patterns as older investors become locked into appreciated assets to avoid income tax that would result from the sale of those assets.

A more uniform tax treatment which does not produce pressure either to hold or to sell could be achieved by first imposing the income tax on appreciation on property passing at death, and then allowing that income tax so imposed as a deduction from the taxable estate for estate tax purposes. The estate tax would then be imposed upon the balance with the result that the transfer tax would be imposed on he same wealth base regardless of whether the wealth has been accumulated from earned income or from capital appreciation.

B. INTERSPOUSAL TRANSFERS

A number of problems arise because of the present 50 percent marital deduction:

1. The present marital deduction is limited to one-half of the property transferred by a decedent to a surviving spouse. This means that there may be a substantial tax on property which is intended to provide for the old age of the surviving wife. This adverse effect is primarily felt by widows whose husbands leave smaller estates. Based on a special study of 1957–59 returns, 50 percent of husbands with estates under $500,000 transferred property to their surviving spouses in amounts which exceeded the allowable marital deduction for Federal estate tax purposes. In contrast, only 14 percent of husbands with estates over $1 million transferred property to their widows in amounts exceeding the marital deduction. Thus, the transfer tax burden, under present rules, falls relatively more heavily on the widows who are most in need of funds to sustain themselves for the balance of their lives than on widows who receive substantial amounts of wealth unreduced by taxes on the husband's death.

Table 3 indicates the period by which estate taxes are accelerated under present law by taxing one-half of the family property in the estate of the first spouse to die. Correspondingly, it demonstrates the distribution of the benefit that would be derived if all estate taxes were deferred until the death of the surviving spouse.

TABLE 3.—*Period of widows surviving their husbands*

Years after husband's death:	*Percent of widows surviving*
1	94
2	88
5	78
10	54
20	27
30	9

NOTE.—This is based on data from matching estate tax returns. The data were smoothed.

2. Extension of the marital deduction to only 50 percent of the property transferred to the surviving spouse favors the wealthy who can provide for the old age of the surviving spouse with the amount exactly equal to the marital deduction. The balance of the property can then be passed onto the next generation untaxed on the death of the wife. Less wealthy persons, however, who must make the entire estate available to provide for the surviving wife, are required to pass property onto the children in a form which incurs a tax on the entire estate upon the death of the wife. This disparity of tax results is counter both to progressivity and equity.

Table 4 demonstrates that present rules primarily impose the double tax on small estates. The study of the 1957–59 returns further bears this out. Approximately 63 percent of husbands with adjusted gross estates in excess of $1 million made property available to the surviving wife in an amount in excess of the allowable marital deduction, but in a form which enabled that property to escape estate tax liability on the death of the wife. On the other hand, only 27 percent of husbands with estates under $500,000 could transfer property to their surviving spouses in an amount in excess of the marital deduction in a form which gave the wife the economic benefits of the property but avoided subjecting that property to estate tax on her death.

TABLE 4.—PATTERN OF BEQUESTS OF MARRIED DECEDENTS

Gross Transfer Class (Thousands)	Percent of adjusted gross estate			
	Marital deduction	Outright bequests to to spouse	Property left outright to spouse not under marital deduction	Bequests to spouse in trust
Below $300	41.6	71.5	29.9	10.6
$300 to $1,000	40.9	55.0	14.1	14.5
$1,000 and over	38.2	42.3	4.1	10.3

3. The present 50 percent marital deduction produces extremely arbitrary results where the spouse in whose name the property is held is the last to die. The maximum tax benefits are realized under present law when the estate is split equally between the husband and wife. (The combined tax on two separate $500,000 estates is $253,000; the tax on a single $1 million estate is $303,200.) Present rules permit this result to be achieved only by means of lifetime gifts by the spouses, with resultant gift taxes because only half of the property can be transferred tax free. Further the present system provides an incentive for such transfers which in some families might well not exist in the absence of these tax provisions.

4. Present rules with regard to interspousal transfers provide maximum benefits to extremely complex transfers and forms of ownership that bear little relationship to economic realities with respect to control and enjoyment of the property. The Federal Government has no real interest in whether the husband or the wife controls the passing of the property to the next generation; it need only be concerned that all of the property is subject to tax at the time it finally leaves the hands of the older generation and moves onto the younger generation.

C. THE EXISTENCE OF SEPARATE ESTATE AND GIFT TAXES

1. *Characteristics of present dual tax structure*

(*a*) *Two separate rate structures.*—The estate tax utilizes a progressive rate structure operative on property transferred at death. The gift tax also employs a progressive rate structure to tax lifetime transfers. However, the gift tax is imposed on the cumulative total of property transferred during lifetime entirely without regard to property transferred at death. Similarly, the estate tax progessive rate structure is operative only on the transfers at death entirely without regard to transfers during lifetime. Thus the person making transfers during life is subjected to a tax based on one set of progressive rates, but the property he transfers at death is subjected to a new and very low beginning set of rates.

(*b*) *Lower gift tax rates.*—In addition to the fact that persons who can transfer wealth during lifetime get to start at the bottom of two separate rate structures, the gift tax rates are substantially lower than the estate tax rates. The following tables 5 and 6 set forth the present estate and gift tax rates. The tables reveal the marked preference accorded lifetime gifts as compared to the same gift transferred at death.

TABLE 5.—*Federal estate tax rates*

If the taxable estate is:	The tax shall be:
Not over $5,000	3% of the taxable estate.
Over $5,000 but not over $10,000	$150, plus 7% of excess over $5,000.
Over $10,000 but not over $20,000	$500, plus 11% of excess over $10,000.
Over $20,000 but not over $30,000	$1,600, plus 14% of excess over $20,000.
Over $30,000 but not over $40,000	$3,000, plus 18% of excess over $30,000.
Over $40,000 but not over $50,000	$4,800, plus 22% of excess over $40,000.
Over $50,000 but not over $60,000	$7,000, plus 25% of excess over $50,000.
Over $60,000 but not over $100,000	$9,500, plus 28% of excess over $60,000.
Over $100,000 but not over $250,000	$20,700, plus 30% of excess over $100,000.
Over $250,000 but not over $500,000	$65,700, plus 32% of excess over $250,000.
Over $500,000 but not over $750,000	$145,700, plus 35% of excess over $500,000.
Over $750,000 but not over $1,000,000	$233,200, plus 37% of excess over $750,000.
Over $1,000,000 but not over $1,250,000.	$325,700, plus 39% of excess over $1,000,000.
Over $1,250,000 but not over $1,500,000.	$423,200, plus 42% of excess over $1,250,000.
Over $1,500,000 but not over $2,000,000.	$528,200, plus 45% of excess over $1,500,000.
Over $2,000,000 but not over $2,500,000.	$753,200, plus 49% of excess over $2,000,000.
Over $2,500, 000 but not over $3,000,000.	$998,200, plus 53% of excess over $2,500,000.
Over $3,000,000 but not over $3,500,000.	$1,263, 200, plus 56% of excess over $3,000,000.
Over $3,500,000 but not over $4,000,000.	$1,543,200, plus 59% of excess over $3,500,000.
Over $4,000,000 but not over $5,000,000.	$1,838,200, plus 63% of excess over $4,000,000.
Over $5,000,000 but not over $6,000,000.	$2,468,200, plus 67% of excess over $5,000,000.
Over $6,000,000 but not over $7,000,000.	$3,138,200, plus 70% of excess over $6,000,000.
Over $7,000,000 but not over $8,000,000.	$3,838,200, plus 73% of excess over $7,000,000.
Over $8,000,000 but not over $10,000,000.	$4,568,200, plus 76% of excess over $8,000,000.
Over $10,000,000	$6,088,200, plus 77% of excess over $10,000,000.

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TABLE 6.—*Federal gift tax rates*

If the taxable gifts are—	The tax shall be—
Not over $5,000	2¼% of the taxable gifts.
Over 5,000 but not over $10,000	$112.50, plus 5¼% of excess over $5,000.
Over $10,000 but not over $20,000	$375, plus 8¼% of excess over $10,000.
Over $20,000 but not over $30,000	$1,200, plus 10½% of excess over $20,000.
Over $30,000 but not over $40,000	$2,250, plus 13½% of excess over $30,000.
Over $40,000 but not over $50,000	$3,600, plus 16½% of excess over $40,000.
Over $50,000 but not over $60,000	$5,250, plus 18¾% of excess over $50,000.
Over $60,000 but not over $100,000	$7,125, plus 21% of excess over $60,000.
Over $100,000 but not over $250,000	$15,525, plus 22½% of excess over $100,000.
Over $250,000 but not over $500,000	$49,275, plus 24% of excess over $250,000.
Over $500,000 but not over $750,000	$109,275, plus 26¼% of excess over $500,000.
Over $750,000 but not over $1,000,000	$174,900, plus 27¾% of excess over $750,000.
Over $1,000,000 but not over $1,250,000.	$244,275, plus 29¼% of excess over $1,000,000.
Over $1,250,000 but not over $1,500,000.	$317,400, plus 31½% of excess over $1,250,000.
Over $1,500,000 but not over $2,000,000.	$396,150, plus 33¾% of excess over $1,500,000.
Over $2,000,000 but not over $2,500,000.	$564,900, plus 36¾% of excess over $2,000,000.
Over $2,500,000 but not over $3,000,000.	$748,650, plus 39¾% of excess over $2,500,000.
Over $3,000,000 but not over $3,500,000.	$947,400, plus 42% of excess over $3,000,000.
Over $3,500,000 but not over $4,000,000.	$1,157,400, plus 44¼% of excess over $3,500,000.
Over $4,000,000 but not over $5,000,000.	$1,378,650, plus 47¼% of excess over $4,000,000.
Over $5,000,000 but not over $6,000,000.	$1,851,150, plus 50¼% of excess over $5,000,000.
Over $6,000,000 but not over $7,000,000.	$2,353,650, plus 52½% of excess over $6,000,000.
Over $7,000,000 but not over $8,000,000.	$2,878,650, plus 54¾% of excess over $7,000,000.
Over $8,000,000 but not over $10,000,000.	$3,426,150, plus 57% of excess over $8,000,000.
Over $10,000,000	$4,566,150, plus 57¾% of excess over $10,000,000.

2. *Effects of dual tax system*

(*a*) *Inequities.*—The present disparity between the tax on property transferred during lifetime and that imposed on property transferred at death is excessive from the standpoint of tax equity. The magnitude of the favoritism in present law to those that can "afford" lifetime gifts can be seen by comparing gross transfers of $1 million at the top of the estate and gift brackets. At death the 77 percent top rate applies and only $230,000 is transferred to the beneficiary. If this is transferred during life, the top rate is 57.75 percent which is applied to the gift not including the tax. Thus a transfer of approximately $634,000 could be made, the beneficiary getting almost three times as much because the transfer is made during life.

The data show that little use is made of lifetime gifts by those with smaller accumulations of wealth. Rather, lifetime gifts are used by the wealthy to take advantage of the lower gift tax rates, the exemption granted to lifetime gifts, and the smaller tax base that applies to lifetime transfers as compared to deathtime transfers. Table 7 shows that the wealthy transfer a little more than 10 percent of their total wealth accumulations during lifetime. On the other hand, those with small accumulations of wealth transfer less than 2 percent of their property by means of lifetime gifts. Put in another way, table 8 shows that 52 percent of those with large estates make gifts during lifetime. However, only 10 percent of those with small estates made lifetime transfers. These data demonstrate that the present disparity between the tax treatment of lifetime gifts and deathtime transfers confers a very substantial advantage on the wealthy, because the tax advantages of making lifetime gifts become increasingly greater as the size of wealth accumulations increase. The preferential gift treatment thus serves to confer enormous benefits on those whose situation permits utilizing lifetime gifts—generally those who are so prosperous that they do not depend on this wealth and the income it yields for living expenses and security.

TABLE 7.—GROSS TRANSFERS AT DEATH AND DURING LIFE, ALL DECEDENTS, 1957 AND 1959

[Dollar amounts in thousands]

Estate size	Number of decedents	Total amount of gross transfers	Number of decedents making noncharitable transfers during life	Noncharitable gifts	Gift tax paid	Noncharitable bequests	Taxes paid by estate
1957:							
Small	398	$46,333	40	$1,147	$3	$41,388	$2,255
Medium	876	403,544	263	15,311	517	297,411	70,545
Large	1,119	2,787,869	583	154,652	19,999	1,415,053	775,149
1959:							
Small	471	56,318	48	1,509	9	50,331	3,084
Medium	968	461,536	299	21,579	884	341,359	78,363
Large	1,137	2,706,969	636	180,933	21,063	1,437,266	675,591

Source: Special program study, 1957–59; table printed in Carl Shoup's, Federal Estate Gift Taxes.

TABLE 8.—GROSS TRANSFERS DURING LIFE AND AT DEATH, PERCENTAGES. ALL DECEDENTS, 1957 AND 195

[Dollar amounts in thousands]

Estate size	Number of decedents	Amount of gross transfers	Noncharitable lifetime gifts		Taxes	
			Number of estates reporting	As a percentage of gross transfers	Gift tax paid as a percentage of noncharitable gifts	Estate tax paid as a percentage of noncharitable bequests
1957:						
Small	398	$46,333	10.0	2.5	0.3	5.4
Medium	876	403,544	30.0	3.8	3.4	23.7
Large	1,119	2,787,869	52.1	5.5	12.9	54.8
1959:						
Small	471	$56,318	10.2	2.7	.6	6.1
Medium	968	461,536	30.9	4.7	4.1	23.0
Large	1,137	2,706,969	55.9	6.7	11.6	47.0

(*b*) *Pressures to use certain patterns of disposition.*—Not only do the foregoing effects produce inequity for taxpayers with relatively smaller wealth holdings but also they operate as powerful pressures to make particular family dispositions, even though an entirely different disposition might be desired for nontax reasons.

(*c*) *Complexity.*—The present dual tax structure also produces a "gray" area in which extremely complex rules have developed. In many situations both gift and estate taxes are incurred, with a credit being given for the gift taxes paid. This hybrid form of tax treatment results from highly refined concepts of what constitutes "ownership" for tax purposes, concepts which are often necessary to prevent gross evasion of the estate tax and to recognize the economic reality of property control and enjoyment.

(*d*) *Two sets of exemptions.*—Two sets of exemptions are provided, one for transfers during life and a separate one for transfers at death. The person whose holdings and family disposition patterns permit lifetime transfers can thus arrange to use both exemptions, whereas a person with different holdings or disposition patterns may be able to utilize only the exemption for deathtime transfers.

(*e*) *Different tax bases.*—The gift tax is imposed on a different and smaller tax base than is the estate tax. This results from the fact that the estate tax is paid, and properly so, out of the property transferred whereas the gift tax is paid out of other property of the donor. Thus, the amount used to pay the gift tax is removed from the transfer tax base, although this result does not apply in the case of the estate tax. For example, if a taxpayer dies with an estate of $10 million, the estate tax is $6,088,200 and the heirs will receive slightly less than $4 million. If the entire estate were transferred prior to death, the taxpayer would be able to transfer slightly more than $7 million, retaining approximately $3 million for payment of the gift tax on that amount. In this case, 75 percent more of the wealth can be retained by transferring it before death than if it were to be held until death.

As noted above, tables 7 and 8 demonstrate that the advantages conferred on lifetime giving as compared to deathtime transfers—lower rates, additional exemption, and smaller tax base—are utilized by the wealthy much more than by persons with modest estates. This is because the present system is structured to increase the tax benefits that result from lifetime gifts as a person's wealth increases.

D. GENERATION SKIPPING

For the estate tax to be equally distributed, it should apply to the entire amount of property available for distribution from one generation to the next generation. However, under present law, enormous tax savings can be realized by the wealthy by transferring property through several generations in a form that will avoid tax upon the expiration of each intervening generation. Thus, a donor can set up a trust providing for ultimate disposition of his property to his great-grandchildren. His children and grandchildren can be given the benefit of the income from that property and, indeed, the property itself under specified circumstances, without any transfer tax being imposed as the children and grandchildren each succeed to the enjoyment of the property. Persons of relatively modest means are usually not able to take advantage of these tax-skipping transfers. As a consequence, the great-grandchildren of the less wealthy receive their property reduced by transfer taxes as it is passed through each generation, whereas great-grandchildren of the wealthy receive the property undiminished by transfer taxes.

The data bearing on generation-skipping transfers are summarized in table 9. Those decedents whose gross estates were under $300,000 made transfers to persons, outright and in trust, amounting to $4.4 billion; of these transfers, only 9.4 percent are estimated to be generation skipping; among decedents with gross estates of $1 million or more, however, 25.4 percent of transfers to persons were generation skipping. This marked tendency of wealthier decedents to more frequently utilize generation-skipping transfers, particularly in trust, can be further illustrated by the following comparison: Among husband decedents with estates below $500,000 who bequeathed to family trusts, 77 percent bequeathed to trusts that were not generation skipping; but among husband decedents with estates over $2 million who bequeathed to family trusts, only 25 percent bequeathed to trusts that were not generation skipping, and 60 percent made their trust bequests entirely in generation-skipping form.

TABLE 9.—PROPORTION OF TOTAL NONCHARITABLE TRANSFERS SKIPPING A GENERATION, BY ESTATE SIZE AND TYPE OF DISPOSITION

[Dollar amounts in millions]

Gross estate size (in thousands of dollars)	Gross transfers [1] (1)	Transfer tax (2)	Noncharitable transfers (1−2)	Generation skipping transfers [2]: Total: Amount	Total: Percent of noncharitable transfers	Not in trust: Amount	Not in trust: Percent of noncharitable transfers	In trust: Amount	In trust: Percent of noncharitable transfers
Under 300	$4,574	$219	$4,355	$410	9.4	$158	3.6	$252	5.8
300 to 1,000	3,649	470	3,179	533	16.7	157	4.9	376	11.8
1,000 and over	4,502	1,089	3,413	868	25.4	225	6.6	643	18.8

[1] Total value of noncharitable transfers made during life and at death plus the amount of transfer taxes paid.

[2] A special study prepared by IRS identified remaindermen of trusts as children, grandchildren, great grandchildren, other relatives and nonrelatives (as well as additional categories not here relevant such as charity, brothers and sisters, etc.). Thus, the bequests to lineals could be clearly distinguished between generation skipping and others. For other, relatives and nonrelatives it was necessary to look to dispositions to lineals to estimate the likely portion of bequests to other relatives and nonrelatives that were generation skipping. With regard to direct bequests to lineals the portion that was generation skipping was 5 percent below $300,000, 10 percent from $300,000 to $1,000,000, and 15 percent above $1,000,000. For trust remaindermen the portion generation skipping among lineals was 33 percent below $300,000, 50 percent from $300,000 to $1,000,000, and 75 percent above $1,000,000.

Source: IRS, "Special Tabulation on Estate and Gift Tax Returns, 1957–59."

E. CHARITABLE TRANSFERS

Present rules with respect to estate and gift-tax treatment of charitable transfers produce inequity and tend to reduce progressivity. Present artificial rules of legal ownership permit the creation of split interest trusts whereby the donor or an estate can obtain a present deduction in an amout in excess of that which the charity will actually receive from the gift or bequest. 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. In such circumstances, the trust property is clearly being invested for the benefit of the donor's family to the detriment of the charitable interest.

In addition, under present rules, the operation of the charitable deduction can increase the amount of the marital deduction simply by the form in which the transfer is cast. Thus, a person can transfer property to a charity, retaining complete enjoyment and control of the property for his lifetime. While this property is included in his estate for estate tax purposes, the only effect is to increase the amount of property that can pass tax free under the marital deduction. There is no increase in estate tax liability because the full value of the charitable transfer is deductible for estate tax purposes.

F. ESTATE TAX RATE STRUCTURE

Present estate tax rates in many respects run counter to progressivity. The rates move from 3 percent to 25 percent for the first $50,000 of taxable estate. (See table 5.) Yet, the rates do not go higher than 32 percent until a taxable estate of $500,000 is reached. To be consistent with progressivity, the estate tax rates should be spread in more uniform brackets on taxable estates up to $500,000.

In addition, the structure and level of rates should be examined in light of changes to deal with other problems so that the overall burden on transfers, including that involved in any change in the income taxation of appreciation transferred at death, is appropriate.

G. ILLIQUID ESTATES

Estates which contain farms or closely held businesses sometimes encounter difficulty in finding the cash needed to pay the Federal taxes which become due shortly after death. This can result in different disposition patterns than would have been selected had sufficient cash been available to pay the Federal tax on the transfer at death. These problems can be alleviated by permitting tax free interspousal transfers and by easing rules for payment of taxes for estates consisting largely of farms or closely held businesses.

IV. Specific Reform Proposals

A. TAXATION OF APPRECIATION OF ASSETS TRANSFERRED AT DEATH OR BY GIFT

An income tax on appreciation in value of property transferred at death or by gift would be imposed. Generally, gains (or losses) on assets held at death would be subject to a tax as long term capital gains (or losses); however, appreciation and depreciation in value occurring before the date of enactment would not be considered. Any income tax due on such gains would be deductible in computing the transfer tax base (i.e., the value of the estate). The exclusions that apply to the unified transfer tax (unlimited marital deduction, orphan exclusion, and charitable exclusions) would also apply to exempt gains on property transferred to those beneficiaries. In addition, a "minimum basis rule" is proposed which would generally exempt appreciation from tax in smaller estates. Data on the operation of the proposal for taxing appreciation on property transferred at death or by gift are set forth in table 10, which show the effects of the proposal after full implementation.

TABLE 10.—DATA ON THE OPERATION OF THE PROPOSAL FOR TAXING GAINS AT DEATH, 1981 [1]

Economic estate class (in thousands of dollars)	Percent of estate of appreciable assets [2]	Percent of appreciation [3]	Appreciation as percent of economic estate	Net capital gains tax as percent of economic estate [4]	Net capital gains tax as percent of present law estate tax after credits
60 to 100	62	20	12.3	0.7	84.0
100 to 200	67	22	14.5	1.4	30.0
200 to 400	75	23	17.4	1.6	15.2
400 to 600	78	25	19.7	1.9	12.9
600 to 1,000	80	27	21.4	2.2	13.3
1,000 to 2,000	83	30	24.5	2.6	13.5
2,000 to 3,000	82	32	26.2	2.7	12.4
3,000 to 5,000	83	35	29.1	2.9	12.0
5,000 and up	86	37	32.2	2.8	11.7

[1] Assume an effective date of Jan. 1, 1970.

[2] Includes stock, real estate, trust interests, and noncorporate business assets. The economic estate is gross estate less debts.

[3] This takes into account the observed patterns that appreciation rates and holding period are higher at the upper wealth levels plus some shifting asset composition. (E.g., the personal residence with a low appreciation rate is more important at low wealth levels.)

[4] This takes into account 4 factors: (a) the tendency for applicable capital gain rates to be higher at upper wealth levels, (b) the deduction for contributions which is higher at upper wealth levels, (c) the deduction of marital bequests which is greater at lower wealth levels, and (d) the deduction of the capital gains tax against the estate tax (at 1960 rates) which is more valuable at higher wealth levels.

B. TAX-FREE TRANSFERS BETWEEN HUSBAND AND WIFE

The present 50-percent limitation on the marital deduction for transfers to a spouse would be removed, thus permitting transfers between spouses to be made free of transfer tax. The marital deduction would also be expanded to cover gifts of income interests. These changes would greatly simplify the transfer tax law by recognizing that most married couples regard themselves as a single economic unit within which individual title to property is not significant and by eliminating transfer tax consequences from shifts of property within that economic unit.

C. UNIFICATION OF ESTATE AND GIFT TAXES

Instead of the present separate gift and estate taxes, a single cumulative tax rate schedule would be applied to all transfers of property whether made during life or at death. This would include a single exemption for all transfers during life and at death. Table 11 shows the tax change due to elimination of the present double exemption accorded lifetime and deathtime transfers.

TABLE 11.—TAX CHANGE DUE TO UNIFICATION UNDER A $60,000 EXEMPTION, ALL DESCENDANTS

Gross transfer class (in thousands of dollars)	Unification: Percent of tax	Unification: Percent of transfer	Gross transfer class (in thousands of dollars)	Unification: Percent of tax	Unification: Percent of transfer
Below 100	5.0	0.05	750 to 1,000	5.9	1.2
100 to 150	8.7	.3	1,000 to 1,500	5.3	1.2
150 to 200	6.1	.5	1,500 to 2,000	6.4	1.5
200 to 300	7.2	.7	2,000 to 3,000	6.1	1.7
300 to 400	5.8	.8	3,000 to 5,000	8.0	2.4
400 to 500	4.8	.8	5,000 to 10,000	7.5	2.5
500 to 750	6.9	1.3	Over 10,000	11.0	4.1

D. TAXATION OF GENERATION SKIPPING

A substitute tax would be imposed to reach certain transfers which, by passing property to a distant generation, presently avoid the taxes which would have been imposed had the property passed outright to each intervening generation.

E. RATE REDUCTION AND REVISION

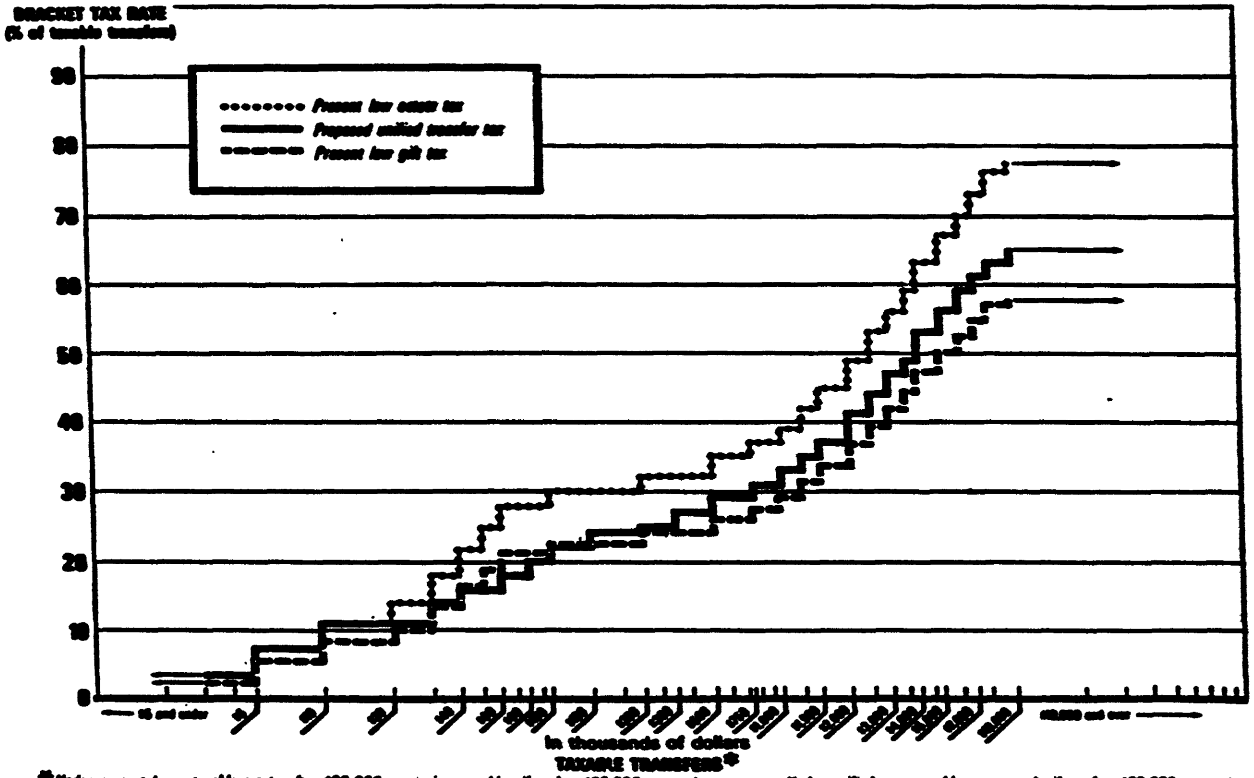
Reductions in the present level of estate tax rates are proposed which would take place in month-to-month steps over a 10-year period. The new single set of rates would apply both to lifetime and deathtime transfers. In addition, structural revisions in the width of the brackets would be made to improve the structure of the rate tables (see table 11A). Chart I shows the relationship between the new unified transfer tax rates and the present separate estate and gift tax rates.

TABLE 11A.—STRUCTURAL REVISIONS OF SELECTED ESTATE TAX BRACKETS

Taxable estate bracket (in thousands of dollars)	Present rate	Rate after basic "20 percent of net Federal tax" reduction	Structrual change	New rate
30 to 40	18	14.4		14
40 to 50	22	17.8	−2	16
50 to 60	25	20.2	−4	16
60 to 80	28	22.6	−5	18
80 to 100	28	22.6	−3	20
100 to 150	30	24.2	−2	22
150 to 250	30	24.2	0	24
250 to 350	32	26.2	−1	25
350 to 500	32	26.2	+1	27
500 to 750	35	28.9	0	29

CHART I

UNIFIED TAX SCHEDULE COMPARED WITH PRESENT ESTATE & GIFT TAX RATES



*Under present law: taxable estate after $60,000 exemption, taxable gifts after $30,000 exemption. Under unified tax: taxable estate and gifts, after $60,000 exemption.

F. LIBERALIZATION OF PAYMENT RULES

Provision is made for liberalization of the present rules governing the deferral of payment of transfer taxes in cases where estates include interests in a closely held business or farm. Special deferred payment provisions would also apply in these cases to the capital gain tax incurred as a result of transfer of appreciated property at death.

G. TECHNICAL REVISIONS

There are a number of technical revisions dealing with the taxation of powers of appointment, jointly owned property, life insurance, employee death benefits, deductions and disclaimers.

V. EFFECTS OF PROPOSALS

The effect of the proposals on transfers of property by gift or at death are summarized in tables 13 and 14 for married and nonmarried transferors.

TABLE 13. ESTIMATED CHANGES IN EFFECTIVE RATES OF TRANSFER TAX UNDER THE PROPOSED PROGRAM, BY SIZE OF GROSS TRANSFERS DURING LIFE AND AT DEATH; MARRIED TRANSFERORS [1]

[Percent of gross transfers]

Size of gross transfers during life and at death (in thousands of dollars)	Effective tax rate under present law	Combined effects of proposed program [2]	Changes in effective transfer tax rates due to proposal to—								
			Reduce rates	Accomplish structural revisions—				Increase future transfer taxes			
				Total	Provide unlimited marital deduction [3]	Tax on appreciated transfers at death	Unify transfer taxes	Total discounted to date of taxpayer's death	Incurred by surviving spouse due to [3]		Substitute tax on generation skipping transfers
									Increased inheritance	Tax on appreciated transfers	
Below 100	0.3	+0.6	(4)	−0.1	−0.2	+0.1	(4)	+0.7	+0.2	+1.3	(4)
100 to 200	2.1	+.2	−0.2	−1.0	−1.6	+.4	+0.2	+1.4	+.8	+2.0	(4)
200 to 400	7.4	−1.9	−.6	−3.7	−4.8	+.7	+.4	+2.4	+2.7	+2.0	+0.2
400 to 600	11.8	−1.3	−1.2	−4.6	−6.2	+.8	+.8	+4.5	+6.0	+2.2	+.8
600 to 1,000	14.6	−.8	−1.6	−4.3	−6.4	+.9	+1.2	+5.1	+6.0	+2.5	+1.8
1,000 to 2,000	17.2	+.1	−2.2	−3.7	−6.5	+1.2	+1.6	+6.0	+7.3	+2.7	+2.0
2,000 to 3,000	20.6	+.4	−2.9	−2.4	−5.8	+1.5	+1.9	+5.7	+6.9	+2.4	+2.2
3,000 to 5,000	22.3	+1.6	−3.2	−1.3	−5.3	+1.8	+2.2	+6.1	+6.9	+2.4	+3.0
5,000 and over	22.2	+2.6	−3.3	+.4	−4.0	+1.9	+2.5	+5.5	+6.0	+1.8	+3.2

[1] The estimates in this table relate to the cases of married taxpayers survived by their spouses. To facilitate a comparison of the proposed program with present law, tax liabilities are evaluated at the time of the taxpayer's death and relate only to the transfers made by him during his life and at his death.

[2] These estimates reflect the full force of all the proposals. During the transition period which has been recommended for reducing transfer tax rates, the indicated increases would nevertheless be smaller, the indicated decreases larger, due to the exclusion of all prior lifetime gifts from the unified transfer tax base and the designation of the date of enactment as the basis date for valuing appreciation of property transferred at death.

[3] These estimates represent the saving to decedents who have utilized the unlimited marital deduction in order to maximize the wealth holdings of their surviving spouses, averaged among all married decedents. The saving in this column is achieved at the death of the first spouse, and since it is implicit in this wealth devolution pattern that the two spouses regard the family wealth as a unitary estate for their joint and common support, the subsequent increase in transfer tax which occurs on the death of the second spouse is shown separately as a future effect of the proposed program.

[4] Less than 0.05 percent.

TABLE 14.—ESTIMATED CHANGES IN EFFECTIVE RATES OF TRANSFER TAX UNDER THE PROPOSED PROGRAM BY SIZE OF GROSS TRANSFERS DURING LIFE AND AT DEATH; NONMARRIED TRANSFERORS [1]

[Percent of gross transfers]

Size of gross transfers during life and at death (in thousands of dollars)	Effective tax rate under present law	Combined effects of proposed program	Changes in effective transfer tax rates due to proposal to: Reduce rates	Accomplish structural revisions: Total	Accomplish structural revisions: Provide unlimited marital deduction [2]	Accomplish structural revisions: Tax on appreciated transfers at death	Accomplish structural revisions: Unify transfer taxes	Include substitute tax on generation skipping transfers: Discounted	Include substitute tax on generation skipping transfers: When paid
Below 100	1.1	+1.4	−0.1	+1.5	(3)	+1.4	+0.1	(3)	(3)
100 to 200	8.8	+1.0	−2.4	+3.1	−0.2	+2.4	+.9	+0.3	+0.7
200 to 400	16.7	+.1	−4.2	+3.5	−.3	+2.7	+1.1	+.8	+1.7
400 to 600	21.9	+.8	−4.4	+3.9	−.4	−3.0	+1.3	+1.3	+2.6
600 to 1,000	24.0	+1.3	−4.8	+4.7	−.5	+3.4	+1.8	+1.4	+2.9
1,000 to 2,000	26.4	+2.4	−4.9	+5.5	−.5	+3.8	+2.2	+1.8	+3.7
2,000 to 3,000	28.4	+3.2	−4.9	+5.8	−.6	+3.9	+2.5	+2.3	+4.6
3,000 to 5,000	33.0	+4.1	−5.4	+6.9	−.7	+4.2	+3.4	+2.6	+5.3
5,000 and over	39.7	+3.4	−6.6	+6.5	−.8	+3.7	+3.6	+3.5	+7.0

[1] The estimates in this table relate to unmarried taxpayers as well as to widows and widowers. To facilitate a comparison of the proposed program with present law, tax liabilities are evaluated at the time of the taxpayer's death and relate only to the transfers made by him during his life and at his death.

[2] These estimates represent the saving attained by widows and widowers who have utilized the unlimited marital deduction for interspousal transfers to divide the family wealth into 2 separately taxed estates, averaged among all decedents included in this table. This saving attributed to the second spouse is put within reach of those spouses who regard the family wealth primarily as a fund to benefit heirs other than themselves by the unlimited marital deduction which enables them to insure that their combined wealth will be taxed at the lowest possible marginal transfer tax rates thereby maximizing the net inheritances of their successors.

[3] Less than 0.05 percent.