Calendar No. 1029

96TH CONGRESS 2d Session } SENATE { REPORT No. 96-940

TAX REDUCTION ACT OF 1980

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

H.R. 5829

together with

ADDITIONAL VIEWS

SEPTEMBER 15 (legislative day, JUNE 12), 1980.—Ordered to be printed

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CONTENTS

Page

I. Summary 1
II. General Reasons for the Bill 11
III. Revenue Effects of the Bill 14
IV. Explanation of the Bill 22
A. Duty-free entry of bells 22
B. Individual income tax reductions 22
1. Overview 22
2. Reduction in tax rates and increase in zero bracket amount 26
3. Increase in the personal exemption 30
4. Changes in filing requirements and withholding 31
5. Changes in earned income credit 32
6. Deduction for two-earner married couples 34
C. Capital formation and productivity tax reductions 39
1. Corporate income tax rates 39
2. Depreciation and investment tax credit revisions 41
a. Simplified cost recovery 41
b. Expensing in lieu of cost recovery for small business 58
c. Depreciation of real property 62
d. Revision of progress expenditure rules 70
e. Investment credit for rehabilitation expenditures 75
3. Other provisions affecting small business 77
a. Increase in minimum accumulated earnings credit 77
b. Increase in used property qualifying for regular investment tax credit 79
c. Subchapter S corporations allowed 25 shareholders 80
d. Incentive stock options 81
e. Time for furnishing form W–2 to terminated employees 85
f. Reserves for market-making activities 87
g. Deferred application of Revenue Procedure 80–5 and Revenue Ruling 80–60 relating to inventory writedowns 89
h. Refund of excise tax for certain fuels used in intercity, local, and school buses 90

IV. Explanation of the Bill—Continued
C. Capital formation—Continued | Page
4. Credit for research and experimental expenditures 92
5. Liberalization of individual retirement savings provisions 101
a. Increase of IRA deduction limitations 102
b. Deduction for certain contributions by active participants in tax-qualified pension, etc., plans 102
6. Employee stock ownership plan tax credit 104
7. Capital gains tax cuts 106
a. Capital gains deduction for individuals 106
b. Corporate alternative tax for capital gains 109
8. Foreign earned income exclusion 111
V. Costs of Carrying out the Bill and Vote of the Committee in Reporting H.R. 5829 117
VI. Regulatory Impact of the Bill and Other Matters to be Discussed Under Senate Rules 118
VII. Changes in Existing Law Made by the Bill, as Reported 120
VIII. Additional Views of Senators Dole, Roth, Danforth, Chafee, Heinz, Wallop, and Durenberger 121
IX. Additional Views of Senator Durenberger 125

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SEPTEMBER 15 (legislative day, JUNE 12), 1980.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.R. 5829]

The Committee on Finance, to which was referred the bill (H.R. 5829) for the relief of the Foundry United Methodist Church, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the bill as amended do pass.

The amendment is shown in the text of the bill in italic.

I. SUMMARY

TARIFF PROVISION

H.R. 5829, as passed the House, permits the duty-free entry of six bronze bells for the use of the Foundry United Methodist Church of Washington, D.C.

The Committee on Finance approved the bill, with an amendment—the Tax Reduction Act of 1980—summarized below.

TAX REDUCTION PROVISIONS

The Tax Reduction Act of 1980 provides tax cuts to accelerate the recovery from the current recession, reduce inequities in the tax system and increase incentives for work, saving and investment. The bill reduces taxes by $18.3 billion in fiscal year 1981 and $38.9 billion in calendar year 1981.[1] More than 40 percent of these tax cuts are specifi-

[1] The $18.3 billion figure for fiscal year 1981 includes $0.1 billion for the refundable part of the earned income credit, which is technically an outlay.

cally targeted to increase capital formation and productivity. The rest is designed to offset the individual income and payroll tax increases which will occur next year.

The principal provisions of the bill include:

- A reduction in individual income tax rates of between one and three percentage points, including a reduction in the bottom rate from 14 to 12 percent and a reduction in the top rate from 70 to 67 percent.
- An increase in the personal exemption from $1,000 to $1,100.
- An increase in the zero bracket amount (which replaced the standard deduction in 1977) by $100 for single persons and $200 for married couples.
- An increase in the earned income tax credit.
- Relief from the marriage tax penalty through a new deduction for two-earner married couples equal to 10 percent of the earnings of the spouse with the lower amount of earnings.
- A revision of depreciation rules, which both simplifies and liberalizes depreciation.
- A reduction in the top corporate income tax rate from 46 percent to 44 percent.
- Cuts in corporate income tax rates in lower tax brackets, which will primarily help small businesses.
- A series of tax changes designed to simplify and reduce taxes on small businesses.
- A 25-percent tax credit for expenditures on research and experimental expenditures in excess of base period levels.
- A wage-based tax credit for employer contributions to employee stock ownership plans as an alternative to the present extra investment credit.
- Introduction of limited employee retirement accounts for persons participating in qualified pension plans and increases in the limits on deductions for contributions to individual retirement accounts.
- An increase in the percentage of long-term capital gains excluded from taxable income from 60 percent to 70 percent, which will reduce the maximum capital gains rate from 28 to 20.1 percent, and a cut in the corporate capital gains tax rate from 28 to 20 percent.
- Liberalization of the exclusion for income earned abroad.

A. Individual Income Tax Cuts

The broad-based individual income tax cuts in the committee's bill total $11.0 billion in fiscal year 1981 and $22.4 billion in calendar year 1981. (In addition, some of the tax cuts targeted to improving capital formation and productivity, described below, will reduce individual income taxes.) Both the overall amount and the distribution by income class of the tax cut are approximately the same as the sum of the payroll tax increases scheduled to take effect next year and the income tax increases resulting from inflation. The tax cut will become effective on January 1, 1981.

1. Rate reductions

The principal individual income tax cut in the bill is a reduction in income tax rates. Each income tax bracket receives a rate cut of between 1 to 3 percentage points. The lowest tax rate is reduced from 14 percent to 12 percent, and the top rate is reduced from 70 percent to 67 percent. This will be the first across-the-board rate reduction since 1964. The revenue loss will be $7.9 billion in fiscal year 1981 and $12.8 billion in calendar year 1981.

2. Personal exemption

The bill increases the personal exemption from $1,000 to $1,100. This increase includes both the exemptions which taxpayers may claim for themselves and their dependents and the extra exemptions for the blind and the elderly. The revenue loss will be $1.7 billion in fiscal year 1981 and $4.8 billion in calendar year 1981.

3. Zero bracket amount

The bill increases the zero bracket amount (formerly the standard deduction) from $2,300 to $2,400 for single persons and from $3,400 to $3,600 for married couples who file joint returns. The revenue loss will be $1.0 billion in fiscal year 1981 and $1.5 billion in calendar year 1981.

4. Earned income credit

The bill increases the earned income credit from 10 percent of the first $5,000 of earnings to 11 percent of that amount. In addition, it extends the phaseout of that credit from the income range between $6,000 and $10,000 of income to the range between $7,000 and $11,000 of income. This increase involves tax cuts and outlays of $0.1 billion in fiscal year 1981 and $0.6 billion in calendar year 1981.[2]

5. Marriage penalty

An important innovation in the committee's bill is a provision designed to alleviate the tax penalty which results when two people with relatively equal incomes marry each other. The bill provides a new deduction for two-earner married couples equal to 10 percent of the first $30,000 of earnings of the spouse with the lower amount of earnings (5 percent in 1981). This will substantially alleviate the marriage penalty and reduce the disincentives to work which result from the high tax rates applicable to a second earner's earnings because these earnings are stacked on top of the other spouse's income. The revenue loss will be $0.3 billion in fiscal year 1981, $2.7 billion in calendar year 1981 and $6.4 billion in calendar year 1982.

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[2] To the extent that the earned income tax credit exceeds tax liability, the budget treats it as an outlay.

B. Capital Formation and Productivity Tax Reductions

1. Depreciation and investment credit revisions

a. Changes in the depreciation of personal property

The bill includes a major liberalization and simplification of the rules for depreciating tangible personal property (e.g., equipment) used in the United States.

Under the committee bill, a new method of depreciating most personal property will be substituted for the present depreciation methods, including the Asset Depreciation Range (ADR) system. Unlike ADR, the new system will be mandatory. Public utility property, however, will continue to use present law, except that the ADR variance for it will be increased from 20 percent to 30 percent.

Under the committee's simplified cost recovery system, tangible personal property will be divided into 5 asset classes, corresponding to tax lives of 2, 4, 7 and 10 years. When a taxpayer places in service tangible personal property, he will add the entire cost of the property to one of four openended recovery accounts, without reduction for the property's estimated salvage value. For assets which have a normal construction period of 2 years or more, progress payments made towards the acquisition of the asset may be added to the appropriate asset account when the payments are made, rather than when the asset actually is placed in service. The system utilizes a half-year convention [3] for all asset costs (including progress payments).

A declining balance method (200 percent, 150 percent or 100 percent, at the election of the taxpayer) will be used to compute each year's depreciation deduction for all assets within a particular open-ended recovery account. The amount of the depreciation for the year will then be subtracted from the amount in the account to establish the balance of the account on which the next year's deduction will be computed. For example, assume the balance in the 4-year recovery account equals $1,000. The taxpayer will choose one of the three fixed percentages for this account (50 percent, 37.5 percent, or 25 percent) and multiply this percentage by $1,000 in order to determine the allowable depreciation for the assets in this account. If the taxpayer elects to apply 50 percent (i.e., the percentage representing 200 percent of the straight-line rate for the 4-year recovery period), the depreciation deduction would be $500. The balance in the account used to determine the depreciation in the next year would be $500, increased or decreased by any additions or subtractions to the account resulting from purchases or sales of assets in the next year.

Generally, no gains or losses will be recognized on the disposition of assets. Instead, the amount realized on the disposition will reduce the balance of the appropriate asset account which, in turn, will reduce

[3] Under the half-year convention, one-half of the asset's cost is placed in the account in the year that the asset is placed in service. The other half of the asset's cost is added to the account in the subsequent year.

the amount of depreciation deductions in the year of the disposition and in subsequent years. If the amount realized from the disposition of assets reduces the balance of the account to a negative amount, however, the taxpayer will have to include the amount of the negative balance as ordinary income.

The bill classifies assets into the four new asset classes based on their ADR guideline period (also called their ADR midpoint life) according to the following schedule:

ADR guideline period:	*Recovery period (years)*
6.5 years or less	2
7.0 years to 11.5 years	4
12.0 years to 16.5 years	7
More than 16.5 years	10

The Treasury Department will be required to publish simplified tables which set forth these shortened lives and the lives for those types of tangible personal property not now covered by the ADR system.

This new depreciation system will significantly simplify depreciation of tangible personal property for both taxpayers and the Internal Revenue Service. First, it will reduce the number of different asset classes for tangible personal property (other than public utility property) from nearly 100 under the ADR system to four. Second, it will eliminate the option to base tax lives on the "facts and circumstances" pertaining to each asset. Third, it will eliminate issues involvng salvage value of equipment. Fourth, it will eliminate "recapture" of depreciation on most sales of tangible personal property. Fifth, it will enable most taxpayers to maintain no more than four permanent depreciation accounts for equipment, instead of the much larger number generally required by the present system.

In addition, the bill greatly simplifies capital cost recovery for small businesses by allowing taxpayers to "expense" (take an immediate deduction for) up to $25,000 of expenditures each year for tangible personal property (new or used).

b. Investment credit modifications

The investment tax credit for assets in the 7- or 10-year accounts will remain at 10 percent. Assets in the 4-year account will be eligible for a 6-percent investment tax credit. Assets in the 2-year account will be eligible for a 2.5-percent investment tax credit. These new percentages will also apply to property which is not subject to the new cost recovery system (primarily public utility property).

No investment tax credit will be allowed for those assets for which an immediate deduction is taken under the $25,000 "expensing" provision.

The committee bill also provides a significant liberalization of the rules which allow the investment credit to be claimed with respect to progress payments for property which takes more than two years to construct.

c. Optional approaches to depreciating real property

The committee bill provides several new elective approaches to depreciation of real property (without eliminating the present methods). First, a taxpayer may elect to depreciate structures over a period of 20 years using the straight-line method and composite depreciation.

(Under composite depreciation, the entire structure must be depreciated over a single life; in contrast, under component depreciation, different parts of the structure are depreciated over different lives.) Second, a taxpayer may elect to depreciate low-income rental housing over 15 years using a straight line method and composite depreciation. Third, certain owner-occupied business structures can be depreciated over a period of 15 years using the 150-percent declining balance method. However, if this last election is made, the recapture rules currently applicable to depreciable personal property will apply. Under these personal property recapture rules, gain on the sale of depreciable property is treated as ordinary income to the extent of prior allowable depreciation deductions. These 15-year and 20-year lives will be audit-proof; i.e., if the taxpayer were to make one of these elections, the useful life could not be challenged by the Internal Revenue Service.

For depreciable real property which has a normal construction period of 2 years or more, progress payments made toward the acquisition of the property may be treated as subject to depreciation in the taxable year when payments are made or amounts are chargeable to capital account, rather than when the building actually is placed in service.

d. Rehabilitation tax credit changes

The present 10-percent rehabilitation tax credit for industrial and commercial structures will be increased to 25 percent for amounts paid or incurred after December 31, 1980. Under present law and under the bill, costs which qualify for the credit are depreciable rehabilitation costs incurred for the interior or exterior renovation, restoration or reconstruction of a building which has been in use for at least 20 years.

e. Effective dates

These provisions generally apply to assets placed in service after December 31, 1980. However, a fiscal year taxpayer with a taxable year which begins in 1980 may elect not to apply the simplified cost recovery system to assets placed in service prior to his first taxable year beginning in 1981. In addition, property placed in service prior to that time can become subject to the system, at the election of the taxpayer, in taxable years beginning after December 31, 1984.

f. Revenue effect

These changes will reduce revenues by $4.3 billion in fiscal year 1981 and $10.1 billion in calendar year 1981.

2. Corporate income tax rates

Under the committee bill, the corporate income tax structure will be modified in 1981 and again in 1982. The effect of the modifications will be to reduce the rates and broaden the brackets generally for small businesses and to reduce the top rate over a 2-year period. Among the rate changes, the lowest rate will decrease from 17 percent to 15 percent, and the highest rate will decrease from 46 percent to 45 percent in 1981 and to 44 percent in 1982. The brackets are also revised, as set forth below.

Present law corporate tax brackets and rates are as follows:

Taxable income	*Tax rate (percent)*
$0 to $25,000	17
$25,000 to $50,000	20
$50,000 to $75,000	30
$75,000 to $100,000	40
Over $100,000	46

For 1981, the brackets and rates will be as follows:

Taxable income	*Tax rate (percent)*
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $100,000	30
$100,000 to $150,000	40
Over $150,000	45

Beginning in 1982, the brackets and rates will be as follows:

Taxable income	*Tax rate (percent)*
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $75,000	25
$75,000 to $100,000	30
$100,000 to $150,000	35
$150,000 to $200,000	40
Over $200,000	44

These changes will reduce revenues by $1.0 billion in fiscal year 1981 and $2.2 billion in calendar year 1981. About one-third of this tax cut results from the rate cuts targeted to small businesses.

3. Other provisions affecting small business

In addition to the $25,000 expensing provision and the corporate rate cuts targeted to lower tax brackets, the bill contains the following changes designed to aid small businesses:

- An increase from $150,000 to $250,000 in the minimum accumulated earnings credit under the accumulated earnings tax on corporate income retained beyond the reasonable needs of the business.
- An increase in the maximum amount of used property eligible for the investment tax credit from $100,000 to $150,000.
- An increase in the maximum number of shareholders in a subchapter S corporation from 15 to 25.
- Capital gains treatment for certain incentive stock options.
- A tax incentive to encourage broker-dealers to make markets in stocks of small companies.
- Certain other simplifications of the tax law of interest to small business.

4. Research and development tax credit

The bill provides a nonrefundable income tax credit for research and experimental expenditures to the extent they exceed the average of such expenditures in a base period. The rate of the new credit will be 25 percent of the incremental research expenditure amount. In the case

of an individual or a subchapter S corporation entitled to a credit for research expenditures in a taxable year, no deduction shall be allowed for that portion of research expenditures in the year which is equal to the amount allowable as a credit. The revenue loss will be $0.2 billion in fiscal year 1981 and $0.5 billion in calendar year 1981.

5. Deduction for individual retirement savings

Under present law an employee generally is entitled to deduct amounts contributed to an individual retirement account or individual retirement annuity or used to purchase retirement bonds (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year is generally the lesser of 15 percent of compensation for the year or $1,500. For a "spousal IRA," in which equal contributions are made for both spouses, the deduction limit is $1,750. No IRA deduction is allowed to an individual who is an active participant in a tax-qualified retirement plan, a tax-sheltered annuity, or a governmental plan in a taxable year. Also, employee contributions to retirement plans other than IRAs are not deductible.

The committee bill provides that an active participant in a tax-qualified retirement plan or tax-sheltered annuity will be allowed a deduction for an amount contributed to the plan or to an IRA. The maximum deduction will be the lesser of 15 percent of compensation or $1,000.

In addition, for individuals who are not active participants in tax-qualified plans, etc., the contribution limit for an IRA will be increased from $1,500 to $1,750. The limit for spousal IRAs will be increased from $1,750 to $2,000.

The revenue loss will be $0.3 billion in fiscal year 1981 and $0.6 billion in calendar year 1981.

6. Employee stock ownership plan tax credit

An innovative way to encourage greater productivity is to encourage employees to own stock in the companies for which they work. An employee stock ownership plan (generally called an ESOP) is an employer-maintained tax-exempt trust under which employees share in stock ownership of the employer.

Under present law, an employer is allowed an extra investment tax credit of one-percent for stock contributions to an ESOP plus an extra one-half of one percent if the contributions are matched by equal employee contributions.

The committee bill will permit an employer to claim a tax credit based on a percentage of payroll for contributions to an ESOP. A sponsoring corporation will have the option of claiming either the tax credit based on payroll for employees covered by the plan or the additional investment tax credit provided under existing law. The percentage of payroll eligible for this credit will be as follows:

1981	½ of 1 percent
1982	¾ of 1 percent
1983	1 percent

The wage-based credit, like the additional investment tax credit, will expire December 31, 1983.

The revenue loss will be $0.3 billion in fiscal year 1981 and $0.6 billion in calendar year 1981.

7. Capital gains tax cut

Under present law, noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year. The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's entire net capital gain is 28 percent (70 percent top tax rate times the 40-percent of the capital gain which is taxed). An alternative capital gains tax rate of 28 percent applies to a corporation's net capital gain (in lieu of any capital gains deduction) if that rate is lower than the corporation's regular tax rate. Alternatively, a corporation may elect to pay a tax on the entire gain at its regular tax rate.

The committee bill increases the net capital gain deduction for noncorporate taxpayers from 60 to 70 percent, *i.e.*, 30 percent will be included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's entire net capital gain will be 20.1 percent (67 percent top tax rate under the bill times the 30 percent of the net capital gain which is taxed). The committee bill does not change the present treatment of capital losses.

In the case of corporations, the alternative capital gain tax rate will be reduced from 28 to 20 percent.

The lower rates will apply in the case of gains properly attributable to periods after August 20, 1980. Special rules are provided to determine the period to which gains are properly attributable in the case of pass-through entities.

The revenue loss is expected to be $0.8 billion in fiscal year 1981 and $1.9 billion in calendar year 1981.

8. Foreign earned income exclusion

Under present law, Americans working abroad generally are eligible for deductions intended to reflect the excess costs of living abroad if they were bona fide residents of a foreign country for an entire taxable year or if they were physically present in a foreign country for 510 days (approximately 17 months) out of 18 consecutive months.[4] Taxpayers residing in hardship area camps may claim a $20,000 annual earned income exclusion in lieu of the excess living cost deductions.

The committee bill liberalizes the rules governing the taxation of income earned abroad. The liberalized rules apply to individuals working in developing countries (other than tax havens), regardless of the nature of the services they perform. In addition, the revised rules also apply to individuals working in other foreign countries if those individuals perform charitable, export-related, or natural resource-related services.

For those individuals described above, the committee bill will replace the present system of excess foreign living cost deductions with an exclusion of foreign earned income of $50,000 a year, increasing to $65,000 for individuals residing abroad for more than 2 years. In addition, the exclusion will be increased by the excess of the individual's

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[4] The excess foreign living cost deduction consists of separate excess housing, education, home leave, and general cost of living elements. An additional $5,000 hardship allowance is allowed to taxpayers working in hardship areas.

housing costs over 16 percent of the salary of a Government employee at step 1 of grade GS–14 (the 16-percent figure is currently $5,554). The eligibility requirement of present law will be modified to allow the exclusion for individuals overseas for 11 out of 12 months (or a shorter period where forced to leave because of civil unrest).

Income received for the performance abroad of export-related services, or compensation for employment abroad with an employer (including a branch) substantially all of whose income is derived from the export of U.S. goods or the performance of export-related services will qualify for the exclusion as export-related services. These services include:

(1) construction, architectural, engineering, or repair services performed in connection with agricultural, construction, or engineering projects located in a foreign country,

(2) services associated with the export of U.S. products (including marketing and market analysis, advertising and promotional activities, sales and distribution services, packaging and assembly, warehousing, documentation and customs clearing, and financing), and

(3) any other services performed overseas which are designated by the Secretary of the Treasury (after consultation with the Special Trade Representative and the Secretary of Commerce) as contributing significantly to U.S. exports.

Income received for services performed abroad in the exploration for or extraction of petroleum or other natural resources, or compensation for employment abroad with an employer (including a branch) substantially all of whose income is derived from those activities, will qualify for the exclusion as natural resource-related services. Services performed abroad by an employee for an employer who meets the requirements of section 501(c)(3) will qualify for the exclusion as charitable services.

The revenue loss will be $0.2 billion in fiscal year 1981 and $0.3 billion in calendar year 1981.

II. GENERAL REASONS FOR THE BILL

The committee believes that a tax reduction is needed to stimulate capital formation, productivity and innovation throughout the economy, to offset the personal tax increases which will occur in 1981, and to promote a more substantial economic recovery. In deciding on the specific structure of the tax reduction, the committee attempted to design broadly based tax cuts that improve incentives to earn, produce, save and invest. In deciding on the size of the tax reduction, the committee was concerned that the tax cut be large enough to advance its many objectives, but not so large as to provoke a significant increase in the rate of inflation or to preclude balanced budgets by the mid-1980's.

Most economic forecasters who testified before the committee predicted that the economy will perform badly in the rest of 1980 and in 1981 if there is no change in policy. The real output of the economy is expected to decline by approximately 3 percent in 1980 and then to grow at a slow rate in 1981. Thus, without a change in policy, real output is not expected to reach its early-1980 level again until early 1982. Both the unemployment rate and the inflation rate are predicted to remain at high levels throughout 1981. Among the reasons that were given for expecting a slow economic recovery are several tax increases that are embodied in the 1981 budget, including increases in the individual income tax, the social security tax and the windfall profit tax. The committee believes that these tax increases should be offset by general tax reductions.

Individual Income Tax Reductions

The committee believes that excessively high income taxes on individuals are undesirable because they lessen work incentives, encourage unproductive efforts towards tax avoidance and diminish households' control over the disposition of their earnings. The proportion of household income that is paid in individual income and social security taxes is now greater than at any other time in the last two decades. Moreover, sizable increases in individual income and employee social security taxes are now scheduled to take effect in 1981. First, the rate of social security tax on employers and employees will increase from 6.13 to 6.65 percent, and the maximum amount of earnings subject to that tax will increase by $1,500 more than would result from automatic indexing. The net increase in social security taxes on employees and the self-employed amounts to $8.5 billion. Second, an automatic income tax increase of $15.1 billion will occur from the interaction of inflation and the fixed dollar amounts in the tax law. (About $2.3 billion of this income tax increase has already been offset by the interest and dividend exclusion adopted in the Crude Oil Windfall Profit Tax Act of 1980.) Thus, the net increase in income and payroll taxes in 1981 will amount to about $21 billion. The committee believes that this tax

increase would greatly retard the recovery from the recession by reducing consumer spending and, therefore, should be offset by personal tax reductions.

A second reason for tax reductions is the impact of the income tax in discouraging productive work efforts. High tax rates encourage people to spend their time engaging in nontaxable activities and figuring out ways to avoid taxes. The personal tax reductions in the bill, particularly the reduction in income tax rates, the marriage penalty deduction and the expansion of the earned income credit, are targeted to improve work incentives.

Third, tax changes are needed to reduce, and eventually eliminate, the marriage tax penalty which results when two persons with relatively equal incomes marry each other. Large tax penalties on marriage are bad public policy because they undermine respect for the family and for the tax system itself. The bill, therefore, is designed to achieve significant reductions in the marriage penalty as a step toward completely eliminating it.

The committee concluded that the appropriate size of the tax reduction for individuals is $22 billion for calendar year 1981, approximately the size of the sum of the income and payroll tax increases. This amount of tax reduction balances the many objectives of the bill with the needs to bring the Federal budget more nearly into balance and to avoid an excessive stimulation of consumer spending, which would provoke more inflation. Most of the testimony before the committee indicated that a personal tax reduction of this size would have no more than a small impact on prices.

Capital Formation and Productivity Tax Reductions

The committee believes that tax reductions designed to stimulate capital formation are urgently needed. Business investment in new plant and equipment is crucial for increasing productivity, reducing the rate of inflation, and improving the nation's competitiveness in international trade. Investment spending in excess of what is needed to replace worn-out parts of the existing capital stock has been too small in recent years. In the late 1970's, annual investment for plant and equipment in excess of depreciation (measured in constant dollars) was approximately one-third lower than it had been during the ten preceding years; as a percentage of the gross national product, it was only one-half of its former value. Furthermore, an increasing share of investment spending in the 1970's was for satisfaction of governmentally mandated requirements, uses which serve worthwhile objectives but may not augment production capacity.

Major areas in which the tax system has been criticized as a hindrance to capital formation include its treatment of depreciation and capital gains.

A considerable amount of testimony before the committee maintained that the methods for determining depreciation deductions under current law work against adequate and efficient capital formation. The

committee agrees. The committee therefore structured a new system of capital cost recovery which encourages investment spending overall by providing for more accelerated depreciation (with appropriate modifications of the investment tax credit). The new system applies a more neutral tax treatment to the full range of assets and thereby will lead, not only to more investment, but also to a more productive mix of investment spending. In addition, the new system vastly simplifies paperwork and compliance for taxpayers, especially for small businesses.

The committee believes that reductions in corporate income tax rates are necessary. Income from investments made by incorporated businesses is taxed once under the corporate income tax and again under the individual income tax when shareholders receive dividends or sell appreciated shares. This double taxation, which reduces the supply of funds available for investment spending, will be reduced by the lower corporate income tax rates in the committee's bill. To promote the vitality of small businesses, the five-step graduated rate structure which exists under current law is expanded to a seven-step structure.

The committee believes that the existing capital gains tax discourages investment and sales of appreciated assets to such an extent that it does not yield as much revenue as would result from lower capital gains rates. Furthermore, the capital gains tax is inequitable to the extent that gains are taxed which only represent inflationary increases in value. The committee, therefore, decided to increase to 70 percent the proportion of capital gains which are excludable by noncorporate taxpayers and to reduce to 20 percent the alternative capital gains tax rate for corporate taxpayers. The evidence from the behavior of financial markets after the 1978 capital gains tax cut suggests that a further cut in capital gains taxes will encourage capital mobility and make it easier for new firms to raise equity capital.

The committee also believes that the tax system should encourage the wider use of employee stock ownership plans. These plans encourage employees to invest in the stock of their employer and provide employees with a direct incentive to increase productivity. The bill contains incentives to achieve this goal.

One area in which other nations are rapidly encroaching on what was once a dominant American position is research and development. Research and development is essential to improving productivity. The bill, therefore, contains a major new tax incentive to encourage this activity.

About 40 percent of the tax reductions in the committee bill are specifically targeted towards improving capital formation and productivity. The committee believes that these tax cuts will make a major contribution towards improving economic growth and lowering inflation. They represent a significant, long-overdue redirection of American economic policy.

III. REVENUE EFFECTS OF THE BILL

Tax Reduction Provisions

The revenue effects of the tax provisions of the bill, as reported by the Senate Finance Committee, are presented in two tables. Table 1 shows the revenue effects of the tax provisions on fiscal year budget receipts, while Table 2 depicts these effects on calendar year tax liabilities. The revenue effects are shown by provision and are summarized in two major categories: individual tax cut provisions, and capital formation and productivity tax reductions. In the latter category, separate subtotals are shown for the depreciation and investment credit items, as well as for corporate rate reduction and small business provisions. A memorandum line at the end of the table shows the total of all the provisions that have been designed to benefit primarily small business.

As shown in Table 1, the bill provides a tax reduction of $18.3 billion in fiscal year 1981, $46.7 billion in fiscal year 1982, and $75.5 billion in fiscal year 1985.

On the calendar year basis, the tax reduction is $38.9 billion in 1981, $58.1 billion in 1982, and $80.0 billion in 1985.

Table 3 shows the distribution of the individual income tax provisions (including capital gains) of the bill, at 1979 income levels. 76.5 million returns will receive a $20.5 billion reduction, averaging $268 each.

Tariff Provisions

The tariff provisions of the bill, relating to duty-free entry of bronze bells for the use of the Foundry United Methodist Church, will reduce budget receipts by $2,000 in fiscal year 1981.

Table 1.—Estimated Revenue Effects of Tax Reduction Provisions as Reported by Senate Finance Committee, Fiscal Years 1981–85

[Millions of dollars]

Item	Fiscal year—				
	1981	1982	1983	1984	1985
A. Individual Tax Cut Provisions					
1. Increase in personal exemption	−1, 687	−4, 864	−5, 108	−5, 363	−5, 632
2. Increase in zero bracket amount	−1, 015	−1, 550	−1, 627	−1, 709	−1, 795
3. Increase in earned income credit [1]	−83	−586	−540	−496	−457
4. Deduction for two-earner couples	−325	−3, 385	−6, 890	−8, 416	−9, 772
5. Rate reductions	−7, 926	−14, 312	−17, 288	−20, 920	−25, 060
Total, individual tax cuts	**−11, 036**	**−24, 697**	**−31, 453**	**−36, 904**	**−42, 716**
B. Capital Formation and Productivity Tax Reductions					
1. Depreciation and investment credit revisions:					
a. Depreciation of personal property and revised useful life requirements for investment credit	−2, 139	−8, 854	−14, 192	−14, 935	−16, 001
b. Expensing in lieu of cost recovery for small business	−1, 623	−2, 952	−1, 701	−1, 257	−925
c. Depreciation of real property	−45	−161	−256	−298	−326
d. Revision of progress expenditure rules	−329	−1, 223	−1, 860	−1, 824	−1, 646
e. Investment credit for rehabilitation expenditures	−202	−524	−604	−682	−755
Subtotal, depreciation and investment credit revisions	−4, 338	−13, 714	−18, 613	−18, 996	−19, 653

See footnotes at end of table.

Table 1.—Estimated Revenue Effects of Tax Reduction Provisions as Reported by Senate Finance Committee, Fiscal Years 1981–85—Continued

[Millions of dollars]

Item	Fiscal year—				
	1981	1982	1983	1984	1985
***B. Capital Formation and Productivity Tax Reductions*—Continued**					
2. Corporate rate reduction and small business provisions:					
a. Corporate rate reductions from 46 percent to 45 percent in 1981 and to 44 percent in later years	−676	−2, 367	−3, 653	−4, 184	−4, 750
b. Corporate rate reductions on income below $150,000 in 1981 and below $200,000 in 1982 and later years	−304	−1, 129	−1, 797	−2, 058	−2, 336
c. Increase in accumulated earnings credit	−11	−31	−35	−37	−42
d. Increase in used equipment eligible for investment credit to $150,000	−61	−154	−159	−165	−173
e. Increase in number of subchapter S shareholders to 25	(2)	(2)	(2)	(2)	(2)
f. Incentive stock options	(2)	(2)	(2)	(2)	15
g. Elimination of certain W–2 filing requirements					
h. Reserves for market making activities	−40	−90	−70	−40	−20
i. Deferral of application of revenue ruling on inventory writedowns [3]	−25	(4)	(4)	(4)	(4)

j. Refund of excise tax on certain fuels used in intercity, local and school buses	(5)	(5)	(5)	(5)	(5)
Subtotal, corporate rate reduction and small business	−1, 117	−3, 771	−5, 714	−6, 484	−7, 306
3. Research and development tax credit	−214	−522	−622	−711	−798
4. Retirement savings incentives (IRAs & LERAs)	−291	−725	−922	−1, 099	−1, 236
5. Payroll-based ESOP credit	−286	−995	−2, 011	−1, 642	−266
6. Capital gains tax cut [6]	−799	−1, 935	−2, 262	−2, 632	−3, 043
7. Foreign earned income exclusion	−240	−360	−389	−420	−454
Total, capital formation and productivity tax reductions	**−7, 285**	**−22, 022**	**−30, 533**	**−31, 984**	**−32, 756**
Total, Tax Reduction Provisions	**−18, 321**	**−46, 719**	**−61, 986**	**−68, 888**	**−75, 472**
Memorandum: Tax reduction provisions designed primarily for small business [7]	**−2, 064**	**−4, 356**	**−3, 762**	**−3, 557**	**−3, 481**

[1] These figures include both the reduction in revenues and the increase in outlays from the changes in the earned income credit. The outlays are: $77 million in fiscal year 1981, $541 million in 1982, $497 million in 1983, $458 million in 1984, and $421 million in 1985.

[2] Loss of less than $5 million.

[3] Loss of $25 million in 1981 and a comparable gain in later years, primarily 1990.

[4] Negligible gain.

[5] Negligible loss.

[6] These figures are net of the following revenue generated by increased sales of capital assets: negligible in fiscal year 1981, $648 million in 1982, $524 million in 1983, $375 million in 1984, and $201 million in 1985.

[7] Includes the provision allowing expensing in lieu of cost recovery for small business and provisions (b.–j.) in section B.2.

Table 2.—Estimated Revenue Effects of Tax Reduction Provisions as Reported by Senate Finance Committee, Calendar Years 1981–85

[Millions of dollars]

Item	Calendar year—				
	1981	1982	1983	1984	1985
A. Individual Tax Cut Provisions					
1. Increase in personal exemption	−4, 780	−5, 019	−5, 270	−5, 534	−5, 811
2. Increase in zero bracket amount	−1, 499	−1, 574	−1, 653	−1, 736	−1, 823
3. Increase in earned income credit [1]	−593	−546	−502	−462	−425
4. Deduction for two-earner couples	−2, 711	−6, 404	−7, 774	−9, 368	−11, 148
5. Rate reductions	−12, 784	−15, 249	−18, 538	−22, 381	−26, 702
Total, individual tax cuts	**−22, 367**	**−28, 792**	**−33, 737**	**−39, 481**	**−45, 909**
B. Capital Formation and Productivity Tax Reductions					
1. Depreciation and investment credit revisions:					
a. Depreciation of personal property and revised useful life requirements for investment credit	−4, 948	−13, 984	−14, 467	−15, 550	−16, 593
b. Expensing in lieu of cost recovery for small business	−3, 756	−1, 897	−1, 443	−1, 011	−811
c. Depreciation of real property	−108	−235	−290	−308	−351
d. Revision of progress expenditure rules	−761	−1, 828	−1, 901	−1, 722	−1, 547
e. Investment credit for rehabilitation expenditures	−489	−573	−647	−731	−788

Subtotal, depreciation and investment credit revisions	−10, 062	−18, 517	−18, 748	−19, 322	−20, 090
2. Corporate rate reduction and small business provisions:					
a. Corporate rate reductions from 46 percent to 45 percent in 1981 and to 44 percent in later years	−1, 503	−3, 422	−3, 936	−4, 487	−5, 070
b. Corporate rate reductions on income below $150,000 in 1981 and below $200,000 in 1982 and later years	−675	−1, 684	−1, 936	−2, 207	−2, 494
c. Increase in accumulated earnings credit	−30	−33	−36	−40	−44
d. Increase in used equipment eligible for investment credit to $150,000	−151	−157	−163	−169	−176
e. Increase in number of subchapter S shareholders to 25	(2)	(2)	(2)	(2)	(2)
f. Incentive stock options	(2)	(2)	(2)	(2)	20
g. Elimination of certain W–2 filing requirements					
h. Reserves for market making activities	−90	−80	−50	−30	−20
i. Deferral of application of revenue ruling on inventory writedowns [3]	(4)	(4)	(4)	(4)	(4)
j. Refund of excise tax on certain fuels used in intercity, local and school buses					
Subtotal, corporate rate reduction and small business	−2, 449	−5, 376	−6, 121	−6, 933	−7, 784

See footnotes at end of table.

Table 2.—Estimated Revenue Effects of Tax Reduction Provisions as Reported by Senate Finance Committee, Calendar Years 1981–85—Continued

[Millions of dollars]

Item	Calendar year—				
	1981	1982	1983	1984	1985
***B. Capital Formation and Productivity Tax Reductions*—Continued**					
3. Research and development tax credit	−475	−580	−673	−758	−846
4. Retirement savings incentives (IRAs & LERAs)	−617	−835	−1, 016	−1, 185	−1, 294
5. Payroll-based ESOP credit	−636	−1, 433	−2, 717	−328	−190
6. Capital gains tax cut [5,6]	−1, 917	−2, 243	−2, 611	−3, 020	−3, 373
7. Foreign earned income exclusion	−345	−373	−402	−435	−469
Total, capital formation and productivity tax reductions	**−16, 501**	**−29, 357**	**−32, 288**	**−31, 981**	**−34, 046**
Total, Tax Reduction Provisions	**−38, 868**	**−58, 149**	**−66, 025**	**−71, 462**	**−79, 955**
Memorandum: Tax reduction provisions designed primarily for small business [7]	**−4, 702**	**−3, 851**	**−3, 628**	**−3, 457**	**−3, 525**

[1] The figures include both the reduction in revenues and the increase in outlays from the changes in the earned income credit. The outlays are: $547 million in calendar year 1981, $503 million in 1982, $463 million in 1983, $426 million in 1984 and $392 million in 1985.

[2] Loss of less than $5 million.

[3] Loss of $25 million in 1979 and a comparable gain in later years, primarily 1989.

[4] Negligible gain.

[5] These figures are net of the following revenue generated by increased sales of capital assets: $648 million in calendar year 1981, $524 million in 1982, $375 million in 1983, $201 million in 1984, and $100 million in 1985.

[6] This provision also has a calendar 1980 revenue loss of $506 million.

[7] Includes the provision allowing expensing in lieu of cost recovery for small business and provisions (b.–j.) in section B.2.

Table 3.—Distribution of Individual Income Tax Provisions of the Tax Reduction Act of 1980 (H.R. 5829)

(1979 income levels; dollars in millions; returns in thousands)

Expanded income class [1]	Tax reduction excluding capital gains [2]			Capital gains reduction [3]			Tax reduction including capital gains		
	Returns	Reduction	Average reduction per return (dollars)	Returns	Reduction	Average reduction per return (dollars)	Returns	Reduction	Average reduction per return (dollars)
Under $5,000	6,981	$269	$39	41	$1	$13	6,981	$270	$39
$5,000–$10,000	17,307	1,982	115	354	5	14	17,307	1,987	115
$10,000–$15,000	14,256	2,227	156	569	16	28	14,256	2,243	157
$15,000–$20,000	11,811	2,490	211	607	30	49	11,811	2,520	213
$20,000–$30,000	15,695	4,763	303	1,031	96	93	15,695	4,859	310
$30,000–$50,000	8,001	4,271	534	1,003	178	177	8,001	4,449	557
$50,000–$100,000	1,999	1,797	899	530	262	494	1,999	2,059	1,034
$100,000–$200,000	345	443	1,284	141	222	1,574	345	665	1,927
Over $200,000	91	395	4,341	51	1,073	20,904	91	1,468	16,201
Total	76,486	18,637	244	4,328	1,883	435	76,486	20,520	268

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

[2] Includes the impact of rate reductions, increase in zero bracket amount, increase in personal exemption, and change in the earned income credit.

[3] Includes a 70 percent exclusion and a 20 percent maximum rate for the alternative minimum tax.

NOTE.—Details may not add to totals owing to rounding.

IV. EXPLANATION OF THE BILL

A. DUTY-FREE ENTRY OF BELLS

H.R. 5829, as passed by the House and the corresponding section of the committee bill (sec. 401), direct the Secretary of the Treasury to admit free of duty six bronze bells, including all parts and accessories, from the Ruetschi Bell Foundry of Aarau, Switzerland, for the use of the Foundry United Methodist Church of Washington, D.C.

The bill requires reliquidation of the entry within 90 days after enactment of the bill and appropriate refund of the duty, notwithstanding section 514 of the Tariff Act of 1930, if liquidation of the entry for consumption on any of these articles has become final.

The column 1 (MFN) rate of duty on imports of sets of tuned bells containing not over 22 bells is currently 4.8 percent ad valorem. Imports from beneficiary developing countries are eligible for duty-free treatment under the generalized system of preferences.

B. INDIVIDUAL INCOME TAX REDUCTIONS

1. Overview

In shaping the individual income tax reductions contained in this bill, the committee gave particular attention to two factors: (1) the impact of scheduled 1981 tax changes and (2) the need to reduce marginal rates of taxation (i.e., the tax rate applicable to the last dollar of a taxpayer's income), particularly for married couples in which both spouses work.

Tax increases in 1981

Three significant personal tax changes are scheduled to go into effect in 1981: the income tax increase resulting from inflation, the income tax decrease resulting from the $200 interest and dividend exclusion enacted in the Crude Oil Windfall Profit Tax Act of 1980, and the increase in social security taxes. The individual income tax cuts contained in the committee's bill are so designed that each income class receives a tax cut approximately equal to the tax increases which result from these three changes.

Inflation causes increases in income taxes because price increases erode the real value of the personal exemption, the zero bracket amount, the dollar limits which set the amount of taxable income which is taxed at each tax rate, and the figures which determine eligibility for, and the amount of, the earned income credit. The total increase in tax liability resulting from inflation between 1980 and 1981 will be about $15.1 billion. Because $2.3 billion of this increase will be offset by the $200 interest and dividend exclusion, the net increase in individual income tax liability will be $12.8 billion.

The social security payroll tax on employees is scheduled to rise in January 1981 from 6.13 percent of the first $25,900 of wages to 6.65 percent of the first $29,700 of wages. For the self-employed, the rate is scheduled to rise from 8.1 percent to 9.3 percent. (The maximum amount of earnings subject to tax for the self-employed is the same as for employees.) The increase in the maximum taxable wage base beyond the level necessary to match the increase in average wages (approximately $28,200) and the increase in the tax rate will increase the social security tax liability of employees and self-employed persons by about $8.5 billion in 1981. Allowing these tax increases to go into effect is essential in order to maintain the financial soundness of the social security system; however, the onerous burden of these increases on taxpayers and the overall economic situation make it imperative that they be offset by reductions in the income tax.

Table 1.—Composition of Tax Increases Scheduled Under Current Law and Tax Decreases Provided Under Committee Bill

[1979 income levels, millions of dollars]

Expanded income class [1]	Tax increases scheduled under current law			Tax decreases under committee bill [3]		
	Self-employment and employee social security taxes [2]	Individual income tax increase from inflation minus decrease from interest exclusion	Total	Total	Tax returns affected (thousands)	Average decrease per return (dollars)
Under $5,000	286	176	462	269	6, 981	$39
$5,000 to $10,000	636	1, 252	1, 888	1, 982	17, 307	115
$10,000 to $15,000	852	1, 196	2, 048	2, 227	14, 256	156
$15,000 to $20,000	1, 009	1, 327	2, 336	2, 490	11, 811	211
$20,000 to $30,000	1, 946	2, 615	4, 561	4, 763	15, 695	303
$30,000 to $50,000	1, 664	2, 504	4, 168	4, 271	8, 001	534
$50,000 to $100,000	446	1, 435	1, 881	1, 797	1, 999	899
$100,000 to $200,000	77	403	480	443	345	1, 284
Over $200,000	20	135	155	395	91	4, 341
Total	6, 936	11, 043	17, 979	18, 637	76, 486	244

[1] Expanded income equals adjusted gross income plus minimum tax preferences less investment interest to the extent of investment income.

[2] Amount resulting from increase in base above the amount necessary to match the increase in average wages and from increase in tax rates.

[3] Includes the impact of rate reductions, increase in zero bracket amount, increase in personal exemption, and changes in the earned income credit.

Note: Details may not add to totals owing to rounding.

These income and social security tax increases scheduled for 1981 sum to $21.3 billion. The committee's bill provides individual income tax reductions of $22.4 billion for calendar year 1981; therefore, these reductions will completely offset the impact of the scheduled tax increases. Table 1 shows that the committee's tax reductions (estimated at 1979 levels of income) offset the scheduled increases not just in the aggregate, but also for almost every income class of taxpayers. The increase in the lowest income class could not be fully offset because many of the individuals in this class who are liable for payroll taxes have incomes too low to have income tax liability. These individuals cannot benefit from income tax cuts, unless they are families with children who will benefit from the increase in the earned income credit provided in this bill. Although the table indicates that adjustments in tax rates and the personal exemption and the new deduction for two-earner couples do not fully offset scheduled increases for taxpayers in the $50,000 to $200,000 income classes, these taxpayers will benefit disproportionately from many of the productivity-related tax cuts provided in other sections of this bill. When the increase in the capital gains exclusion is taken into account, for example, taxpayers in these classes will, on the average, receive a tax cut larger than their combined income and social security tax increases. (See table 3 in Part III of this report.)

Marginal tax rates and incentives

The second important factor to which the committee gave particular attention in shaping individual income tax reductions is the need to reduce marginal rates of taxation; that is, the portion of a taxpayer's last dollar of income which must be paid as income tax. High marginal tax rates encourage people to evade taxes by participating in the "underground economy" and discourage both saving and work effort by lowering excessively the monetary return to those activities. To reduce marginal tax rates, the committee bill reduces the tax rate in every bracket by one to three percentage points.

A group of taxpayers to which the bill provides special relief in this regard is two-earner married couples. Because the marginal rate which applies to both spouses who file a joint return depends on their combined income, many married individuals whose spouses work are subject to marginal rates substantially higher than those which would apply if these individuals were unmarried. This is particularly important because studies show that the willingness of second earners to take paying jobs outside the home is very sensitive to the tax on their earnings.

To deal with this problem, the committee bill provides, for two-earner married couples, a new deduction equal to a percentage (5 percent for 1981 and 10 percent thereafter) of the first $30,000 of earnings of the spouse with the lower earnings. When fully effective, this will provide a 10-percent reduction in the marginal tax rate applying to the earnings of a lower-earning spouse with less than $30,000 of earnings.

2. Reduction in Tax Rates and Increase in Zero Bracket Amount (secs. 101 and 105 of the bill and secs. 1, 63, and 541 of the Code)

Present law

Under present law, individual income tax rates begin at 14 percent on taxable income in excess of $3,400 on a joint return and $2,300 on a single return. There is no tax on taxable income below these amounts, and this tax-free level of taxable income is called the "zero bracket amount." There is also a floor under itemized deductions equal to the zero bracket amount, so that itemizers can deduct only expenses in excess of that amount. Individual tax rates range up to 70 percent on taxable income in excess of $215,400 for joint returns and $108,300 for single returns. The existing tax rate schedule for joint returns is shown in Table 2.

There is also a 70-percent tax on undistributed income of personal holding companies, which are closely held companies whose income consists largely of passive investment income.

Reasons for change

The individual tax cuts provided in the committee bill place particular emphasis on reductions in tax rates; over half of the revenue loss in this portion of the bill is due to rate reductions. As shown in table 2, which compares the present rate schedule for married couples filing joint returns to the rate schedule provided in the bill, every tax rate has been reduced, in some cases by as many as three percentage points.

Individual income tax rate reductions are needed to offset the impact of rising social security taxes and of increasing income tax liabilities caused by inflation. The reductions in the committee's bill are designed to offset these tax increases in each income class.

The committee believes that rate reductions are necessary for several reasons. An individual's marginal tax rate depends on the tax bracket into which he or she falls, and it is the marginal tax rate which determines what portion of any extra income the individual may retain rather than pay as extra income tax. The committee believes that by reducing marginal tax rates, and thus increasing the portion of extra income which the individual keeps, the bill will provide a stimulus to the activities which give rise to extra income—work effort and saving. Thus, rate reductions provide a complement to the provisions, in the other sections of the bill, which will spur productivity and economic growth. In addition, the committee believes that reducing rates will encourage compliance and lower the appeal of participation in the "underground economy."

The zero bracket amount serves to set an amount of taxable income which is exempt from tax and to determine the percentage of taxpayers who itemize their deductions. Both to prevent too many low-income taxpayers from having an income tax liability and to preserve

the simplification which results when a large group of taxpayers are not required to itemize deductions, the committee determined that a moderate increase in the zero bracket amount was desirable at this time.

Explanation of provision

The committee bill reduces tax rates in every tax bracket and increases the zero bracket amount. The specific rate reductions for joint returns are shown in table 2. Comparable rate reductions are made in the rate schedules applying to single persons, heads of households, married persons filing separate returns, and estates and trusts.

Under the committee bill, individual income tax rates in every bracket are reduced by 1 to 3 percentage points. The rate in the lowest bracket is reduced from 14 percent to 12 percent, and the rate in the highest bracket is reduced from 70 percent to 67 percent. Some tax brackets have been narrowed in order to achieve the precise distribution of the tax reduction desired by the committee. In addition, the zero bracket amount and the corresponding floor under itemized deductions is increased from $3,400 to $3,600 for married couples, from $2,300 to $2,400 for single persons and heads of households, and from $1,700 to $1,800 for married persons filing separate returns.

In conformance with the reduction in the maximum individual income tax rate from 70 percent to 67 percent, the bill reduces the tax rate on undistributed personal holding company income to 67 percent.

Effective date

The reduction in tax rates, including the higher zero bracket amount, is effective for taxable years beginning after December 31, 1980.

The bill specifically applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow them the benefits of the new rates for that part of their fiscal year which falls after December 31. Under this provision, fiscal year taxpayers are to compute their tax liability for fiscal years 1980–1981 and 1981–1982 both under the old rates and new rates. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling after December 31.

Revenue effect

The revenue loss from these changes is expected to be $14.3 billion in calendar year 1981, $16.8 billion in calendar year 1982, $8.9 billion in fiscal year 1981, and $15.9 billion in fiscal year 1982.

Table 2.—Tax Rates for Married Couples Filing Joint Returns: Comparison of Committee Bill and Present Law: [1]

Present Law

If taxable income is:	*The tax is:*
Not over $3,400	No tax.
Over $3,400 but not over $5,500	14% of excess over $3,400.
Over $5,500 but not over $7,600	$294, plus 16% of excess over $5,500.
Over $7,600 but not over $11,900	$630, plus 18% of excess over $7,600.
Over $11,900 but not over $16,000	$1,404, plus 21% of excess over $11,900.
Over $16,000 but not over $20,200	$2,265, plus 24% of excess over $16,000.
Over $20,200 but not over $24,600	$3,273, plus 28% of excess over $20,200.
Over $24,600 but not over $29,900	$4,505, plus 32% of excess over $24,600.
Over $29,900 but not over $35,200	$6,201, plus 37% of excess over $29,900.
Over $35,200 but not over $45,800	$8,162, plus 43% of excess over $35,200.
Over $45,800 but not over $60,000	$12,720, plus 49% of excess over $45,800.
Over $60,000 but not over $85,600	$19,678, plus 54% of excess over $60,000.
Over $85,600 but not over $109,400	$33,502, plus 59% of excess over $85,600.
Over $109,400 but not over $162,400	$47,544, plus 64% of excess over $109,400.
Over $162,400 but not over $215,400	$81,464, plus 68% of excess over $162,400.
Over $215,400	$117,504, plus 70% of excess over $215,400.

Committee Bill

If the taxable income is:	*The tax is:*
Not over $3,600	No tax.
Over $3,600 but not over $5,600	12.0% of excess over $3,600.
Over $5,600 but not over $7,600	$240 plus 14.0% of excess over $5,600.
Over $7,600 but not over $11,600	$520 plus 17.0% of excess over $7,600.
Over $11,600 but not over $15,600	$1,200 plus 20.0% of excess over $11,600.
Over $15,600 but not over $20,000	$2,000 plus 23.0% of excess over $15,600.
Over $20,000 but not over $24,400	$3,012 plus 27.0% of excess over $20,000.
Over $24,400 but not over $29,700	$4,200 plus 29.0% of excess over $24,400.
Over $29,700 but not over $35,000	$5,737 plus 35.0% of excess over $29,700.
Over $35,000 but not over $45,600	$7,592 plus 41.0% of excess over $35,000.
Over $45,600 but not over $59,800	$11,938 plus 48.0% of excess over $45,600.
Over $59,800 but not over $85,400	$18,754 plus 53.0% of excess over $59,800.
Over $85,400 but not over $109,200	$32,322 plus 58.0% of excess over $85,400.
Over $109,200 but not over $162,200	$46,126 plus 63.0% of excess over $109,200.
Over $162,200 [2]	$79,516 plus 67.0% of excess over $162,200.

[1] Comparable tax rate reductions and bracket changes also are made for single and head-of-household tax schedules.

[2] The bill collapses the present 68- and 70-percent tax brackets into a 67-percent bracket.

3. Increase in the Personal Exemption (secs. 102 and 105 of the bill and sec. 151 of the Code)

Present law

Under present law, the amount of the personal exemption is $1,000 for the taxpayer, his or her spouse, and each dependent whose gross income is less than $1,000. (This income limit is waived if the dependent is a child of the taxpayer who is under the age of 19 or a student). Additional exemptions are provided for taxpayers who are blind and taxpayers who are age 65 or older.

Reasons for change

The amount allowed for each personal exemption is one of the key determinants of the relative tax burdens of families of different sizes and of the relative burdens of aged and non-aged taxpayers. In view of the inflation which has occurred since the $1,000 exemption went into effect in 1979, the committee believes that an increase to $1,100 is now appropriate.

Explanation of provision

Under the committee bill, each personal exemption to which the taxpayer is entitled is increased to $1,100. In addition, the gross income limit for a dependent is increased from $1,000 to $1,100.

Effective date

The increase in the personal exemption is effective for taxable years beginning after December 31, 1980.

The bill specifically applies the rules for rate changes of fiscal year taxpayers (sec. 21 of the Code) to allow them the benefits of the new personal exeemption for that part of their fiscal year which falls after December 31. Under this provision, fiscal year taxpayers are to compute their tax liability for fiscal years 1980–1981 and 1981–1982 both under the old amount and new amount. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling after Deceember 31.

Revenue effect

The revenue loss is expected to be $4.8 billion in calendar year 1981 and $5.0 billion in calendar year 1982, and $1.7 billion in fiscal year 1981 and $4.9 billion in fiscal year 1982.

4. Changes in Filing Requirements and Withholding Changes (secs. 101 and 102 of the bill and secs. 6012 and 3402 of the Code)

Present law

Under present law, a tax return must be filed by a single person and a head of household if his or her income is $3,300 or more a year and by a married couple filing a joint return if their income is $5,400 or more.

These amounts represent the zero bracket amount of $2,300 for single persons and heads of households and $3,400 for joint returns plus $1,000 for each personal exemption. For each additional exemption resulting from the taxpayer or his spouse being age 65 or older (or blind), these amounts are increased by $1,000. Thus, a single person age 65 or older need not file until his or her income is $4,300 or more; a married couple with only one spouse age 65 or over, $6,400 or more; and a married couple, both age 65 or older, $7,400 or more.

The withholding tax rates reflect the present tax rates, the zero bracket amount, and the amount of the personal exemption.

Reasons for change

When the zero bracket amount and the amount of the personal exemption are increased, the income levels for filing a tax return should be conformed to the new tax-free income levels. In addition, any general tax cuts should be reflected in withholding changes.

Explanation of provision

The income levels at which a tax return must be filed will be increased to reflect the increase in the zero bracket amount from $2,300 to $2,400 for single persons and heads of households and from $3,400 to $3,600 for joint returns, as well as the increase in the personal exemption from $1,000 to $1,100. Consequently, the new filing level under the bill will be $3,500 for a single person or head of household (an increase of $200 over present law) and $5,800 for a married couple if both spouses are under age 65 (an increase of $400 over present law). The filing level for a married couple with one spouse age 65 or older will be $6,900; if both spouses are age 65 or older, the filing level will be $8,000.

The withholding rates and tables are to be changed by the Secretary of the Treasury to reflect the tax rate reductions and the increases in the zero bracket amount and the personal exemption provided by the bill. The percentage method withholding table is changed to reflect the increase in the personal exemption. In addition, a conforming change is made in the provision under which additional withholding exemptions can be claimed for itemized deductions in excess of the zero bracket amount to reflect the increases in the zero bracket amount and the personal exemption.

Effective date

The change in the filing requirements is effective for taxable years beginning after December 31, 1980, and the withholding changes apply to remuneration paid after December 31, 1980.

5. Changes in Earned Income Credit (sec. 103 of the bill and secs. 43 and 3507 of the Code)

Present law

Under present law, an eligible individual is allowed a refundable credit against tax equal to 10 percent of the first $5,000 of earned income (for a maximum credit of $500). The maximum allowable credit is phased down as income rises above $6,000. Specifically, the allowable earned income credit for any taxable year is limited to the excess of $500 over 12.5 percent of the excess of adjusted gross income (or, if greater, earned income) over $6,000. Thus, the credit is zero for families with incomes over $10,000. The particular amount of any eligible individual's credit is determined under tables prescribed by the Secretary. In addition, eligible individuals may receive the benefit of the credit throughout the year by electing advance payments.

Earned income eligible for the credit includes all wages, salaries, tips, and other employee compensation, plus net earnings from self-employment. Amounts received as pension or annuity benefits may not be taken into account for purposes of the credit, nor is the credit available with respect to income of non-resident alien individuals which is not connected with a U.S. trade or business.

Individuals who are eligible for the credit are married individuals who are entitled to a dependency exemption for a child, surviving spouses, and heads of households who maintain a household for a child. In each case, for a taxpayer to qualify as eligible for the credit, the child must reside with the taxpayer in the United States. Furthermore, in order to claim the credit, an individual must not exclude or deduct any amounts from gross income under Code section 911 (relating to income earned by individuals in certain camps outside the United States), section 913 (relating to deductions for certain expenses of living abroad), or section 931 (relating to income from sources within possessions of the United States).

Reasons for change

The committee believes that the earned income credit is an effective way to provide relief from social security and income taxes to low-income families who might otherwise need large welfare payments. The credit, which originally was enacted by the Congress in 1975, was last increased in 1978.

Because the purpose of the credit has been to offset social security taxes, and, thus to provide a work incentive, the committee believes that it would be appropriate to increase the amount of the credit to take into account the increase in social security taxes. Thus, the committee has decided that the rate of the credit should be increased from 10 percent to 11 percent. In addition, in order to compensate for inflation since 1978, the committee has decided to raise the level at which the credit begins to phase out from $6,000 to $7,000.

Explanation of provision

Under the bill, an eligible individual will be allowed a refundable credit against tax equal to 11 percent of the first $5,000 of earned income. Thus, the maximum allowable earned income credit will be $550. This amount will be phased down as income rises above $7,000. Specifically, the allowable earned income credit for any taxable year will be limited to the excess of $550 over 13.75 percent of the excess of adjusted gross income (or, if greater, earned income) over $7,000. Thus, the credit will be zero for eligible individuals with incomes over $11,000. Conforming changes are made in the tables used for advance payments of the credit.

Effective date

This increase in the earned income credit will apply to taxable years beginning after December 31, 1980. The changes affecting advance payments will apply to remuneration paid after December 31, 1980.

Revenue effect

The increase in the earned income credit is expected to increase outlays and reduce revenues by $0.6 billion in calendar year 1981, $0.5 billion in calendar year 1982, $0.1 billion in fiscal year 1981 and $0.6 billion in fiscal year 1982. (To the extent that the earned income credit exceeds tax liability, it is treated as an outlay under budget procedures.)

6. Deduction for Two-Earner Married Couples (sec. 104 of the bill and secs. 85, 105 and new sec. 221 of the Code)

Present law

Under present law, a married couple generally is treated as one tax unit which must pay tax on its total taxable income. While couples may elect to file separate returns, the law is structured so that filing separate returns almost always results in a higher tax than filing joint returns. In addition, different tax rate schedules apply to single persons and to single heads of households. Along with other provisions of the law, these rate schedules give rise to a "marriage penalty" when persons with relatively equal incomes marry each other and a "marriage bonus" when persons with relatively unequal incomes marry each other. In general, if two person's combined income is allocated bebetween them more evenly than 80%-20%, their combined income tax liability will increase when they marry.

Reasons for change

The committee is concerned about the marriage tax penalty, and has decided that a suitable response to this problem is to allow married couples a new deduction equal to a percentage of the earnings of the spouse with lower earnings.

Any attempt to rectify the marriage penalty involves the reconciliation of several competing objectives of tax policy. For many years, an accepted goal has been the equal taxation of married couples with equal incomes. This has been viewed as appropriate because married couples frequently pool their income and consume as a unit, and thus it has been thought that married couples should pay the same amount of tax regardless of how the income is divided between them. This result generally is achieved under current law.

The committee believes that alleviation of the marriage penalty is now necessary because large tax penalties on marriage undermine respect for the family and for the tax system itself. To do this, the committee was obliged to make a distinction between one-earner and two-earner married couples because the simplest way to alleviate the marriage penalty is to allow 10 percent of the earned income of the spouse with the lower earnings to be, in effect, free from income tax.

The provision will also alleviate another effect of the current system for all married couples—high marginal tax rates on the second earner's income. Recent studies have shown that these high marginal rates have a significant adverse effect on second earners' decisions to seek paying jobs. The 10-percent reduction in marginal tax rates for second earners provided by the new deduction will offset much of this work disincentive. In addition, some contend that two-earner couples are less able to pay income tax than one-earner couples with the same amount of income because the former have more expenses resulting from earning income, as well as less free time. Under this theory, the

new deduction will improve equity by reducing the tax burden of two-earner couples compared to one-earner couples.

The second-earner deduction will reduce the marriage tax penalty and improve work incentives for second earners without abandoning the basic principle of joint returns. Separate filing would be very complex because of the necessity for rules allocating income and deductions between the spouses. If separate filing were optional, many couples would compute tax liability under both options (separately and jointly) in order to determine which method minimizes their liability. Further, separate filing would provide tax reductions with respect to all types of income, while the committee believes that relief is most essential for earned income. Also, separate filing would reduce taxes only for couples affected by the marriage penalty, while the committee believes there should be a reduction for all two-earner married couples.

The substantial reductions in the marriage penalty resulting from the committee bill are shown in table 3. This new deduction is a major step towards the committee's goal of eliminating the marriage penalty completely.

Explanation of provision

With certain exceptions, two-earner married couples who file a joint return will be allowed a deduction from gross income in arriving at adjusted gross income. Taxpayers may claim this deduction even if they do not itemize their personal deductions. The deduction will equal 10 percent (5 percent for taxable years beginning in 1981) of the lesser of $30,000 or the "qualified married earner amount." Thus, the maximum deduction will be $1,500 for taxable years beginning in 1981 and $3,000 for subsequent taxable years.

The "qualified married earner amount" is the qualified earned income of the spouse with the lower qualified earned income for the taxable year. If the qualified earned income of each spouse for the taxable year is the same, then the qualified married earner amount is the qualified earned income of either one of the spouses.

In general, qualified earned income is earned income within the meaning of Code section 401(c)(2)(C) or Code section 911(d)(1) (as redesignated by the bill) less specified deductions allowable under Code section 62 that are properly allocable to or chargeable against such earned income in determining the qualified married earner amount. Qualified earned income will be determined without regard to the 30-percent limitation on compensation from a trade or business in which both personal services and capital are material income-producing factors. Qualified earned income is not intended to include unemployment compensation.

Under the bill, qualified earned income does not include any amount that is not includable in gross income, because untaxed income does not give rise to a work disincentive or a marriage penalty. In addition, the qualified earned income of each spouse will be computed without regard to any community property laws; that is, earned income will be attributed to the spouse who rendered the services for which the earned income is received.

Pensions, annuities, individual retirement plan distributions and deferred compensation are excluded from qualified earned income. In

general, deferred compensation is any amount received after the close of the taxable year following the taxable year in which the services to which the amount is attributable are performed. Pensions and annuities are excluded because these amounts are largely composed of investment income (i.e., interest on plan contributions) that has accumulated tax-free. This exclusion is also necessary to focus the benefits of this deduction on individuals currently earning income and to avoid a windfall for those whose work took place in past years. The exclusion of pensions and annuities is consistent with the definitions applicable to the earned income credit. Distributions from individual retirement plans have been excluded to maintain parity with qualified plans. Other forms of deferred compensation are excluded from qualified earned income for similar reasons.

Wages exempt from certain social security taxes because an individual is in the employ of his or her spouse are also excluded from qualified earned income. These amounts are excluded because the existing exemption of these wages from social security tax already provides substantial relief to these second earners and because, otherwise, there could be opportunities to shift earned income between spouses and attribute an inaccurate or unreasonable amount of earned income to the second earner.

Certain items deductible under Code section 62 must be deducted in computing qualified earned income. These items are: (1) deductions attributable to a trade or business from which earned income is derived, except that if some of the gross income from a trade or business does not constitute earned income, only a proportional share of the deductions attributable to such trade or business must be deducted (Code section 62(1)); (2) deductions consisting of expenses paid or incurred in connection with the performance of services as an employee (Code section 62(2)); (3) deductions for contributions by a self-employed person to a qualified retirement plan (Code section 62(7)); (4) certain deductions relating to pension plans of subchapter S corporations (Code section 62(9)); and (5) contributions to an individual retirement plan (Code section 62(10)).

The bill includes conforming amendments specifying that the amounts of unemployment compensation and disability income included in adjusted gross income are to be computed wtihout regard to this deduction. Then, the deduction is to be computed, excluding from qualified earned income amounts of disability (or other) income not included in gross income.

The bill also provides that no deduction is allowable if either spouse claims, on the couple's joint return for the taxable year, the benefits of Code section 911 (relating to income earned by individuals in certain camps outside the United States), Code section 913 (relating to deduction for certain expenses of living abroad), or Code section 931 (relating to income from sources within possessions of the United States). Couples benefiting from these provisions are excluded from the new deduction because of the substantial relief provided elsewhere in the bill for income earned abroad and the complexity of coordinating the new deduction with these provisions. This is consistent with the eligibility rules for the earned income credit.

Finally, a married couple would be allowed to take this deduction into account in determining withholding allowances under Code section 3402(m).

Effective date

The new deduction will be effective for taxable years beginning after December 31, 1980.

Revenue effect

The revenue loss is expected to be $2.7 billion in calendar year 1981, $6.4 billion in calendar year 1982, $0.3 billion in fiscal year 1981 and $3.4 billion in fiscal year 1982.

Table 3.—Effect of Marriage on Tax Liability[1] Under Present Law and Committee Bill[2]

Family income	Share of lesser-earning spouse: 0 percent	10 percent	20 percent	30 percent	40 percent	50 percent
$10,000:						
Present law	−475	−275	−85	100	182	202
Committee bill	−506	−333	−170	−9	87	98
$20,000:						
Present law	−1, 092	−460	42	238	355	391
Committee bill	−1, 115	−557	−83	86	157	156
$30,000:						
Present law	−1, 929	−749	−26	439	785	903
Committee bill	−1, 975	−912	−234	114	346	377
$50,000:						
Present law	−3, 344	−1, 094	454	1, 731	2, 439	2, 674
Committee bill	−3, 512	−1, 542	−252	776	1, 252	1, 313
$100,000:						
Present law	−3, 464	359	2, 699	4, 014	4, 369	4, 394
Committee bill	−3, 512	−252	1, 507	2, 287	2, 542	2, 542

[1] The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person on his or her portion of their combined income. Marriage bonuses are negative in the table; marriage penalties are positive.

[2] Committee bill computations assume 10 percent rate for two-earner couple deduction.

Note: It is assumed that taxpayers do not itemize their deductions and have no dependents and that all income is earned.

C. CAPITAL FORMATION AND PRODUCTIVITY TAX REDUCTIONS

1. Corporate Income Tax Rates (sec. 201 of the bill and sec. 11 of the Code)

Present law

Under present law, corporate taxable income is subject to tax under a 5-step graduated structure. The corporate taxable income brackets and tax rates are:

Taxable income	*Tax rate (percent)*
$0 to $25,000	17
$25,000 to $50,000	20
$50,000 to $75,000	30
$75,000 to $100,000	40
Over $100,000	46

For example, the tax on $50,000 of taxable income equals 17 percent of the first $25,000 of income plus 20 percent of the next $25,000 of income, or $9,250.

Reasons for change

The committee believes that reductions in corporate income tax rates are necessary to stimulate business spending for new plant and equipment. These investments are important for increasing the rate of economic growth and holding down the rate of inflation, but testimony before the committee strongly suggested that the amount of net investment has been inadequate in recent years. Lower tax rates enable corporations to retain more funds for capital expenditures. In addition, lower tax rates, by reducing the double taxation of income from corporate investments, enable corporations to attract more capital.

Aware of the special problems encountered by small businesses in raising money in equity markets and in borrowing funds for investment, the committee believes that additional graduation in the corporate income tax structure for smaller amounts of taxable income is necessary to encourage capital formation by small businesses.

Explanation of provision

Under the committee bill, the corporate income tax structure will be modified in 1981 and again in 1982.

For 1981, the tax brackets and tax rates will be:

Taxable income	*Tax rate (percent)*
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $100,000	30
$100,000 to $150,000	40
Over $150,000	45

Beginning in 1982, the tax brackets and tax rates will be:

Taxable income	*Tax rate (percent)*
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $75,000	25
$75,000 to $100,000	30
$100,000 to $150,000	35
$150,000 to $200,000	40
Over $200,000	44

Effective date

The corporate income tax structure for 1981 will apply to taxable years that begin in 1981.

The corporate income tax structure for 1982 and later years will apply to taxable years that begin after December 31, 1981.

The bill specifically applies the rules for rate changes of fiscal year corporate taxpayers (sec. 21 of the Code) to allow these corporations the benefits of the new corporate rates for that part of their fiscal year which falls after December 31. Under this provision, fiscal year taxpayers are to compute their tax liability for fiscal years 1980–1981 and 1981–1982 both under the old rates and new rates. The difference in these two amounts is then to be prorated over the fiscal year, and the tax reduction is allowed to the extent of the amount falling after December 31.

Revenue effect

It is estimated that this provision will reduce revenues by $1.0 billion in fiscal year 1981, $3.5 billion in fiscal year 1982, $5.5 billion in fiscal year 1983, $6.2 billion in fiscal year 1984, and $7.1 billion in fiscal year 1985.

2. Depreciation and Investment Tax Credit Revisions

a. Simplified cost recovery (secs. 211, 212, 213, and 216 of the bill and secs. 46, 57, 167(m), 312(k), 751, and 1348(b) and new sec. 168 of the Code)

Present Law

Depreciation

Depreciation in general

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, decay or decline from natural causes, exhaustion and obsolescence,[1] the adjusted basis (less salvage value in excess of 10 percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use.[2] This approach to the recovery of the basis of an asset is referred to as depreciation.

Depreciation of personal property

For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method, the sum-of-the-years-digits method, or any other method used consistently by the taxpayer which does not result in the allowance of greater aggregate depreciation deductions during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method (e.g., methods based on units of production, machine time, etc.). Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property.[3]

The key factors which determine the amount and the timing of depreciation deductions with respect to any depreciable asset are: (1) the cost of the asset; (2) the salvage value of the asset; (3) the useful life assigned to the asset; and (4) the method of depreciation (e.g., straight line or an accelerated method). Since determinations of ap-

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[1] If the asset is not subject to these factors, depreciation is not allowable. For example, land is not depreciable.

[2] In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for expenditures for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

[3] Rev. Rul. 57-352, 1957-2 C.B. 150; Rev. Rul. 59-389, 1959-2 C.B. 89. Accelerated methods are not allowed for intangible assets (sec. 167(c)).

propriate useful lives and salvage values are essentially factual and are based on circumstances which may be unique to the taxpayer's situation, many controversies arise between taxpayers and the Internal Revenue Service. Thus, a major purpose for establishing the ADR system was to reduce the controversies relating to useful lives and salvage values for certain types of property. Similarly, a repair allowance system was provided to reduce controveries over the classification of expenditures as currently deductible repairs or as capital improvements.

ADR System

In general

The regular rules relating to allowable methods of depreciation generally are applicable under the ADR system. However, in the case of new tangible personal property with a useful life of three years or more, a taxpayer who elects ADR may select only the straight-line, declining balance (up to 200 percent), or sum-of-the-years-digits methods. For used depreciable personal property, accelerated depreciation is limited to the 150-percent declining balance method, i.e., 150 percent of the straight-line rate.

Election

A taxpayer must make an irrevocable election to apply the provisions of the ADR system to eligible property placed in service during the taxable year. This election is applicable to all eligible assets placed in service during the taxable year and is effective as to those assets for all subsequent taxable years. This election must be made on Form 4832 and filed with the taxpayer's income tax return for each year that application of the ADR system is elected. If, in a subsequent taxable year, the taxpayer does not elect to apply the ADR system, the regular rules regarding depreciation will be applicable to any depreciable assets placed in service during that taxable year. A valid election to apply the ADR provisions must contain the taxpayer's consent to comply with all of the ADR requirements and must specify certain information (for example, the asset guideline class and the first-year convention adopted by the taxpayer for the taxable year of election). In addition, the taxpayer must maintain books and records from which certain specific information can be drawn (for example, the depreciation period and salvage value for each vintage account established for the taxable year and each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance). Also, taxpayers who elect the ADR provisions must respond to infrequent data surveys conducted by the Treasury Department.[4]

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable tangible property for which an

[4] The information reporting requirements for an electing taxpayer were reduced and simplified by the Treasury Department on January 26, 1979 (Treas. Reg. § 1.167(a)-11, as amended by T.D. 7593, 44 Fed. Reg. 5419). In general, much of the information which was required on IRS form 4832 is no longer automatically required to be submitted. Instead, the books and records of the taxpayer must be maintained so that such information is readily available, and if the Treasury Department surveys the taxpayer, the information called for must be submitted on the survey request.

asset guideline class and an asset guideline period have been prescribed by the Treasury Department for the taxable year of election. If used property constitutes a significant portion of the property placed in service during a taxable year (10 percent), a taxpayer may elect to apply the ADR system only to new property.

Presently, with certain very limited exceptions, the ADR system does not apply to depreciable real property. Until class lives under the ADR system are prescribed for real property, a taxpayer who has elected the ADR system may elect to determine the useful life of depreciable real property under Revenue Procedure 62-21 (which reflects the prior general IRS position on useful lives) as in effect on December 31, 1970, or on the basis of the facts and circumstances of the particular case.[5]

Vintage accounts

Under the ADR system, the allowance for depreciation is computed on the adjusted bases of the assets grouped together in a vintage account. The vintage of the account refers to the taxable year during which the eligible property is first placed in service. Each eligible property may be placed in a separate vintage account, or, under certain circumstances, assets in the same guideline class may be placed in the same vintage account. However, new and used eligible property may not be combined in a single vintage account. Certain other property also may not be combined in a single vintage account, e.g., property eligible for additional first-year depreciation may not be combined with ineligible property.

Certain special rules have been provided to account for ordinary and extraordinary retirement of assets in a vintage account. Likewise, special rules are provided in connection with the recognition of gain or loss on retirements.

Useful lives and asset guideline classes

In general, the estimated useful life of assets in each asset guideline class is established by the Office of Industrial Economics of the Treasury Department. Each asset guideline class consists of a category of assets that have certain common characteristics or that are utilized in the same or related activities. Generally, a class life is established to reflect the actual asset replacement practices being employed by taxpayers and other factors, such as obsolescence. The taxpayer may use a depreciation life within a range (asset depreciation range) of 20 percent below or above the predetermined life of the asset guideline class. For example, if the asset guideline period for a certain asset guideline class is 10 years, the taxpayer may elect a useful life with respect to assets in that guideline class that is not less than 8 years (20 percent below the asset guideline period) nor more than 12 years (20 percent above the asset guideline period). Although the ADR system applies to property which is used predominantly outside the United States, Treasury takes the position that the asset depreciation range may not be used for such property so that lives shorter or longer than the asset guideline periods cannot be used for such property. Under the ADR system, there are 14 asset classes for specific categories of depreciable assets. These categories apply to assets of specific types (e.g.,

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[5] Section 5 of Public Law 93-625.

automobiles) regardless of the type of business in which the assets are used. There are also approximately 116 classes (or subclasses) of depreciable assets grouped by the type of activity in which the assets are used. Table 1 illustrates the useful lives of a limited number of asset classes under ADR.

TABLE 1.—ADR USEFUL LIVES OF VARIOUS ASSETS

Description of assets in guideline class	Asset depreciation range (in years)		
	Lower limit	Asset guideline period	Upper limit
Certain short-lived assets:			
Manufacture of fabricated metal products—special tools	2.5	3	3.5
Manufacture of motor vehicles—Special tools	2.5	3	3.5
Breeding hogs	2.5	3	3.5
Manufacture of electrical equipment—special tools	4.0	5	6.0
Certain intermediate-lived assets:			
Data handling equipment except computers	5.0	6	7.0
Assets used in drilling of oil and gas wells	5.0	6	7.0
Manufacture of electronic products	5.0	6	7.0
Certain long-lived assets:			
Railroad cars and locomotives, except those owned by railroad transportation companies	12.0	15	18.0
Vessels, barges, tugs, and similar water transportation equipment, except those used in marine contract construction	14.5	18	21.5
Industrial steam and electric generation and/or distribution systems	17.5	22	26.5
Telephone central office equipment	16.0	20	24.0

Source: Revenue Procedure 77–10, 1977–1 C.B. 548, as modified by Rev. Proc. 79–26, 1979–1 C.B. 566, and Rev. Proc. 79–65, 1979–2 C.B. 579.

"Half-year convention" rules

Under the ADR system, two alternative conventions are provided for purposes of determining depreciation for the year during which property is first placed in service. First, the "modified half-year convention" provides that depreciation for a full year is allowed for all eligible property placed in service during the first half of the taxable

year. All other eligible property will be treated as being placed in service on the first day of the next taxable year. Second, the "half-year convention" provides that depreciation is allowable for a half-year for all eligible property placed in service during the taxable year. The same convention must be used for all vintage accounts of the same taxable year but may be changed for vintage accounts of subsequent taxable years.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain. Thus, if salvage value is less than 10 percent, it may be ignored. The salvage value of each vintage account must be estimated by the taxpayer at the time of electing the ADR system for assets placed in service for a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

Treatment of repairs, maintenance, etc.

Under present law, the characterization of certain expenditures for the repair, maintenance, rehabilitation, or improvement of property is a factual determination. If these expenditures substantially prolong the life of an asset or are made to increase its value or adapt it to another use, the expenditures are capital in nature and are recoverable in the same manner as the cost of a capital asset. All other expenditures for repair, maintenance, etc., are allowed as a deduction for the taxable year in which paid or incurred.

If a taxpayer elects to apply the ADR provisions, the taxpayer may make a further election to apply the provisions of the asset guideline class "repair allowance." Under these provisions, a taxpayer is allowed a current deduction for amounts paid or incurred for certain repairs, maintenance, and similar expenditures to the extent that the expenditures do not exceed, in general, the average unadjusted basis of all repair allowance property multiplied by the repair allowance percentage. "Repair allowance property" is eligible property in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The repair allowance percentage is a predetermined rate established for each asset guideline class. Property improvements (including the amount of repairs, maintenance, etc., in excess of the asset repair allowance) and excluded additions are capitalized in a special basis vintage account, subject to the ADR rules. If a taxpayer does not elect to use the asset guideline class repair allowance for assets in an asset guideline class, the regular rules regarding the treatment of expenditures for the repair, maintenance, rehabilitation, or improvement of property are applicable. If the repair allowance is elected, the taxpayer must maintain books and records to identify repair expenditures relating to specific classes of property, to allocate to specific classes of property the expenditures relating to properties in two or more classes, and to identify expenditures for excluded additions, e.g., expenditures which are clearly for capital items.

Recognition of gain or loss on retirement

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. Thus, under normal tax rules, each retirement of depreciable personal property (coupled with a sale, exchange, or abandonment) would result in current recognition of gain or loss.

Under the ADR system, recognition of gain or loss is postponed for "ordinary retirements" of assets included in a vintage account, i.e., retirements occurring for routine causes during the range of years selected for the account. In this case, the proceeds from the retirement are added to the depreciation reserve of the vintage account. However, in the case of an "extraordinary retirement," any gain or loss resulting from the retirement is recognized. (The characterization of gain or loss is governed by the normal rules relating to depreciation recapture and gain or loss on property used in a trade or business (secs. 1231 and 1245).) For this purpose, an extraordinary retirement would include a retirement attributable to an insured casualty.

Other rules relating to depreciation

Additional first-year depreciation

Under present law, the provision for additional first-year depreciation (sec. 179) permits an owner of tangible personal property with a useful life of six years or more to elect, for the first year the property is subject to depreciation, a deduction for additional first-year depreciation in an amount not exceeding 20 percent of the cost of the property. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return). Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Recapture

Under present law, with certain limited exceptions, gain from the disposition of depreciable personal property (and certain other property—generally property which is eligible for the investment credit) is "recaptured" as ordinary income to the extent of the depreciation taken (sec. 1245). Gain in excess of the depreciation taken may be treated as capital gain under section 1231 (unless the gain is offset by losses on sec. 1231 assets).

Accelerated depreciation and the minimum tax

Under present law, a 15-percent minimum tax is imposed on the amount of a taxpayer's tax preferences in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the regular income tax in the case of a corporation and one-half of the amount of the regular income tax in the case of an individual.[6]

One of the tax preferences in the minimum tax is accelerated depreciation on leased personal property.[7] The tax preference is the amount by which the income tax deduction for depreciation (or amortization)

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[6] The 15-percent minimum tax is separate and apart from the alternative minimum tax (under sec. 55).

[7] For this purpose, the term 'personal property" means property which is subject to depreciation recapture under section 1245.

exceeds the depreciation deduction which would have been allowed if the property had been depreciated under the straight line method of depreciation for each year of its useful life for which the taxpayer owned the property. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a shorter life than the ADR guideline period (or "class life") established for the asset, any increase in depreciation for the year due to using a useful life shorter than the guideline period is included in the amount of the preference. Thus, additional ADR depreciation is a preference even if the straight line method is used in conjunction with a life shorter than the ADR guideline period, as well as when an "accelerated" method is used. This tax preference does not apply to corporations other than personal holding companies and subchapter S corporations.

These tax preference items also reduce the amount of personal service taxable income eligible for the 50-percent maximum tax on personal service taxable income.

Earnings and profits

Generally, a corporate distribution with respect to the corporation's stock is taxable as a dividend only if it is made out of the corporation's current or accumulated "earnings and profits." Otherwise, it is treated as a nontaxable return of capital to the extent of the shareholder's basis in his stock and as a capital gain to the extent the distribution exceeds such basis. Generally, earnings and profits are computed in a manner similar to the manner in which taxable income is computed. However, a number of adjustments and special rules apply.

Under one of these special rules, for taxable years beginning after June 30, 1972, depreciation in excess of straight-line depreciation is not taken into account for purposes of determining earnings and profits of a domestic corporation (sec. 312(k)).

Investment tax credit

Present law provides a 10-percent regular investment credit and a 10-percent energy investment credit (or, in certain cases, an 11- or 15-percent energy investment credit) for investments in certain tangible property used in a trade or business or for the production of income. The amount of each credit is generally 10 percent of a taxpayer's eligible cost in acquiring qualifying property. The credits are used to offset the taxpayer's income tax liability.[8]

To be eligible for these credits, property must be depreciable or amortizable and must have a useful life of three years or more. However, reduced credits are allowed where property has a useful life of less than seven years. Under these rules, if the property has a useful life of three or four years, a credit is allowed on one-third of the cost of the property. Similarly, a credit is allowed on two-thirds of the cost where the property has a useful life of five or six years. This determi-

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[8] Under certain circumstances, a corporate taxpayer may elect an additional one percent investment tax credit if an amount equal to one percent of the qualified investment for the year is contributed to an employee stock ownership plan (ESOP). Further, an additional one-half of one-percent investment tax credit is available if (a) an equivalent amount is contributed to the ESOP by the taxpayer and is matched by employee contributions and (b) certain other requirements concerning the operation of the ESOP are met.

nation generally is made on the basis of the useful life which is used for purposes of depreciation or amortization. These useful life limitation rules also are applied where the credit has been claimed and the property is disposed of by the taxpayer before the end of its useful life. In such situations, the credit is recomputed on the basis of the property's actual useful life in the hands of the taxpayer. This may result in a reduction in the allowable credit and a recapture of the excess credit from the taxpayer.

For purposes of the regular investment credit, qualifying property includes tangible personal property (such as motor vehicles, machinery, and office equipment) and also other tangible property (such as blast furnaces, pipelines, railroad track, and utility poles) used as an integral part of manufacturing, production, extraction, or furnishing of certain services, including electrical, gas, and steam utility services. However, buildings and their structural components generally are not eligible for the regular investment credit. Qualifying property for purposes of the energy investment credit generally includes certain property which is designed (1) to use sources of energy or substances other than oil or natural gas, (2) to convert these alternate substances into a fuel, or (3) to conserve energy. The energy credit is available for buildings and their structural components which otherwise qualify as energy property. However, the energy credit generally does not extend to energy property used to provide electrical, gas, steam, and other public utility services.

Generally, the investment credits are claimed for the taxable year in which qualifying property was placed in service. However, in certain cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction before the property is completed and placed in service.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 70 percent for 1980 and will increase by increments of 10 percentage points a year to 90 percent for 1982 and later years. The energy credit applies against all tax liability not offset by the regular credit (and the ESOP credit). Unused regular and energy credits from a taxable year may be carried over to apply against tax liability for the three preceding and seven succeeding years.

Reasons for Change

The committee believes that the present rules relating to depreciation and the investment credit—the principal means of recovering costs of tangible personal property—require substantial revision. Because of current rates of inflation, the present timing of deductions, even when coupled with the investment credit, often is inadequate to reflect recovery of the original cost of an asset expressed in terms of the purchasing power which was invested in that asset. This is particularly true of longer-lived assets. Reductions in the real value of depreciation deductions can seriously impair the ability of businesses to finance the repacement of old equipment with newer, more modern equipment which reflects recent technology. In addition, the committee believes that it is important to provide business with additional

incentives to make investments in equipment because additional investments are required to improve productivity.

Undue complexity is another major concern of the committee with the present system. The ADR system has approximately 130 classes of assets and requires mastery of lengthy, complicated regulations. Useful lives determined under a facts and circumstances test is the major alternative under existing law. This alternative has the disadvantages of (1) substantial uncertainty as to agreements by the IRS and the taxpayer on useful lives and (2) complexity due to numerous item accounts, elections, and rates of depreciation. Furthermore, the choice of an appropriate life is complicated by the interaction of the depreciation rules and the investment credit. In some circumstances the election of longer lives (up to 7 years) may well be advantageous even though shorter lives could be used.

In providing a simplified system of depreciation which is intended to give substantially shorter recovery periods for the cost of most tangible personal property, the committee believes that it is appropriate to provide additional incentives for these investments. However, these incentives should be limited so that the total discounted present value of allowable credits and deductions normally would not exceed the discounted present value of a current deduction of the entire acquisition cost of the property. The committee generally believes that benefits more generous than current expensing would result in encouraging uneconomic investments. Also, the committee has carefully structured this new system so that the tax laws provide the smallest feasible distortion in business choices about whether to invest in assets with short or long useful lives.

Explanation of Provisions

(1) Depreciation of personal property

Overview

Under the committee bill, a new method of depreciating most tangible personal property (the "Simplified Cost Recovery" system) is substituted for present depreciation methods, including the Asset Depreciation Range (ADR) system. Generally, the new system is mandatory for all eligible property. Public utility property is not eligible property and will continue to be depreciated under present rules, except that the ADR variance for such property is increased from 20 percent to 30 percent.

The depreciable basis of eligible property (referred to as recovery property) will be assigned to one of four open-ended recovery accounts. These four recovery accounts represent recovery periods of 2, 4, 7, and 10 years. Most property now eligible for ADR will be assigned to a recovery account which has a recovery period that is at least 40 percent shorter than the property's present asset guideline period (i.e., the midpoint life under the present ADR system) except that no recovery period will be less than 2 years. In addition, progress expenditures made toward the acquisition of assets which are being constructed by or for the taxpayer and which have a normal construction period of 2 years or more may be added to the appropriate account to which such assets would be assigned when the progress expenditures are

made, rather than when the asset is placed in service. The depreciable bases of all eligible property with the same recovery period are placed in the same open-ended recovery account.

The amount of the allowable deduction ("recovery deduction") is determined for each recovery account by using a declining balance method of depreciation. The taxpayer may elect annually one of three declining balance methods (200 percent, 150 percent, or 100 percent) for each account. The amount of the recovery deduction is subtracted from the account balance to establish the opening balance in the account on which the subsequent year's recovery deduction will be computed. Generally, no gain or loss will be recognized on the disposition of recovery property. In general, the amount realized on a disposition will reduce the balance in the account; as a result, the recovery deductions in the current and subsequent taxable years will reflect this reduction. If the amount realized from the disposition of recovery property reduces the balance of the account to a negative amount, such amount generally will be recaptured as ordinary income.

Under other provisions of the bill, a taxpayer will be permitted to make an annual election to "expense" (take an immediate deduction for) up to $25,000 of the costs of new or used tangible personal property purchased for use in the taxpayer's trade or business and placed in service during the taxable year. This provision replaces the present provision which permits a taxpayer to elect an additional first year depreciation allowance for qualified property placed in service during a taxable year.

Recovery property

Most tangible personal property presently subject to an allowance for depreciation will be included in the new simplified cost recovery system. Eligible property, referred to as "recovery property," generally will include both new and used tangible personal property that is used in a trade or business or held for the production of income and which is placed in service after December 31, 1980. Such property is tangible property described in Code section 1245(a)(3) except elevators, escalators, and certain real property subject to amortization. However, recovery property will not include: (1) public utility property; (2) certain livestock (described in Code sec. 1231(b)(3)), unless the taxpayer elects to treat such livestock as recovery property; (3) property which may be amortized (in lieu of depreciated) and for which the taxpayer elects such amortization; (4) property subject to a method of depreciation not expressed in a term of years (such as property depreciated under the units of production or machine-hour methods of depreciation), if the taxpayer elects to exclude such property; (5) leasehold improvements properly depreciated or amortized over the term of the lease; (6) certain boilers fueled by oil or gas (as described in Code sec. 167(p)); (7) property which is depreciated under the retirement-replacement method; and (8) property which is used predominantly outside the United States, within the meaning of Code section 48(a)(2), during the taxable years.[9] Personal property which

[9] Property which meets the "place of use" requirements of the investment tax credit by reason of the rules of clauses (i) through (xi) of Code section 48(a)(2)(B) will not be treated as used predominantly outside the United States for any taxable year for which such requirements are satisfied.

is not recovery property is to be depreciated under methods permitted by present law.

Open-ended recovery accounts

Under the committee's simplified cost recovery system, the depreciable basis of recovery property is placed in one of four open-ended recovery accounts. Under an open-ended account system, the costs of all eligible property with the same recovery period are placed in the same open-ended account regardless of the year of acquisition. Used and new recovery properties are aggregated in the same recovery account. This system will apply in lieu of vintage accounts under the ADR system and item accounting.

The amount which is added to the recovery account is the taxpayer's basis in the property without reduction for salvage value. Thus, the new system will eliminate all disputes as to salvage value. Progress payments made toward the acquisition of assets which are being constructed by or for the taxpayer and which have a normal construction period of 2 years or more will be added to the appropriate recovery account if the taxpayer elects. (See detailed discussion under "Revisions of progress expenditures rules," below.)

The system utilizes a half-year convention for the additions of property costs (including progress payments and, in the case of like-kind exchanges and involuntary conversions, money and other consideration furnished ("boot")) to a recovery account. Under the half-year convention, one-half of the cost of the recovery property is added to the account in the year that the asset is placed in service (other than progress payments which previously have been taken into account). The remaining half of the cost is added to the account in the subsequent taxable year.[10]

The recovery periods of the four recovery accounts correspond to depreciation terms of 2, 4, 7, and 10 years. The bill requires that property be assigned to a recovery account with the longest recovery period that is at least 40-percent shorter than the property's present asset guideline period under the present ADR system, except that no recovery period shall be reduced below 2 years. A property's present asset guideline period will be the useful life which is not longer than the asset guideline period applicable to such property as of August 20, 1980.

The bill specifically provides that the Treasury Department will have the authority to shorten, but will not have authority to lengthen, the asset guideline period of any asset class. Consequently, the Treasury cannot take administrative action which would result in assets being placed in a recovery account with a longer recovery period than the recovery period in which they would fall under the IRS revenue procedures now in effect. However, Treasury is to continue to have the authority to make determinations as to the classification of previously unclassified assets.

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[10] The application of the simplified cost recovery system to taxable years of less than 12 months shall be in accordance with regulations prescribed by Treasury. It is assumed that deductions for short taxable years will be annualized in a manner similar to the rules in Treas. Reg. § 1.167(a)–11(c)(2)(iv).

Assets will be assigned to recovery accounts in accordance with the following schedule:

Asset guideline period	*Recovery period (years)*
6.5 years or less	2
7.0 years to 11.5 years	4
12.0 years to 16.5 years	7
More than 16.5 years	10

For example, assets used to manufacture clothing which now have an asset guideline period of 9 years, will be placed in a recovery account with a 4-year recovery period (unless an election is made to place them in a recovery account with a 7-year recovery period). Equipment placed in the 7-year class will include the following assets which now have an asset guideline period of 12 years: assets (other than special tools) used in the manufacture of fabricated metal products, electrical equipment, motor vehicles, ships, and railroad cars. The bill requires that the Treasury Department publish simplified tables which set forth these shortened recovery periods and establish the recovery periods of those types of tangible personal property which are not currently covered by the ADR system.

The bill will permit a taxpayer to elect to place property in a recovery account having the next longer recovery period than the recovery period otherwise prescribed for that property.[11] This election can be made for the taxable year in which the property is placed in service (or, if qualified progress expenditures are recovered in earlier years, for the first taxable year in which such expenditures for the property are placed in a recovery account).

Computation of the annual recovery deduction

The amount of the allowable recovery deduction for any taxable year is computed by using a declining balance method. For each recovery account, the taxpayer elects annually which of three declining balance methods (200 percent, 150 percent, or 100 percent) will apply. The recovery deduction for a particular taxable year is then computed by multiplying the ending balance (unrecovered costs) in the recovery account by a recovery percentage. The recovery percentage reflects the number of years in the recovery period and the declining balance method elected for that year. The amount of the allowable recovery deduction is subtracted from the account to determine the opening balance in the account for the following year.

For example, assume that the unrecovered costs in the 4-year recovery account at the end of the taxable year amount to $1,000. The taxpayer may elect one of three declining balance methods (200 percent, 150 percent, or 100 percent) to compute the recovery deduction. If the taxpayer elects the 200-percent declining balance method, the recovery percentage is determined by dividing the declining balance percentage by the number of years in the recovery period (200 divided by 4). In the example, the recovery percentage is 50 percent. Thus, the recovery deduction is computed by applying the recovery percentage (50%) to the balance in the account ($1,000). The re-

[11] Elections made under these provisions of the bill may be made on an original return (including a late-filed original return). Once such elections are made, they may be revoked only with the consent of the Treasury.

covery deduction allowable for the taxable year would be $500. The balance in the account which would be used to determine the recovery deduction for the subsequent year would be $500, increased or decreased by any additions to, or subtractions from, the account for that year.

Additions would be made to an account (under the half year convention) upon the placing in service of qualified assets or, if an election is made, the making of qualified progress expenditures. A subtraction would be made from the account balance equal to the amount realized, in the case of the sale of an asset assigned to the account, or the fair market value of the asset, in the case of a transfer other than a sale (except for like-kind exchanges, involuntary conversions, and certain transactions where basis carries over).[12] If the balance of an account at the end of the taxable year, but prior to computation of depreciation, is either zero or a negative amount, no recovery deduction would be allowed for the year.

Disposition of assets and recapture

Under the simplified cost recovery system, gains and losses on the disposition of recovery property generally are deferred. Instead of immediate gain or loss recognition, the amount realized on the disposition will reduce the balance in the account which, in turn, will reduce the amount of recovery deductions in the year of the disposition and subsequent years. If the amount realized reduces the balance in the account to a negative amount, such amount generally will be recaptured as ordinary income.[13] However, the recapture will be reduced to the extent of the remaining one-half of the depreciable bases of assets placed in service during the taxable year (or the remaining one-half of qualified progress expenditures made or boot paid).

In a disposition where recovery property is transferred and the transferee's basis is determined by reference to the adjusted basis of the transferor (such as gifts and certain corporate nonrecognition transfers), the amount by which the transferor's recovery account is reduced is generally an amount which bears the same ratio to the balance in the recovery account as the fair market value of the transferred property bears to the fair market value of all assets (including the transferred property) in the account. However, the Secretary of the Treasury may prescribe alternative methods for determining the transferred amount. The transferee's basis in the transferred property will

[12] No such reduction will be made by reason of a transfer at death. Thus, no gain will be realized and the recovery deduction for the decedent's final return will be determined by reference to the account balance on the date of death. The transferee's addition to its recovery account for the assets received will be in the amount of the fair market of those assets (Code sec. 1014(a)). The half-year convention will apply with respect to such addition.

[13] To the extent it applies, the recapture rule in these new provisions overrides Code section 1231 which, in some circumstanecs, permits gain on the sale of depreciable personal property to be treated as capital gain to the extent such gain exceeds the amount of depreciation previously deducted on such property. Because simplified cost recovery eliminates separate basis computations for each property, the rules provided under Code section 1231 are not feasible for recovery property. In addition, receipts from sales or exchanges of recovery property do not go into the section 1231 computation for purposes of characterizing gains and losses from sales or exchanges of section 1231 property other than recovery property.

be determined by reference to this amount ("transferred amount").[14]

In the case of like kind exchanges or involuntary conversions where the properties exchanged are assigned to the same recovery account, no changes will be made to the account unless additional consideration in the form of money or other nonqualifying property ("boot") is involved. Where boot is involved or where the properties exchanged are assigned to different recovery accounts, adjustments would be made to the appropriate accounts in accordance with regulations to be prescribed by the Treasury Department.

Property which ceases to be recovery property, such as property which is converted to personal use or to a use predominantly outside of the United States, is treated as if it were disposed of during the taxable year in which it ceases to be recovery property. The balance of the recovery account to which it is assigned is reduced by the fair market value of the property at the time it ceases to be recovery property. If such property continues to be depreciable property in the hands of the taxpayer (as it might if it were used predominantly outside the United States), the property's basis will be its fair market value at the time it ceased to be recovery property.

Public utility property

Under the bill, public utility property is not eligible for the new simplified cost recovery rules. Rather, such property will continue to be depreciated under present rules. However, the present 20-percent variance allowed under the ADR depreciation system is increased to 30 percent for public utility property placed in service after December 31, 1980.

Under present law, the regulations generally require a public utility to normalize the tax deferral resulting from the use of a life shorter than the ADR guideline period (or, if shorter, the period for computing the depreciation expense for rate-making purposes) as a condition of eligibility for applying the ADR system to public utility property. (Treas. Reg. sec. 1.167(a)-11(b) (6).) The committee believes that this provision of the regulations accurately reflects Congressional intent in adopting the ADR system. The committee also intends that this normalization requirement apply to the tax deferral which would result from additional shortening of the lives of public utility property due to the increase in the ADR variance under this provision of the committee bill.

This provision of the committee bill and the provision for a simplified cost recovery system are not intended to require a public utility to use the ADR system for public utility property. Rather, the committee intends that utilities which may be using other methods of depreciating public utility property for tax purposes should be free to continue to use such methods if they are appropriate under present law.

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[14] The amount of the deduction for a charitable contribution of recovery property is reduced by the excess of the fair market value of the property over the transferred amount. This approach is similar to present law (Code sec. 170(e)) which reduces the amount of a charitable contribution of depreciable personal property by the amount of depreciation recapture which would have been realized on a sale of the property.

Earnings and profits

In providing accelerated depreciation deductions for taxpayers, the committee wishes to use a simplified cost recovery system for determining the earnings and profits of corporations but does not want to change materially the amount of depreciation deducted in computing earnings and profits because such computations generally determine whether a distribution of the corporation is taxable as a dividend. The committee believes that the method of depreciation used to determine earnings and profits should approximate that achieved under a straight line method of depreciation over the lower life in the asset depreciation range (ADR system) as is permitted under present law. To achieve this result, the committee bill provides that the recovery deduction used in computing earnings and profits is to be the amount which would have been determined for the taxable year under the recovery system if the percentage elected by the taxpayer for each taxable year were 100 percent divided by the number of years in the recovery period.

Also, for purposes of computing the earnings and profits of a corporation, the bill provides that the cost of depreciable personal property deductible under new Code section 179 as a current expense shall be allowed as a deduction ratably over a period of five years beginning with the year for which the cost is deductible. (This new expensing provision is discussed below in "Expensing in lieu of cost recovery for small business.")

Minimum tax and maximum tax

The bill provides that personal property owned by noncorporate lessors is recovery property (unless it is specifically excluded from classification as recovery property by another specific provision, such as the requirement that the system does not apply to public utility property). The bill further provides that the rule in the minimum tax which treats accelerated depreciation on personal property leased by noncorporate lessors as an item of tax preference will also apply to recovery property. For any class of recovery property, the amount of the tax preference is the amount by which the recovery deduction attributable to the portion of the class which is subject to a lease exceeds the deduction which would have been allowable as a recovery deduction with respect to such portion of the class if it were computed for all taxable years using a rate of depreciation equal to 80 percent divided by the number of years in the recovery period for such class. This manner of determining the tax preference generally is designed to take into account the fact that, under present law, taxpayers must take into account the benefit of the ADR variance (the use of a useful life lower than the asset guideline period) in determining the amount of this tax preference. Treasury is to prescribe regulations as to the manner of determining the portion of a class of recovery property which is subject to lease (for noncorporate lessors). This authority includes the authority to prescribe a separate set of recovery accounts for leased recovery property.

Although accelerated depreciation on leased recovery property is a tax preference item for noncorporate lessors for purposes of the minimum tax, it is not a tax peference item for purposes of reducing the

amount of personal service taxable income which is subject to the maximum tax.

(2) Revised useful life requirements for investment tax credit purposes

As a part of its revision of the cost recovery structure, the committee bill revises the rules relating to useful life qualifications of property for the investment tax credit. These rules apply to the investment tax credit available both for property which is subject to the new cost recovery system and other property, including public utility property. Under these rules, the useful life of any recovery property is the recovery period determined under the cost recovery system and the useful life of any other property is the useful life used in computing the allowance for depreciation under the normal depreciation rules (Code sec. 167) for the taxable year in which the property is placed in service. For property the useful life (or recovery period) of which is 2 years or more but less than 4 years, a 2.5-percent regular investment credit is available. (Technically, 25 percent of the cost of the property is eligible for the 10-percent credit). If the useful life (or recovery period) is 4 years or more but less than 7 years, the regular investment credit is 6 percent. If the useful life of the property is 7 years or more, the regular investment credit is 10 percent.

The substantial shortening of useful lives under the recovery system generally will result in a lower amount of investment credit being claimed for many assets. However, for most taxpayers, this is more than offset by the increased present value of the tax savings from acceleration of depreciation deductions. In revising this system, however, the committee did not intend to reduce the amount of energy investment tax credit or the credit for contributions to an employee stock ownership plan. Consequently, the bill provides that, for purposes of the energy percentage and the ESOP percentage, the qualifying basis of recovery property with a useful life of 4 years or more will be 100 percent of such basis, and for property with a recovery period of 2 years, the qualifying basis will be 66⅔ percent. Thus, in the case of energy property for which the 10-percent rate generally is applicable, this energy investment tax credit will not be reduced if the property is depreciated in a recovery account with a useful life of four years.[15]

Effective Date

These provisions generally apply to assets placed in service after December 31, 1980. The bill permits a taxpayer with a fiscal year which begins in 1980 to elect not to apply the simplified cost recovery system (including the investment credit modifications) to assets placed in service prior to his first fiscal year beginning in 1981. In addition, property placed in service prior to January 1, 1981, may become subject to the simplified cost recovery system, at the election of the taxpayer, in taxable years beginning after December 31, 1984.

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[15] A conforming amendment is made to the provision which allows a full investment tax credit for certain commuter highway vehicles so that they may obtain the full investment tax credit even though they are placed in a recovery account with a recovery period of 2 years.

Revenue Effect

It is estimated that the simplified cost recovery provision and the investment tax credit revisions will reduce budget receipts by $2,139 million in fiscal year 1981, $8,854 million in 1982, $14,192 million in 1983, $14,935 million in 1984, and $16,001 million in 1985.

b. Expensing in lieu of cost recovery for small business (sec. 215 of the bill and secs. 179 and 1245 of the Code)

Present law

Under present law, there are no special provisions exclusively applicable to the depreciation of assets by a small business. Thus, a small business may depreciate its assets over useful lives determined on a facts and circumstances basis or, if elected, under guidelines prescribed under the Asset Depreciation Range (ADR) system. Depreciation methods are allowable for small business to the same extent allowable for other taxpayers (i.e., straight-line, declining balance, etc., methods).

Although not limited to small businesses, the provision for additional first-year depreciation (Code sec. 179) was enacted to provide a special incentive for small businesses to make investments in depreciable property. Under this provision, a deduction is allowed for additional first-year depreciation in an amount not exceeding 20 percent of the cost of eligible property. In general, depreciable property placed in service during a taxable year is eligible under the provision if it is tangible personal property with a useful life of 6 years or more. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).[1] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Reasons for change

The committee believes that it is important to allow the many very small businesses which make limited amounts of investment in equipment to have the opportunity to avoid depreciation computations altogether. Thus, although the committee generally believes that it has provided a simplified system of rapid cost recovery in the

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[1] A controlled group of corporations (with a 50 percent control test) is treated as one taxpayer and thus is entitled to have only $10,000 of eligible property each year to be apportioned among the members of the group as provided by regulations (Code sec. 179(d) (6) and (7) ; Reg. § 1.179–2(c)). Also, a partnership is limited to $10,000 of eligible property per year, and a member of a partnership must aggregate his distributive share of the partnership's eligible property with his distributive share of eligible property from other partnerships and from his direct interest in section 179 property in applying the $10,000 (or $20,000) eligible property limitation (Code sec. 179(d) (8)).

A trust is not eligible to elect additional first-year depreciation (Code sec. 179(d) (4)). However, the Code permits an estate to elect to take an additional first-year depreciation allowance on up to $10,000 of qualifying property. Thus, the maximum deduction available to an estate is $2,000. The deduction is reduced, however, in the proportion that the qualifying cost of eligible property is apportioned to an heir, legatee, or devisee. The amount of the allowance under section 179 apportioned from an estate to an heir, legatee, or devisee shall not be taken into account by such heir, legatee, or devisee in determining the dollar limitations applicable to additional first-year depreciation on his own property (Code sec. 179(d) (5)).

simplified cost recovery system described above, it believes that businesses should be allowed to avoid depreciation and investment credit computations completely in situations where the depreciable personal property used in a trade or business does not exceed an annual cost of $25,000. This $25,000 is substantially in excess of the average annual investment in depreciable personal property of most small proprietorships and partnerships (and of many small corporations). The committee also believes that the new cost recovery system and the new expensing rules are, taken together, significantly generous that the provision for additional first-year depreciation (Code sec. 179) is not needed (but is rather only an additional complexity).

Accordingly, the committee bill replaces the present rules for additional first-year depreciation with a new Code provision which generally allows a taxpayer to elect to expense immediately up to $25,000 of the cost of recovery property (i.e., depreciable personal property other than public utility property and certain other limited classes of property) acquired by purchase in the taxable year.

Explanation of provision

Overview

The committee bill generally permits a taxpayer (other than a trust or estate) to elect to treat the cost of up to $25,000 of qualifying property as an expense which is not chargeable to capital account. The costs for which an election is made will be allowed as a deduction for the taxable year in which the qualifying property is placed in service. The aggregate cost limitation of $25,000 applicable to taxpayers generally is reduced to $12,500 in the case of a married individual filing a separate return.

In general, the property for which an election may be made is property which is eligible to be treated as recovery property (personal property which is eligible for the simplified cost recovery system) if the property is acquired by purchase for use in a trade or business. The trade or business limitation means that the election is not available for property which is held merely for the production of income (Code sec. 212), such as property used in a passive leasing activity. The requirement that the property be acquired by purchase is the same as the requirement in present Code section 179 for property which is eligible for additional first-year depreciation. Generally, this means that acquisitions do not qualify if (1) the property is acquired from a person whose relationship to the taxpayer would result in a disallowance of loss on a transaction between the taxpayers, (2) the property is acquired by one component member of a controlled group from another component member of the same group (using a 50-percent control test), or (3) the basis of the property in the hands of the person acquiring it is determined in whole or in part (a) by reference to the adjusted basis of the property in the hands of the person from whom it was acquired or (b) under the step-up basis rules for property acquired from a decedent.

Other dollar limitations

Under the bill, a controlled group of corporations is subject to similar limitations as under the present Code section 179. Thus, a controlled

group of corporations (with a 50-percent control test) is treated as one taxpayer and is entitled to have only $25,000 of eligible property each year to be apportioned among the members of the group as provided in regulations.

Similarly, the same type of dollar limitations will apply in the case of partnerships as currently apply under Code section 179(d)(8). Under the bill, a partnership is limited to $25,000 of eligible property per year, and a member of a partnership must aggregate his distributive share of the partnership's eligible property with his distributive share of eligible property from other partnerships and from his direct interest in section 179 property in applying the $25,000 (or $12,500) eligible property limitation.

Other limitations on eligibility

Under present law, trusts are not eligible for additional first-year depreciation (presumably to prevent multiplication of these deductions where additional first-year depreciation deductions could also be claimed by the beneficiaries on their own depreciable property). However, an estate is eligible for benefits of additional first-year depreciation, and it appears that the heir, legatees or devisee of a portion of the estate may obtain a deduction for additional first-year depreciation with respect to his own property as well as having obtained a benefit of such a deduction apportioned to him by the estate (Code sec. 179 (d)(5)) Treas. Reg. § 1.179-2(6)). Since the benefits of this expensing provision are more significant than the benefits of a limited amount of additional first-year depreciation, the committee bill provides that the election to expense property under this section is not available to estates or trusts.

Dollar limitations where property is traded in

Present Code section 179 provides that the cost of property eligible for additional first-year depreciation does not include the portion of the basis of such property which is determined by reference to the basis of property traded in. A similar rule is provided in the new expensing provision. Under this new rule, if property is acquired in a like-kind exchange or as a result of an involuntary conversion, the amount eligible for expensing is only the amount of the additional consideration (generally money) paid by the taxpayer.

Elections

The bill provides that an election to expense property under this section for any taxable year must specify the items of property to which the election applies and the portion of the cost of each of these items which is to be deducted currently. The election must be made on an original return (including a late filed original return). In order to provide a degree of certainty, the provisions require that an election to expense property and any specification of items or amounts contained in such an election may not be revoked except with the consent of the Treasury Department.

Subsequent treatment of expensed property

If property, the basis of which has been entirely expensed pursuant to this new section is later disposed of, the gain on such property will be recaptured (that is, treated as ordinary income) to the extent of

the cost which was expensed. Thus, for instance, if a taxpayer who had acquired eligible property for a cost of $20,000 in 1982 and expensed the entire amount in such year were later to sell such property for $30,000, the first $20,000 of the gain would be taxed as ordinary income under Code section 1245 and the remaining $10,000 would generally be taxed as capital gain under Code section 1231.

If only a portion of the cost of property is expensed and the remainder of the cost of the property goes into the cost recovery system, then, upon disposition, the property is to be treated in the same general manner as if it were two separate properties with one portion treated as expensed property (referred to above) and the other portion treated as recovery property. Thus, for instance, if a taxpayer who acquired recovery property with a cost of $75,000 and elected to expense $25,000 of the cost of such property were later to sell such property for $60,000, then $20,000 of the proceeds of the property (the same proportion of the proceeds as the portion of the cost which was expensed) would be subject to recapture under section 1245 and $40,000 (two-thirds of the proceeds) would reduce the appropriate recovery account balance.

Relationship with investment tax credit

To the extent that the cost of property is expensed pursuant to this new provision, no investment tax credit is allowable with respect to such cost.

Relationship to progress payments rules

The election to expense the cost of property does not apply to any property with respect to which an election to treat progress payments as property placed in service (under new Code section 168(i)) is made. The primary reason for this prohibition is that a combination of these elections would create undue complexity. Also, it is not anticipated that small taxpayers will have many assets on which progress payments are made.

Effective date

These provisions will apply to property placed in service after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $1,623 million in fiscal year 1981, $2,952 million in 1982, $1,701 million in 1983, $1,257 million in 1984, and $925 million in 1985.

c. Depreciation of real property (sec. 214 of the bill and secs. 167, 1245, and 1250 of the Code)

Present law

Methods of depreciation

Under present law, a depreciation deduction is allowed for the exhaustion, wear, and tear of buildings used in a trade or business or held for the production of income. New residential rental buildings may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the aggregate depreciation allowable during the first two-thirds of the property's useful life does not exceed the amount allowable under the 200-percent declining balance method. For this purpose, a building or structure is considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income is from the rental of dwelling units. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential properties with an estimated useful life of 20 years or more may be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. All other used properties must be depreciated under the straight-line method.

Useful lives

Under present law, depreciation for real estate may be determined by estimating useful lives under a facts-and-circumstances test or under lives prescribed under Revenue Procedure 62–21, as in effect on December 31, 1970. Guideline lives under the class life asset depreciation range system (ADR) generally have not been prescribed for real property.

Under Revenue Procedure 62–21, useful lives are prescribed for certain types of buildings. The useful lives are based on a composite account for the structural shell and all integral parts, including air-conditioning, fire prevention, and power requirements, and equipment such as elevators and escalators. The lives exclude special-purpose structures which are an integral part of a production process and are normally replaced when the equipment housed is replaced. The lives are set forth in Table 2.

TABLE 2.—GUIDELINES LIVES FOR CERTAIN BUILDINGS UNDER REVENUE PROCEDURE 62–21

Type of Building	Useful life (years)
Apartments	40
Banks	50
Dwellings	45
Factories	45
Garages	45
Grain Elevators	60
Hotels	40
Loft Buildings	50
Machine Shops	45
Office Buildings	45
Stores	50
Theaters	40
Warehouses	60

Generally, as indicated in Table 3, taxpayers have claimed useful lives that are shorter than those listed in Rev. Proc. 62–21.

TABLE 3.—COMPARISON OF 1962 GUIDELINES AND LIVES CLAIMED FOR CERTAIN BUILDING TYPES

[In years]

Building type	Guideline lives under revenue procedure 62–21	Average lives claimed by taxpayers (new buildings only)	Percentage of taxpayers claiming lives shorter than guideline lives
Retail (including shopping centers)	50	36	93
Warehouses	60	37	99
Factories	45	37	77
Office buildings	45	41	91
Banks	50	43	79
Apartments	40	32	78

Source: Office of Industrial Economics. Department of the Treasury, *Business Building Statistics* (GPO, Washington, 1975).

Furthermore, by use of the component depreciation method, some taxpayers have claimed depreciation deductions which approximate the deductions which would be obtained by the use of composite lives of as short as 16–20 years on certain new commercial buildings.[1] However, there is no certainty that these deductions will be allowed by IRS or the courts.

[1] Under this depreciation method, a taxpayer allocates the cost of a building to its basic component parts and then assigns separate useful lives to those components. These components would include the basic building shell, plumbing and heating system, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property.

Special amortization rules

Under present law, special depreciation rules are provided for expenditures to rehabilitate certain low-income rental housing (Code sec. 167(k)). For this purpose, low-income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income, as determined by the Secretary in a manner consistent with the Leased Housing Program under section 8 of the United States Housing Act of 1937.

Under the special depreciation rules for low-income rental property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Under present law, only the aggregate rehabilitation expenditures for any housing which does not exceed $20,000 per dwelling unit qualifies for the 60-month depreciation. In addition, for the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the current taxable year—must exceed $3,000 per dwelling unit.

Also, under present law, special depreciation rules are provided for certified historic structures (secs. 167(o) and 191 of the Code). Certified rehabilitation expenditures for certified historic structures may be amortized over a 60-month period. Alternatively, in some cases, the cost of an historic structure, including the rehabilitation expenditures, may be depreciated as a new building, for example, under the 200-percent declining balance method for residential property or the 150-percent declining balance method for nonresidential property.

A 60-month amortization method also is available for certified pollution control facilities and certain expenditures for child care facilities.

Recapture

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231). This portion of the gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

In the case of 60-month amortization, gain is generally recaptured as ordinary income for the full amount of the amortization allowable in the same manner as recapture for depreciable personal property. However, in the case of low-income housing rehabilitation expenditures and certified rehabilitation expenditures for certified historic structures, gain is recaptured as ordinary income only to the extent of the amortization allowable in excess of straight-line depreciation in essentially the same manner as for depreciable real property generally.

Accelerated depreciation on real property in excess of straight-line is treated as a tax preference for minimum tax purposes, reduces the amount of personal service income eligible for the 50-percent maximum tax on personal service income, and is not taken into account in determining the earnings and profits of a corporation.

Reasons for change

The committee believes that the rules for depreciation of real property should be revised to provide more simplicity and more accelerated depreciation than is currently available. These goals, however, must be achieved without increasing tax shelter opportunities.

In general, under present law, the method of depreciation available with respect to depreciable real property depends upon whether the property is new or used, is residential or nonresidential, and, in the case of used residential property, has a useful life of 20 years or more. Present law generally requires that the useful lives in Revenue Procedure 62–21 or useful lives determined on a facts and circumstances test be used. Taxpayers generally use a facts and circumstances test which lacks certainty and results in unnecessary administrative burdens for the taxpayer and the government. Also, to obtain the effect of shorter lives for real property, many taxpayers have depreciated the components of a building separately. Component depreciation creates complexity and uncertainty. As a result, the committee provided for three new elections with respect to depreciable realty which will significantly simplify depreciation calculations: (1) one election for low income housing; (2) one election for qualified owner-occupied industrial and commercial buildings, and (3) another election which is available for any section 1250 property. An election to use a useful life of 15 years (which is to be audit proof) may be made for low-income housing and certain owner-occupied industrial or commercial buildings. An election to use an audit proof useful life of 20 years is provided for all depreciable real property (other than public utility property). If an election is made to depreciate real property under any of three elections provided by this provision, the composite method must be used.

Explanation of provision

In general

The committee bill provides several new elective approaches to depreciation of real property (without eliminating the present law methods).

If any of these elections is made, the useful life will not be subject to change upon examination by the Internal Revenue Service. Any of these elections may apply to any eligible new or used property placed in service by the taxpayer during the taxable year. None of these elections are available for public utility property (within the meaning of Code sec. 167(l)(3)(A)).

For purposes of these elections and the recapture rules, each separate improvement (within the meaning of Code sec. 1250(f)(4)) is to be treated as a separate property.

20-year straight-line election

In general, the bill provides that, at the election of the taxpayer, any section 1250 property (as defined in Code sec. 1250(c)) other than

public utility property may be depreciated using the straight-line method and a useful life of 20 years. If this election is made, only the composite method is allowable.[2] Thus structural components will be depreciated on a straight-line method using a useful life of 20 years.

Low-income housing

At the election of the taxpayer, low-income housing may be depreciated using a fifteen year useful life and the straight-line, composite method of depreciation. For purposes of this provision, the present definition of low-income housing (in Code sec. 1250(a)(1)(B)) is used.

The committee notes that a new federally assisted multifamily program is presently in conference with the appropriate housing committees. To the extent that Congress enacts a new multifamily program which provides assistance for low and moderate income housing, appropriate changes in the tax laws may be necessary with respect to the definition of housing for low and moderate income families. However, to the extent that projects assisted under any new program are insured under section 221(d)(3) of the National Housing Act or are projects financed or assisted by direct loan programs or tax abatement under comparable provisions of State or local laws and with respect to which the owner is regulated as to rate of return and rental or occupancy charges in a manner consistent with those requirements under section 221(d)(3), then it is low-income housing for purposes of the new depreciation rules and the other provisions of the Internal Revenue Code (secs. 189 and 1250) providing special tax benefits for low-income housing.

Owner-occupied commercial and industrial buildings

For qualified owner-occupied industrial and commercial buildings, a taxpayer may elect to depreciate the property over a 15-year period under the declining balance method using a rate not in excess of a 150 percent of the straight-line rate. Also, only the composite method is available for the building and its structural components under this election.

The term "qualified owner-occupied building" means any building or structure located in the United States if (a) such building is 100 percent owned by the taxpayer (not as a condominium within the meaning of applicable State law, if any), (b) an election under this new provision is in effect for such building, and (c) at least 80 percent of the building or structure is used by the taxpayer for a qualified use or uses at all times during the taxable year. For purposes of the 80-percent test, common areas such as halls, stairwells, and convenience facilities, are to be disregarded. For example, if a building or structure has aggregate space amounting to 20,000 square feet and the common area amounts to 5,000 square feet, then, for purposes of the 80-percent test, only 15,000 square feet is to be taken into account.

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[2] Under the composite method, the building and its structural components would all have to be depreciated over the same useful life. However, items treated as personal property, such as elevators and escalators, are not treated as structural components of a building for this purpose. Also, expenditures which are subject to an amortization election are not required to be treated as structural components for purposes of this rule.

Thus, in this case, if at least 12,000 square feet is used by the owner for a qualified use, then the building or structure will qualify under this new provision. Also, in applying the 80-percent test, space is disregarded for any period for which it is not useable. Thus, if a taxpayer uses one-half of a building for a qualified use during a taxable year and the other half of the building is vacant because it is being renovated during such year, the 80-percent test will be satisfied for such year.

In general, the term "qualified use" means use by the taxpayer as an industrial building, retail store, or catalog distribution center.

Under the bill, an industrial building is a building or structure used for manufacturing, production or extraction, or the furnishing of transportation or communications, or as a research facility used in connection with such activities of the taxpayer. Office buildings, retail stores, public utility property (sec. 167(l) (3) (A)), and certain warehouse and storage areas are not industrial buildings under this provision of the bill.

A warehouse or storage area is to be included within the term industrial building if (1) it is an integral part of or adjacent to such a building or structure and necessary for, and directly related to such activities, or (2) it is used for the storage of raw materials or unfinished goods for use by the taxpayer in such an activity. For purposes of this provision, "adjacent to a qualified owner-occupied building" means the warehouse or storage area is contiguous with such building or would be contiguous with such building except for the interposition of a road, street, railroad, stream, or similar property. Assume, for example, that a warehouse or storage area is contiguous to the building or structure but not attached thereto and that the warehouse or storage area serves as an area where finished goods from the manufacturing, etc., process are stored until such time as they enter the distribution channel. In this case, the warehouse or storage area will be considered as necessary for and directly related to a qualified use.

For a research facility to qualify, the facility must be 100 percent owned by the taxpayer and used in connection with an otherwise qualified use of the taxpayer. Where the research facility is used for contract research and, not used in conjunction with a manufacturing, etc., activity of the taxpayer, its use does not qualify as a qualified use. Also, an office building occupied by accountants, lawyers, architects, physicians, and other persons who provide services will not qualify as an industrial building under the provisions of this bill.

Under the bill, the term "retail store" means a building or structure used for the sale of goods to the public for purposes other than resale, and includes a warehouse or storage area which is an integral part of, or adjacent to, such building or structure, used for the storage of such goods, and necessary for, and directly related to, the sale of goods at such location. Incidental sales not at retail will not disqualify a retail store. For this purpose, incidental sales means gross sales of 10 percent or less.

The term "catalog distribution center" means a building or structure used for the distribution of goods ordered by the public from the taxpayer from a catalog or similar publication.

An owner-occupied building that is used for multiple uses qualifies for the election if each use is a qualified use. If, for example, a taxpayer uses part of a building or structure as a catalog distribution center and the rest of the building as a retail store which qualifies under the provisions of this bill, then the multiple use is a qualified use.

Under the bill, a building is not owner-occupied if any person other than the taxpayer is entitled to claim depreciation deductions with respect to such building. Thus, a building is not owner-occupied if it is occupied by a corporation but owned by an individual stockholder (even if the shareholder owns 100 percent of the corporation's stock). However, for purposes of this provision, husband and wife are treated as one taxpayer, and the members of the same affiliated group of corporations are treated as one taxpayer if a consolidated return is filed for such members of the group. Similarly if a partnership owns a building and uses the building for a qualified use, the building will be considered owner-occupied. However, if the building is owned by an individual and used for a qualified use by a partnership in which the individual is a partner, the building will not be considered owner-occupied.

An election to use the 15-year, 150-percent declining balance method for a building can be made only for the taxable year in which the building is placed in service (or the first taxable year for which depreciation is claimed with respect to progress expenditures) and only if the building is a qualified owner-occupied building for such year (or, if progress expenditures are depreciated, it is reasonably anticipated that the building will be a qualified owner-occupied building when it is placed in service). Thereafter, the 15-year, 150-percent declining balance method can be used only for those years that the building is a qualified owner-occupied building. For example, if the 80-percent test is not met at any time during a taxable year after the taxable year for which the initial election is made, then for that taxable year the taxpayer must compute depreciation by using a straight-line composite method and a useful life of 20 years. If in a subsequent taxable year the building is returned to the status of a qualified owner-occupied building, then the taxpayer may re-elect the benefits of this provision. In these cases, depreciation is computed by taking into account the adjusted basis as of the beginning of the taxable year.

Recapture

If an election is made to depreciate a qualified owner-occupied building under this new 15-year method, then gain from the disposition of the property will be subject to ordinary income recapture in accordance with Code section 1245. Once an election has been made under this provision, all depreciation allowable with respect to the property will be subject to ordinary income recapture under Code section 1245.

Except for qualified owner-occupied buildings for which the new 15-year method is elected, the bill retains the current recapture rules under which, in general, only "additional depreciation" is recaptured on the sale of depreciable real property. Thus, if a taxpayer makes either a 20-year straight-line election for real property or a 15-year straight-line election for low-income housing under these new provisions and holds the property for at least 12 months after it is placed

in service (or acquired), there will be no depreciation recapture on a sale of the property.

Effective date

This provision is to be effective with respect to property placed in service after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $45 million in fiscal year 1981, $161 million in 1982, $256 million in 1983, $298 million in 1984, and $326 million in 1985.

d. Revision of progress expenditure rules (secs. 211, 217, and 218 of the bill and secs. 46 and 167 and new sec. 168(i) of the Code)

Present law

Investment tax credit

Under present law, a taxpayer may elect to treat "qualified progress expenditures" made for new property as part of the base for which he may claim an investment credit. In general these qualified progress expenditures are amounts actually paid (or incurred in the case of self-constructed property) for construction (or acquisition or reconstruction) of property which has a normal construction period of at least 2 years and which will have an estimated useful life in the hands of the taxpayer of at least 7 years.

In the case of self-constructed property (that is, property where it is reasonable to believe that the taxpayer will bear more than half of the construction costs directly), "qualified progress expenditures" will generally equal the costs incurred by the taxpayer which are properly chargeable to capital account in connection with that property (for purposes of the investment credit). Also, in the case of self-constructed property, qualified progress expenditures can include amounts expended for parts or materials acquired by the taxpayer to the extent that the taxpayer can establish, to the satisfaction of the Internal Revenue Service, that these parts or materials have been irrevocably allocated to the construction of the property.

In the case of non-self-constructed property, qualified progress expenditures are the amounts paid by the taxpayer to the manufacturer, but only to the extent that there is actual progress made in the construction of the property. For this purpose, "progress" is the percentage of completion, measured in terms of the manufacturer's incurred cost as a fraction of his anticipated cost (as adjusted from year to year), based upon cost accounting records or, in some cases, on engineer's or architect's certificates. In the absence of contrary evidence, progress is deemed to occur not more rapidly than ratably.

Under present law, the taxpayer generally is allowed to claim the full credit to which he is entitled with respect to property in the year in which it is placed in service. However, amounts which were treated as qualified investment with respect to the property in preceding years, due to the operation of the progress payment rules, reduce qualified investment in the taxable year the property is placed in service.

Depreciation

Under present law, the period for depreciation of an asset begins only when the asset is placed in service. In general, property is considered placed in service when it is in a condition or state of readiness and availability for a specifically assigned function. Depreciation may

not be claimed on progress expenditures even though the investment credit may be claimed on such expenditures.

Reasons for change

In the case of property with a long construction period, the committee believes that it is inequitable to defer the beginning of the period for depreciation until the property is placed in service, particularly when substantial payments are made or costs incurred during the course of construction.

The committee believes, therefore, that it is appropriate to allow depreciation to begin with respect to progress payments for property which requires a long period of construction. As a result, the bill provides that, in the case of property that requires at least 2 years to construct, a taxpayer may elect to begin depreciation with respect to progress payments made during the construction period (rather than in the year when the property is ultimately placed in service).

The committee also believes that two sets of rules with respect to the tax treatment of progress expenditure payments (investment credit and depreciation) are not necessary. Thus, the committee made certain amendments to the present law investment credit progress expenditure rules and provided that these rules, as amended, also will apply with respect to depreciation of progress expenditures.

Explanation of provision

Overview

In general, the bill repeals present requirements of the investment credit rules which require that progress expenditure property must have a useful life of 7 years or more when placed in service. Additionally, the present law "more than half" test to distinguish between self- and non-self-constructed property has been repealed. The treatment of qualified progress expenditures also has been extended to depreciation of recovery property (which is depreciated under the new simplified cost recovery system) and certain real property.

Changes in investment credit

Under present law, progress expenditure property mean property constructed by or for the taxpayer (a) which has a normal construction period of 2 years or more and (b) which it is reasonable to believe will be new section 38 property with a useful life of 7 years or more when such property is placed in service. The bill repeals the requirement of a useful life of 7 years or more. Otherwise, progress expenditure property under the committee bill has the same meaning as under present law.

In general, for property with less than a 7-year useful life, the regular investment credit applies only to a limited percentage (applicable percentage) of the cost. (Under the bill, a different set of applicable percentages applies for purposes of the energy investment credit and the ESOP credit.) Since, under the bill, progress expenditure property may have less than a 7-year useful life, only the applicable percentage of qualified progress expenditures may be taken into account in determining qualified investment. For example, assume the reasonably expected useful life of progress expenditure property is 4 years. Under section 213 of the bill, the applicable percentage for the regular

investment credit would be 60 percent (100 percent for the ESOP and energy credits). Accordingly, only 60 percent of the qualified progress expenditures made during the taxable year for the property may be taken into account in determining qualified investment for purposes of the regular investment credit.[1]

The committee repealed the present law "more than half" test which was used to determine whether property was self- or non-self-constructed property. Under the bill, a property is to be divided into two parts—a self-constructed portion and a non-self-constructed portion. The term self-constructed portion means the portion of the property the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer. The term non-self-constructed portion means the portion of the property other than any self-constructed portion. Construction expenditures will be considered made "directly" by the taxpayer only if the taxpayer uses his own employees to construct the property. Construction expenditures made directly by the taxpayer include wages, overhead attributable to construction of that property, materials, supplies and similar items that are to be irrevocably allocated to the construction of that project. Construction expenditures made by the taxpayer to a contractor or manufacturer, in general, will not be considered made directly by the taxpayer. However, expenditures for basic construction materials, such as sheet metal, lumber, glass, and nails, which are used by employees of the taxpayer to construct progress expenditure property, will be considered made directly by the taxpayer.

In the case of the self-constructed portion of the property, qualified progress expenditures are the amounts properly chargeable (during the taxable year) to capital account with respect to such portion. In general, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are properly includible in computing basis under Treas. Reg. § 1.46–3. Amounts treated as an expense and deducted in the year they are paid or incurred are not chargeable to capital account.

Expenditures for component parts constructed by the taxpayer's employees and materials are not to be taken into account until they are irrevocably allocated to the property, even if they are otherwise chargeable to a capital account at an earlier time. Component parts constructed by the taxpayer's employees and materials designed specifically for the property may be considered irrevocably allocated to construction of that property at the time of manufacture. In addition, an item delivered to the site of construction may be considered irrevocably allocated if it would be economically impractical to remove the item to another site.

In the case of the non-self-constructed portion of the property, qualified progress expenditures are the amounts paid by the taxpayer during the taxable year to another person for construction, but only to the extent that there is actual progress made in the construction of that portion of the property. For this purpose, progress will generally

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[1] No similar limit would apply to the amount of progress expenditures to be taken into account (subject to the half-year convention) for depreciation purposes (if an election had been made to depreciate the qualified progress expenditures with respect to this property).

be the percentage of completion, measured in terms of the manufacturer's incurred cost, as a fraction of anticipated cost (as adjusted from year to year) based upon cost accounting records or in some cases on engineer or architect certificates. However, progress in construction of the non-self-constructed portion of the property, under the bill, is deemed to occur, at a minimum, ratably over the normal construction period measured in months.[2] For example, assume physical work pursuant to a contract is begun for a calendar year taxpayer on January 1, 1981 for the manufacture of a machine to be delivered on July 1, 1983 (30 months later). The contract price for the machine is $600,000. For the calendar year 1981, it is determined on the basis of the manufacturer's cost accounting records that the percentage of completion with respect to the machine amounts to 20 per cent; during 1981, payments amounting to $200,000 were made by the taxpayer to the manufacturer. In this case, the amount paid, $200,000, is to be taken into account as a qualified progress expenditure because the amount to be taken into account on the monthly ratable basis, $240,000 (12 months divided by the length of the normal construction period of 30 months amounts to 40 per cent; $600,000 x 40% = $240,000) is greater than the percentage of completion amount, $120,000 ($600,000 x 20%).

Expenditures for component parts which are purchased and merely installed or assembled by the taxpayer are not to be considered as progress expenditures for the self-constructed portion of the property. Thus, the expenditures for component parts are taken into account when paid but only to the extent of actual progress and subject to the ratable construction period rule.

Extension to depreciation rules

The bill permits a taxpayer to elect to depreciate qualified progress payments for taxable years during the construction period rather than commencing depreciation in the taxable year the property is placed in service. This rule applies to recovery property and depreciable real property located in the United States other than public utility property (as defined in Code sec. 167(1) (3) (A)).

The election to take into account progress expenditures in determining qualified investment for investment credit purposes must be made for all progress expenditure property. The bill retains this requirement for purposes of the investment credit. However, for purposes of computing depreciation, the election is to be made on a property-by-property basis, but separate parts of one single integrated unit are not to be treated as separate properties.

For investment tax credit purposes, no change is made in the rule that progress expenditure property be new section 38 property. However, in the case of progress expenditures for which a depreciation deduction is allowable, recovery property and depreciable real property located in the United States other than public utility property are to be substituted for new section 38 property. In computing depreciation for recovery property and real property, the half-year convention is to be used in determining the amount of cost recovery or depreciation to be claimed.

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[2] The presumption under present law that progress occurs not more rapidly than ratably has been deleted.

With respect to depreciation recapture on real property under Code section 1250, the allowable depreciation deduction with respect to progress expenditure property will be considered additional depreciation until such time as the property is actually placed in service and held for a period of more than one year. This rule is to apply notwithstanding the deemed placed in service rule provided for under new Code section 167(s)(1).[3]

Effective date

These provisions apply to progress expenditures made after December 31, 1980.

Revenue effect

It is esimated that this provision will reduce budget receipts by $329 million in fiscal year 1981, $1,223 million in 1982, $1,860 million in 1983, $1,824 million in 1984, and $1,646 million in 1985.

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[3] This deemed placed-in-service rule applies only for purposes of allowing the taxpayer to begin depreciating the property. This rules does not apply for purposes of Code section 1250.

e. Investment credit for rehabilitation expenditures (sec. 219 of the bill and sec. 48(g) of the Code)

Present law

Buildings and their structural components are not eligible for the investment credit, except for qualified rehabilitation expenditures and certain single purpose agricultural structures.

The investment credit is allowed for rehabilitation expenditures for all types of buildings held for business or investment purposes, other than those used for residential purposes. Expenditures which qualify for the credit are depreciable rehabilitation costs incurred after October 31, 1978, in connection with a building which has been in use for at least 20 years, for the interior or exterior renovation, restoration, or reconstruction of the building. Costs for acquiring or completing a building, or for the replacement or enlargement of a building, are excluded. If more than 25 percent of the exterior walls are replaced, the costs will not qualify.

The rehabilitation expenditures must be for property that will have a useful life of at least 5 years, and the credit is determined using the present limitations applicable to useful lives. In addition, the costs must be incurred at least 20 years after the last prior qualifying rehabilitation (if any) was completed.

Reasons for change

The committee expressed concern that the tax incentives for capital formation provided in other sections of this bill might create an unintended and undesirable bias in favor of new structures and new locations at the expense of older structures, neighborhoods, and regions. A new plant in a new structure with new equipment and new organization of production may add little to capital formation or productivity, if it simply replaces an existing plant in an older structure in which the new equipment and production organization could have been installed. Furthermore, the relocation of a business can result in substantial hardship for individuals and communities. Since this hardship does not affect the profitability of the business, it may not have been fully taken into account in the decision to relocate, even though it is an economic detriment to the society as a whole.

Accordingly, the committee action should help to improve the economic prospects of older industrial and commercial locations. The increased credit for rehabilitation expenditures will help revitalize the economic prospects of older locations and prevent the decay and deterioration characteristic of distressed economic areas.

Explanation of provision

The committee bill increases the investment credit for qualified rehabilitation expenditures on structures from 10 percent to 25 percent.

The other present law rules regarding qualified expenditures continue in effect. The only modifications that are made relate to adjustments to conform the rules for partial investment credits to the new rules associated with the depreciation revisions included in this bill.

Effective date

This provision will apply to qualified rehabilitation expenditures made after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $202 million in fiscal year 1981, $524 million in 1982, $604 million in 1983, $682 million in 1984, and $755 million in 1985.

3. Other Provisions Affecting Small Business (secs. 221–228 of the bill)

a. Increase in minimum accumulated earnings credit (sec. 221 of the bill and sec. 535 of the Code)

Present law

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax of 27½ percent to 38½ percent on improperly accumulated corporate earnings where the accumulation occurs in an attempt to avoid the income tax with respect to the corporation's shareholders. In computing the base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. Present law provides a minimum credit of $150,000 of earnings which may be accumulated before any accumulated earnings are subject to this tax.

Since 1975, the minimum credit has been $150,000. During the period from 1958 to 1975, the minimum credit was $100,000, and prior to 1958 the minimum credit was $60,000.

Reasons for change

Since 1975, when the accumulated earnings credit was increased from $100,000 to its present level of $150,000, there have been substantial increases in costs which require additional capital to make an investment of the same type and scope. Increased borrowing costs cause small businesses to rely more heavily upon internal generation of capital for possible future needs. Quite often small businesses do not have the specific plans for expansion which are required, under the law, to justify accumulations of corporate earnings in excess of the minimum credit. An increase in the credit not only adjusts for the rise in costs, but also provides a wider margin for the retention of earnings for future contingencies, and thus reduces borrowing pressures on small businesses. As a result, the committee believes it generally is appropriate to increase the amount of the credit. However, the committee also believes that it is not appropriate to increase the minimum credit for certain types of service corporations. In the case of these corporations, the existing minimum credit and credit equal to the earnings retained for the reasonable needs of the business are adequate to allow the corporation to accumulate capital for possible future needs. In addition, if the minimum credit were increased for these corporations, it would allow the unreasonable accumulation of corporate earnings and the avoidance of the individual income tax.

Explanation of provision

The committee bill increases the minimum accumulated earnings credit to $250,000. However, this increase does not apply to specified service corporations whose principal business consists of the perform-

ance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Effective date

The provision applies to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $11 million in fiscal year 1981, $31 million in 1982, $35 million in 1983, $37 million in 1984, and $42 million in 1985.

b. Increase in used qualified property regular investment tax credit (sec. 222 of the bill and sec. 48(c) of the Code)

Present law

Present law provides a 10 percent regular investment credit with respect to both new and used qualified property. However, the amount of regular investment credit which may be claimed by a taxpayer each taxable year with respect to used qualified property is subject to a dollar limitation.

Under the used property limitation applicable to the regular investment credit (Code sec. 48(c)), a taxpayer may take into account not more than $100,000 of used qualifying property acquired by purchase each taxable year. (Used qualifying property is property which qualifies for the investment credit but which originally was used by someone other than the taxpayer.) This limitation results in a maximum regular investment credit of $10,000 on used property for any taxable year. Where the taxpayer's cost in qualifying used property purchased during the taxable year exceeds $100,000, the taxpayer may select the property on which the regular investment credit is claimed. Rules are also provided which apply the $100,000 limitation to married taxpayers, controlled groups of corporations, and partnerships. In addition, the credit is not allowed where used property is acquired from a related taxpayer, such as a family member or an affiliated corporation, or where the same taxpayer continues to use the property both before and after its acquisition (for example, through a sale and leaseback transaction).

Reasons for change

It appears that many small businesses acquire significant amounts of used property. The committee believes, therefore, that an increase in the regular investment credit for used property is necessary to assure that small businesses participate in the general upgrading of productive facilities which this bill is intended to stimulate. Also, the $100,000 limitation initially became a part of the tax law in 1975, and the committee believes that an adjustment is necessary to reflect the increases in the prices of equipment due to inflation.

Explanation of provision

The bill increases the annual cost limitation on used property for purposes of the 10-percent regular investment credit from $100,000 to $150,000.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

This provision will reduce budget receipts by $61 million in fiscal year 1981, $154 million in 1982, $159 million in 1983, $165 million in 1984, and $173 million in 1985.

c. Subchapter S corporations allowed 25 shareholders (sec. 223 of the bill and sec. 1371 of the Code)

Present law

Subchapter S was enacted in 1958 to minimize the effect of Federal income taxes on the form in which a business is conducted by permitting incorporation and operation of certain small businesses without the incident of income taxation at both the corporate and shareholder levels. Subchapter S rules allow a corporation engaged in an active trade or business to elect to be treated for income tax purposes in a manner similar to that accorded partnerships. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is revoked or terminated.

Under present law, to be eligible for a subchapter S election, the corporation must have 15 or fewer shareholders.

Reasons for change

The committee believes that increasing the permitted number of shareholders to 25 will facilitate the use of the subchapter S provisions by more businesses.

Explanation of provision

Under the provision, the maximum number of shareholders permitted for a corporation to qualify for and maintain subchapter S status is increased from 15 to 25.

Effective date

The provision applies to taxable years beginning after December 31, 1980.

Revenue effect

This provision will reduce budget receipts by less than $5 million per year.

d. Incentive stock options (sec. 224 of the bill and new sec. 422A of the Code)

Present law

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by the rules of section 83 of the Internal Revenue Code. Generally, under section 83, the value of the option constitutes ordinary income to the employee if the option itself has a readily ascertainable fair market value at the time it is granted to the employee. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at the time granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee. Personal service income generally is taxed at a maximum rate of 50 percent.

In addition, the employer generally is allowed a business expense deduction for the amount includible in the employee's income in its corresponding taxable year (Code sec. 83(h)).

Background of tax treatment of stock options

Restricted stock options

The Revenue Act of 1950 added provisions for the use of a "restricted stock option" under which no income tax was imposed either when the option was granted or exercised. Instead, tax generally was imposed at the time the stock involved was sold by the employee. In the case of those restricted stock options where the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time he sold the stock was treated as capital gain. Where the stock option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the option price and the market value of stock at the time of the grant of the option was treated as ordinary income when the stock was sold. Any additional gain at the time the stock was sold in such cases was treated as capital gain. In the case of these restricted stock options, employers were not allowed any deduction for the amount of the gain realized by the employee, whether this gain was treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outline above, the option price must have been at least 85 percent of the market price of the stock at the time the option was granted; the stock and/or the option must have been held by the employee for at least 2 years after the date of the granting of the option and the stock must have been held for at least 6 months after it was transferred to him; the option must not have been transferable other than at death; the individual may not have been a 10-percent shareholder in the corporation (unless the option price was at least 110

percent of the fair market value); and the option must not have been for a period of more than 10 years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock option provisions and added provisions allowing so-called "qualified stock options".

These qualified stock options were taxed in a manner similar to restricted stock options. These options, however, must have been granted with an option price of at least the market price when the option was granted (subject to a 150-percent inclusion in income where a good faith attempt to meet this requirement failed).

In addition, qualified stock options were subject to the following additional rules: the stock must have been held 3 years or more; the option may not have been held more than 5 years; stockholders' approval must have been obtained; the options must have been exercised in the order granted; and no option may have been granted to shareholders owning more than 5 percent of the stock (increased up to 10 percent for corporations with less than $2,000,000 of equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 added a minimum tax under which a tax was imposed equal to 10 percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added. However, the income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options, etc.

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20. 1976 (except for certain transitional options which will cease to be qualified after May 20, 1981). This Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax, and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, the taxes on capital gains were reduced so that the maximum rate of tax on these gains is 28 percent.

Reasons for change

The committee believes that reinstitution of a stock option provision will provide an important incentive device for corporations to attract new management and retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. It is argued that encouraging the management of business to have a proprietary interest in its successful operation will provide

an important incentive to expand and improve the profit position of the companies involved. The committee bill is designed to encourage the use of stock options for key employees without reinstituting the alleged abuse situations which arose with the restricted stock option provisions of prior law.

Explanation of provision

This provision creates an "incentive stock option", which will be subject to taxation in a manner similar to the tax treatment previously available to restricted and qualified stock options—i.e., there will be no tax consequences at the time the option is exercised, and the employee will be eligible for capital gain treatment when the stock is sold. Similarly, no business expense deduction will be allowed to the employer corporation at any time with respect to an incentive stock option.

The taxpayer must hold the option, or stock, for at least two years, and the stock itself for at least one year in order to receive incentive stock option treatment. Where all conditions other than the holding period requirements are met, the tax will be imposed upon the sale of the stock, but the tax will be based on ordinary income rather than capital gain, and the employer will be allowed a deducction at that time. Where the price of the stock at the time of sale is less than the value at exercise, the amount of ordinary income will be limited to the difference between the option price and the actual sales price.

In addition, for the entire time from the date of the granting of the option until 3 months before the date of the exercise of the option, the individual must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirement are waived in the case of the death of the employee.

For an option to qualify as an "incentive stock option," the terms of the option itself must meet certain specified conditions. These requirements are as follows:

1. The option must be granted under a plan which specifies the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.
2. The option must be granted within 10 years of the time the plan is adopted or approved by the stockholders, whichever is earlier.
3. The option must by its terms be exercisable only within 10 years of the time it is granted.
4. The option price must equal or exceed the fair market value of the stock at the time the option is granted (in the case of a variable price option, determined as if the option had been exercised when granted). An exception to this provides that where the option price is less than the market price, but there has been a good faith attempt to value the stock properly, then this condition is to be considered as met.
5. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by him.

6. The employee immediately before the option is granted must not own stock representing more than 10 percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary. For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, wife, ancestors, and lineal descendants. Stock owned directly or indirectly by a corporation, partnership, estate, or trust for this purpose is considered as being owned proportionately by shareholders, partners, or beneficiaries. However, this provision is waived if the option price is at least 110 percent of the fair market value of the stock subject to the option and the option by its terms is not exercisable after the expiration of 5 years from the date it is granted.

The difference between the option price and the fair market value of the stock at the exercise of the option will not be an item of tax preference.

Finally, any option which is a qualified stock option or restricted stock option under present law will become an incentive stock option if it is not exercised before January 1, 1981, and if it otherwise meets the qualifications to be an incentive stock option.

Effective date

The amendments made by this provision will apply to options exercised after December 31, 1980.

Revenue effect

This provision will reduce budget receipts by less than $5 million per year through fiscal year 1984, and will increase budget receipts by $15 million in fiscal year 1985.

e. Time for furnishing Form W-2 to terminated employees (sec. 225 of the bill and sec. 6051 of the Code)

Present law

Under present law, every employer who pays wages from which Federal income tax or FICA (Social Security) tax must be withheld is required to furnish each employee a statement (Form W-2) which sets forth: the names of the employer and employee; the amount of wages subject to income tax withholding and the amount withheld; and the amount of FICA wages and FICA tax withheld. In the case of most employees, W-2 Forms for the calendar year must be furnished no later than January 31 of the following year. However, if an employee terminates employment prior to the close of the calendar year, that employee must be furnished with a Form W-2 on the day on which his or her last salary payment is received.

The Internal Revenue Service has recently published regulations (T.D. 7656, Nov. 28, 1979) which provide that the employer may furnish a Form W-2 to an employee whose employment terminates prior to the close of the calendar year at any time after the termination but no later than January 31 of the following year. However, if an employee who terminates employment prior to the close of the calendar year requests earlier receipt of a Form W-2, and if there is no reasonable expectation on the part of the employer and employee of further employment during the calendar year, then the employee must be given a Form W-2 on or before the later of the 30th day after the request or the 30th day after the last salary payment (Treas. Reg. § 31.6051-1 (d)(1)).[1]

Reasons for change

The committee believes that the present law requirement that a terminating employee be provided a Form W-2 on the date of his or her last salary payment may be unduly burdensome to many small employers. Moreover, the committee feels that this requirement serves no useful purpose in many circumstances. For example, many employees who terminate with one employer often begin work with another employer prior to the close of the calendar year. Since this category of individuals must wait until they receive W-2's from subsequent employment before they can file tax returns, it would not seem necessary to require the former employers to provide W-2's with the last salary payment. Furthermore, it has come to the committee's attention that some individuals in this category are likely to misplace W-2's they have received from a former employer during the year. This imposes additional expense on the employer who then must issue duplicate W-2 Forms.

Because of these concerns, the committee has decided that the general approach of the recently revised Treasury regulations should be

[1] It is not clear that there is a statutory basis for this approach.

codified. Under this general approach, employees who terminate employment during the calendar year would be provided with Forms W-2 at the same time as all other employees. However, a terminating employee would be given the option to receive his or her Form W-2 at an earlier date.

Explanation of provision

Under the committee bill, the employer of an employee who terminates employment prior to the close of the calendar year would be required to furnish the employee with a Form W-2 no later than January 31 of the following year (the same time all other employees must be provided a W-2), unless the employee requests early receipt. If a terminating employee makes a written request for early receipt of a Form W-2, then the employer would be required to furnish the employee with a W-2 no later than 30 days after the receipt of the written request (rather than with the last salary payment).

In addition, the bill would require an employer to furnish a terminating employee with a written notice that he or she may request early receipt of Form W-2 and that if he or she does not so request, then a Form W-2 will be sent to the employee's last known address before January 31 of the next calendar year. This written notice would have to be provided on the day on which the employee receives his or her last salary payment.

Effective date

The provision is effective upon enactment.

Revenue effect

This provision will have no direct effect on revenues.

f. Reserves for market-making activities (sec. 226 of the bill and sec. 81 and new sec. 251 of the Code)

Present law

Under present law, a securities dealer must recognize any gain on the sale of equity securities, even if he is making a market for the securities. Generally, this gain will be treated as ordinary income.

Reasons for change

An important aspect of investing in equity securities is the subsequent marketability of the security. This is particularly true in the case of new offerings of small business securities. In order for a securities dealer to sell a new offering of a small business equity security, the dealer must be willing to support that security in the "after-market" by purchasing those shares of the security which others are willing to sell in daily trading. A securities dealer's support of the security in the "after-market" is known as "making a market" for the security.

The committee believes that by allowing security dealers to defer the recognition of gain on small business stock in which they make a market, it will encourage dealers to make markets for unlisted securities of smaller corporations. The committee believes that this will make new capital markets available to small businesses.

Explanation of provision

Under the bill, a corporaton (other than a subchapter S corporation) which is engaged in market-making activities of certain small business equity securities during the taxable year will be allowed to deduct the lesser of the net gains for that year from the sale of such securities or the amount of the current year addition to the taxpayer's reserve for gains from market-making activities. However, no deduction is allowed to the extent that the reserve exceeds $1 million. In addition, no deduction is allowed to the extent that the addition to the reserve exceeds 30 percent of the fair market value of the taxpayer's average monthly inventory positions in over-the-counter equity securities carried for market-making activities for the year. Finally, the deduction may not exceed the taxpayer's taxable income for the year (determined without regard to this provision).

The term "gain from market-making activities" means net gain from the sale or exchange of over-the-counter equity securities held by the taxpayer for sale in the ordinary course of its trade or business if the securities are of corporations that had $25 million or less of stock and securities outstanding on the last day of the preceding taxable year. An over-the-counter equity security is any equity security of a corporation, none of whose equity securities are traded on a registered security exchange.

A corporation will be considered to be engaged in market-making activities if it is a securities dealer (or a specialist permitted to act as a dealer) which buys and sells over-the-counter equity securities and

it holds itself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell over-the-counter equity securities for its own account on a regular or continuous basis.

Under the bill, the amount of an addition to the reserve for a taxable year will be taken back into income in the fifth year following the year of the addition. However, the taxpayer can withdraw amounts from the reserve at any time during that 5-year period. These early withdrawals (withdrawals are deemed to be from the earliest remaining addition to the reserve) will be taxed in the year of the withdrawal. The unwithdrawn balance of any addition to the reserve will be required to be withdrawn and will be subject to tax in the fifth year following the year it is added to the reserve.

In the case of a controlled group of corporations, the entire group is treated as one taxpayer for purposes of computing the $1 million and "30-percent-of-market-making-inventory" limitations. The amount of the deduction allowable for each member of the group will be its proportionate share of net gain from market-making activities taken into account in determining the amount of the deduction. A "controlled group of corporations" has the same meaning given to such term by Code section 1563(a), except that "more than 50 percent" will be substituted for "at least 80 percent" each place it appears in Code section 1563(a)(1).

Any corporation that transfers substantially all of its assets in a liquidation, reorganization or other transaction will be treated as having withdrawn the remaining unwithdrawn balance in its market making reserve immediately before the transfer. However, in the case of a liquidation where the adjusted basis of the distributed assets is determined under Code section 334(b)(1) or in the case of a reorganization described in Code section 368(a)(1)(D) or (F), the amount of the withdrawal from the market making reserve will be determined under regulations prescribed by the Secretary.

Effective date

This provision applies to taxable years beginning after December 31, 1980.

Revenue effect

This provision will reduce budget receipts by $40 million in fiscal year 1981, $90 million in 1982, $70 million in 1983, $40 million in 1984 and $20 million in 1985.

g. Deferred application of Revenue Procedure 80–5 and Revenue Ruling 80–60 relating to inventory writedowns (sec. 227 of the bill)

Present law

In Revenue Procedure 80–5 and Revenue Ruling 80–60, the Internal Revenue Service provided rules which require taxpayers to conform their method of inventory accounting to the method of inventory accounting approved by the Supreme Court in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979). For taxpayers with excess inventories (inventories) in excess of foreseeable demand) that have been erroneously written down for tax purposes, these pronouncements require that the writedowns be taken back into income.

These Internal Revenue Service pronouncements, which were issued on February 8, 1980, are applicable to 1979 taxable years.

Reasons for change

The committee believes that Revenue Procedure 80–5 and Revenue Ruling 80–60 were released too late to allow taxpayers to comply with certain Treasury Regulations in 1979 that would have mitigated the income recapture required under the *Thor Power* decision.

Explanation of provision

The bill delays the required compliance with Revenue Procedure 80–5 and Revenue Ruling 80–60 to taxable years beginning after December 31, 1979. However, the bill is not intended to deny voluntary compliance with Revenue Procedure 80–5 and Revenue Ruling 80–60 for taxable years ending on or after December 25, 1979. This provision does not apply to taxpayers described in section 3.06 of Revenue Procedure 80–5 (relating to certain taxpayers under audit) who may not make a change in accounting method under Revenue Procedure 80–5.

The bill allows taxpayers who filed tax returns in compliance with Revenue Procedure 80–5 and Revenue Ruling 80–60 to file amended returns as though they had not changed their method of accounting under those pronouncements for taxable years beginning before December 31, 1979.

Effective date

The provision applies to taxable years ending after December 24, 1979.

Revenue effect

It is estimated that this provision will reduce budget receipts by $25 million in fiscal year 1981, and increase them by a comparable amount in later years, primarily 1990.

h. Refund of excise tax for certain fuels used in intercity, local, and school buses (sec. 228 of the bill and secs. 6421 and 6427 of the Code)

Present law

Under present law, a manufacturers excise tax of 4 cents per gallon is imposed on gasoline, and a retailers excise tax of 4 cents per gallon is imposed on diesel fuel and other special motor fuels used or sold for use in a highway motor vehicle (Code secs. 4081 and 4041(a) and (b)).[1]

The Energy Tax Act of 1978 provided that a credit or refund of the excise taxes paid with respect to gasoline and other motor fuels could be obtained to the extent that these fuels are used in a bus engaged in furnishing (for compensation) passenger land transportation available to the general public or in school bus transportation operations.[2]

The present rules relating to refunds of excise taxes on gasoline or other motor fuels provide that a quarterly refund of such taxes on gasoline or other motor fuels can be obtained only if the amount of the refund attributable to any quarter of the taxpayer's taxable year is at least $1,000. Separate computations are made for gasoline and other motor fuels. Those amounts which are not refunded quarterly generally must be claimed by the taxpayer as a credit on his tax return for the taxable year in which the fuel was used (Code secs. 39, 6421(c), and 6427(g)).

Reasons for change

The committee believes that it is inappropriate to require relatively small operators of intercity, local, or school buses to wait until the end of the year to obtain the benefits of the refund or credit of taxes paid on gasoline or other motor fuels. However, the committee believes that it is inappropriate to provide that such fuel could be sold to private bus operators free of tax because, in many circumstances, it is not possible at the time of sale to determine whether the fuel will be used for a qualifying use or for a taxable use.

Consequently, the committee bill provides that a person who is entitled to a refund or credit of the taxes on gasoline or other motor fuels which are used in providing qualifying passenger land transportation available to the general public or school bus operations

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[1] These taxes are scheduled to be reduced to 1½ cents per gallon as of October 1, 1984. Receipts from these taxes attributable to periods prior to October 1, 1984 (when excise tax funding of the Fund is presently scheduled to cease) are transferred into the Highway Trust Fund.

[2] The definitions of "passenger land transportation available to the general public" and "school bus transportation operations" are discussed in detail in S. Rept. 95-529, 55-56 (the report of the Committee on Finance on the tax provisions which became part of the Energy Tax Act of 1978).

may obtain the refund on a quarterly basis if the amount of excise tax attributable to fuel used in the quarter is at least $50.

Explanation of provision

The bill provides that a taxpayer who is entitled to a refund or credit of the excise taxes on gasoline or other motor fuels because such fuels were used in a bus while engaged in (1) the furnishing (for compensation) of certain passenger land transportation available to the general public or (2) the transportation of students or employees of schools will be able to obtain a refund of these taxes on a quarterly basis with respect to fuel used during any of the first three quarters of his taxable year if the refund is $50 or more for fuel used in such quarter. As under current law, any amounts which are not refunded on a quarterly basis (including any amounts attributable to the fourth quarter of the taxpayer's taxable year) may be claimed by the taxpayer as a credit on his income tax return.

In determining whether the $50 minimum is reached with respect to fuel used in one of the first three quarters of a taxpayer's taxable year, amounts payable with respect to gasoline and other motor fuels are to be aggregated.

Effective date

This provision applies to fuel which is used on or after October 1, 1980.

Revenue effect

It is estimated that this provision will have a negligible effect on budget receipts.

4. Credit for Research and Experimental Expenditures (secs. 231–232 of the bill and new Code secs. 44F, 174(f), and 280C(c))

Present law

Overview

Present law does not provide an income tax credit specifically for research and experimental expenditures.[1]

In general, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as a new product, normally must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered on a disposition or abandonment of the asset, or through depreciation or amortization deductions over the useful life of the asset. However, section 174 of the Code permits election of special accounting methods for certain research or experimental expenditures which are paid or incurred during the taxable year in connection with the taxpayer's trade or business.

Section 174 deduction elections

A taxpayer may elect to deduct currently the amount of these expenditures, even if they are treated as capital account charges or deferred expenses on the taxpayer's books or financial statements (Code sec. 174(a); Rev. Rul. 58–78, 1958–1 C.B. 148). For example, a taxpayer may elect to expense the cost of labor and materials used in qualifying research activities, even if such costs otherwise would have to be capitalized. Alternatively, if the property resulting from research and experimental expenditures does not have a determinable useful life (as in the case of secret processes or formulas), the taxpayer may elect to deduct the costs ratably over a period of not less than 60 months (Code sec. 174(b)). If research expenditures are not eligible for these elections, or if the taxpayer does not elect either current deduction or amortization over 60 months or more, the expenditures must be capitalized.[2]

The costs of land and of certain depreciable or depletable property are expressly excluded from section 174 elections (Code sec. 174(c)), as are expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas (sec. 174(d)).[3] How-

[1] A taxpayer's investment in machinery and equipment which are employed in research and experimental activities is eligible under present law for the investment tax credit to the same extent as investment in machinery and equipment which are employed for business purposes or for current production of income (Code secs. 38, 46–48).

[2] If the capitalized expenses relate to depreciable property, deductions may be taken in the form of depreciation allowances spread over the property's useful life. If the capitalized expenses relate to nondepreciable property, those costs are not recoverable until disposition or abandonment of the property.

[3] However, expenses of developing new methods of extracting minerals from the ground may be eligible for section 174 elections (Rev. Rul. 74–67, 1974–1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under Code sec. 616.

ever, depreciation or depletion deductions with respect to property used in connection with research activities are treated as expenditures eligible for the elections (Code sec. 174(c); Treas. Reg. § 1.174–2(b)). Accordingly, buildings and equipment can be depreciated as if used for business purposes or employed in current income production.

A taxpayer may elect section 174 expensing or amortization for the costs of research conducted directly by the taxpayer and for expenses paid or incurred for research carried on in the taxpayer's behalf by another person, such as a research institute, foundation, engineering company, or similar contractor (Treas. Reg. § 1.174–2(a)(2)). However, amounts paid by the taxpayer which are expended by a research entity for land or depreciable property to be used in research carried on in the taxpayer's behalf do not qualify for section 174 elections if the taxpayer acquires ownership rights in such property.

Definition of qualifying expenditures

The Code does not specifically define "research or experimental expenditures" eligible for the election (except to exclude certain costs, as discussed above). However, Treasury regulations (§ 1.174–2(a)) define the statutory term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned." The term also includes the costs of obtaining a patent on such property.

The regulations provide that qualifying research and experimental expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, section 174 elections cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, and similar projects.

Reasons for change

The committee believes that a substantial tax credit for incremental research and experimental expenditures will overcome the resistance of many businesses to bear the costs of staff and facilities which must be incurred in initiating or expanding research programs. While such costs bear characteristics of investment activity, the relationships between the investment and the subsequent earnings often are less directly identifiable, and many businesses are reluctant to allocate scarce investment funds for uncertain rewards.

Research and experimentation are basic activities that must precede the development and application of new techniques and equipment to production and the development and manufacture of new products. The committee believes that its multifaceted approach in the bill, designed to stimulate a higher rate of capital formation and to increase productivity, appropriately includes incentives for greater private activity in research.

In recent years, spending for these purposes by the Federal Government and businesses has not been adequate. Although current ex-

penditures increased throughout the past 12 years, real outlays (expressed in 1972 prices) fluctuated in a $2 billion range between $19.1 and $21.1 billion for most of the period. Relative to real gross national product, real research expenditures decreased through 1978 and increased minimally in 1979.

Explanation of provision

Overview

Under the provision, a nonrefundable income tax credit will be allowed for research and experimental expenditures (hereinafter referred to in this report as "research expenditures") paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer, but only to the extent such expenditures exceed the average amount of the taxpayer's research expenditures in the base period.

The rate of the credit (new Code sec. 44F) will be 25 percent of the incremental research expenditure amount. In computing the credit, only expenditures for research conducted within the United States are taken into account.

The credit is allowable for any incremental research expenditures for the taxable year whether or not the taxpayer has in effect for that year an election under Code section 174 to expense, or amortize over a period of 60 months or more, research expenditures. In the case of an individual or a subchapter S corporation entitled to a credit for research expenditures in a taxable year, no deduction shall be allowed for that portion of research expenditures in the year which is equal to the amount allowable as a credit (see discussion below).

Trade or business requirement

Under the provision, the credit is to be available only with regard to research expenditures paid or incurred in carrying on a trade or business (within the meaning of Code sec. 162) of the taxpayer. The credit, therefore, will not be allowable for research expenditures paid or incurred by a taxpayer merely in connection with, but not in carrying on, a trade or business.

The rule that only research expenditures paid or incurred by the taxpayer in carrying on a trade or business can qualify for the credit is a more stringent requirement than that which has been deemed applicable for purposes of Code section 174 (relating to research and experimental expenditures which are paid or incurred "in connection with" the taxpayer's trade or business). For example, under the trade or business test of new Code section 44F, the credit generally would not be allowable with regard to a taxpayer's expenditures for "outside" or contract research intended to be transferred by the taxpayer to another in return for license or royalty payments. (Receipt of royalties does not constitute a trade or business under present law, even though expenses attributable to those royalties are deductible from gross income (sec. 62(5)) in arriving at adjusted gross income.) In such a case, the nexus between the research and the transferee's business generally would be insufficient to support a finding that the taxpayer had incurred the research expenditures in carrying on a trade or business. (Under appropriate circumstances, nevertheless, the nexus might be deemed adequate for purposes of the section 174 deduction elections.) If, however,

the taxpayer used the product of the research in the taxpayer's trade or business, as well as licensing use of the product by others, the relationship between the expenditures and the taxpayer's trade or business activities would be sufficient for credit purposes.

Definition of research expenditures

The provision contains a definition of research expenditures which will apply both for purposes of the new credit and for purposes of deduction elections under Code section 174, as amended by the provision.[4]

Under this definition, the term "research and experimental expenditures" means amounts paid or incurred by the taxpayer—

> (A) for research for the purpose of discovering information which is potentially useful either (i) in the development of a new business item for the taxpayer or (ii) in bringing about a significant improvement in an existing business item of the taxpayer, or
>
> (B) in application of results obtained by research to develop a plan or design either (i) for a new business item for the taxpayer or (ii) for a significant improvement in an existing business item of the taxpayer.

Expenditures of the taxpayer for research which is considered "basic research" will be eligible for the section 174 deduction elections or for the credit if such expenditures satisfy this definition (and other applicable requirements under the provision, such as the trade or business requirement for the credit, as discussed above). Costs incurred in connection with routine or periodic alterations or improvements (such as seasonal design changes) to existing business items, production lines, or other ongoing operations will not qualify as research expenditures under this definition.

The provision defines "research" to mean a planned search or critical investigation, including experimentation, and "business item" to mean a product, service, process, or technique for use by the taxpayer in a trade or business. An "existing" business item refers to a business item (other than the research in question) sold or used by the taxpayer in a trade or business before the taxpayer paid or incurred the amounts for research or for application of research results. A business item of a person whose research expenditures are aggregated with those of the taxpayer (pursuant to the rules discussed below) is treated as a business item of the taxpayer. For example, amounts paid by a parent corporation for research for purposes of discovering information which is potentially useful in development of a new business item for its wholly owned subsidiary will be treated the same as if such amounts had been paid for research in development of a new business item for the parent corporation.

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[4] While the definition of research expenditures is the same for purposes both of the section 174 deduction elections and the new credit, research expenditures which qualify for the section 174 deduction elections may not be also eligible for the credit. For example, research expenditures may be eligible under section 174 if paid or incurred in connection with the taxpayer's trade or business, but enter into the credit computation only if paid or incurred in carrying on a trade or business of the taxpayer (see discussion above). Also, expenditures for research conducted outside the United States may qualify for section 174 deduction elections but will not qualify for the credit.

Expenditures of a taxpayer will not qualify under the definition if paid or incurred for research, or for the application of research results, in connection with a business item after either (1) the new or significantly improved business item meets specific functional and economic requirements of the taxpayer for that item or (2) the new or improved item is ready for manufacture, sale, or use.

This definition of research expenditures is derived from the definition of "research and development" set forth in Financial Accounting Standards Board ("FASB") Statement No. 2, paragraph 8 (October 1974). However, a determination of whether particular expenditures qualify for the section 174 deduction elections or the new credit is to be based on the language of Code section 174, as amended by this provision, and is not to be controlled by the wording of FASB Statement No. 2 or by any interpretations for accounting purposes of FASB Statement No. 2. Any change by the FASB in the definition or interpretation of "research and development" shall not have any effect on the meaning or interpretation of this provision.

The existing provisions of Code section 174 which exclude certain expenditures from eligibility for the deduction elections also will apply in the case of the new credit.[5] Thus, for example, the costs of land and of certain depreciable or depletable property will not qualify either for the deduction elections or for the credit (Code sec. 174(c)).[6] However, depreciation and depletion deductions with respect to such property used in carrying on research activities will be treated as expenditures eligible for the credit as well as for the section 174 deduction elections to the extent they are so treated under present law (Code sec. 174(c); Treas. Reg. § 1.174–2(b)). As also provided by existing law, expenditures to ascertain the existence, location, extent, or quality of mineral deposits (including oil and gas) will not be eligible either for the section 174 deduction elections or the new credit (Code sec. 174(d)).

The provision excludes from the definition of research expenditures, for purposes both of the section 174 deduction elections and the new credit, any expenditures (1) related to research in the social sciences or the humanities, or (2) to the extent funded by a grant, contract, or subcontract with any Federal, State, or local government agency or instrumentality.

It also is intended that, in accordance with Treas. Reg. § 1.174–2(a), research expenditures do not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys (including market research), advertising, or promotions (including market testing activities), or to the costs of acquiring another person's patent, model, production, or process.

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[5] In conformity with the language of new Code section 174(f), as added by the provision, which uses the term "research and experimental expenditures," the provision changes the term "research or experimental expenditures" in existing Code sec. 174 to "research and experimental expenditures".

[6] In accordance with Treas. Reg. § 1.174–2(a)(2), amounts paid by the taxpayer for research carried on in the taxpayer's behalf by another person and which are expended by the research entity for land or depreciable property to be used in the research do not qualify either for the section 174 deduction elections or for the new credit if the taxpayer acquires ownership rights in such property.

Computation of allowable credit

In general.—The credit will apply to the excess of the taxpayer's research expenditures for the taxable year over the average of the taxpayer's yearly research expenditures during the base period.

For the taxpayer's first taxable year beginning after December 31, 1980, the credit will apply to the amount of research expenditures for that year which exceeds the amount of such expenditures in the preceding taxable year. For the taxpayer's second taxable year beginning after December 31, 1980, the credit will apply to the amount of research expenditures for that year which exceeds the average of such expenditures in the preceding two taxable years. For subsequent taxable years, the credit will apply to the amount of research expenditures for that year which exceeds the average of such expenditures in the preceding three taxable years.

If the taxpayer, or a related person whose research expenditures are aggregated with those of the taxpayer (pursuant to the rules discussed below), was not in existence during a base period year, then the taxpayer, or the related person, is treated as having research expenditures of zero in such year, for purposes of computing annual research expenditures during the base period. If the taxpayer has a short taxable year, research expenditures for that year are to be annualized to the extent provided in Treasury regulations.

Pass-through of credit.—The provision also provides that under Treasury regulations, rules similar to those used with respect to the targeted jobs credit (Code secs. 52(d) and 52(e)) will apply for purposes of apportioning the credit earned by a subchapter S corporation, or by a trust or estate, to the shareholders or beneficiaries.

Determination of incremental research expenditures

Aggregation rules.—To ensure that the new credit will be allowed only for actual increases in research expenditures, and not for artificial increases resulting from shifting the same level of expenditures among commonly controlled or otherwise related persons, the provision includes rules under which research expenditures of the taxpayer are aggregated with research expenditures of other persons for purposes of computing any allowable credit.

Under the provision, all research expenditures of all corporations that are members of a "controlled group of corporations" are treated as if made by one taxpayer. For this purpose, the same controlled group test (50-percent control) is used as applies under rules for computing the targeted jobs tax credit (Code sec. 52(a)). Any research credit earned by a controlled group, computed pursuant to this aggregation rule, is to be apportioned among members of the group on the basis of their proportionate share of the increase in aggregate research expenditures giving rise to the credit.

The provision also requires aggregation, pursuant to Treasury regulations, of all research expenditures of partnerships, proprietorships, and any other trades or businesses (whether or not incorporated) which are under common control with the taxpayer. Any allowable research credit, computed pursuant to this aggregation rule, is to be apportioned, as provided in Treasury regulations, among the persons whose expenditures are aggregated on the basis of their proportionate

share of the increase in aggregated research expenditures giving rise to the credit. This aggregation and apportionment rule is to be based on principles similar to the principles applicable in the case of a controlled group of corporations.

Example.—The following example illustrates the method of apportioning the credit among persons whose research expenditures are aggregated pursuant to the rules discussed above.

Assume that a controlled group of four corporations has research expenditures during the base period and taxable year as follows:

Research Expenditures

(in thousands of dollars)

Corporation	Base period (average)	Taxable year	Change
A	$60	$40	($20)
B	10	15	5
C	30	70	40
D	15	25	10

Treating the research expenditures of the four corporations as if made by one taxpayer, the total amount of incremental research expenditures eligible for the credit is $35,000 ($55,000 increase attributable to B, C, and D, less $20,000 decrease attributable to A). The total amount of credit allowable to members of the group is 25 percent of the incremental amount, or $8,750.

No amount of credit is apportioned to A, since A's research expenditures did not increase in the taxable year. The full $8,750 credit would be allocated to B, C, and D, i.e., to those members of the group with increases in their research expenditures. This allocation would be made on the basis of the ratio of each such corporation's increase in its research expenditures to the sum of increases in research expenditures (counting only members with increases). Inasmuch as the total increase made by those members of the group whose research expenditures went up (B, C, and D) was $55,000, B's share of the $8,750 credit is 5/55; C's share is 40/55; and D's share is 10/55.

If in the example set forth above, A had zero expenditures in the taxable year, the controlled group as a whole would show a decrease rather than an increase in aggregate research expenditures. In that case, no amount of credit would be allowable to any member of the group even though B, C, and D actually increased their research expenditures in comparison with their own base period expenditures.

Changes in business ownership.—The provision includes special rules for computing the credit where a business changes hands. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer. If the provision did not include rules for changes in ownership of a business, a taxpayer who begins business by

buying and operating an existing company might be entitled to a credit even if the amount of research expenditures were not increased. Also, the sale of a unit of a business could cause the seller to lose any credit even though research expenditures increased in a part of the business that was retained.

Under the provision, if a taxpayer acquires (after December 31, 1979) the major portion of a trade or business (or of a separate unit thereof) the credit for any year ending after the acquisition is to be computed as if the business had not changed hands. That is, the taxpayer's research expenditures for periods before the acquisition are to be increased by the amount of research expenditures attributable to the acquired business (or separate unit). Under these rules, a taxpayer is not to be treated as acquiring the major portion of a trade or business (or of a separate unit thereof) merely because the taxpayer acquires some assets used in that trade or business. Instead, this determination is to be made on the basis of whether the acquisition involves the transfer of a viable trade or buiness which can be operated by the taxpayer.

The provision also includes rules for computing the amount of incremental research expenditures where a taxpayer disposes (after December 31, 1979) of a major portion of a trade or business (or of a separate unit thereof). In determining the credit allowable to the taxpayer for a taxable year ending after the disposition, the taxpayer's research expenditures during periods before the disposition are to be decreased by the amount of research expenditures attributable to the business (or separate unit) which has changed hands. This rule permits a taxpayer which operates two businesses to sell one and nevertheless earn a credit for increased research expenditures in the retained business. However, this relief is not provided unless the taxpayer furnishes the acquiring person with information needed to compute the credit under the acquisition rules described in the preceding paragraph.

Limitation and carryover

The amount of credit which can be used in a particular taxable year will be limited to the taxpayer's income tax liability reduced by certain other nonrefundable credits. If the amount of allowable credit exceeds this limitation, the excess credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward seven years, beginning with the earliest year.[7]

Disallowance of deduction

In the case of an individual taxpayer or subchapter S corporation, no deduction shall be allowed for that portion of research expenditures

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[7] In conformity with these credit carryover rules, sec. 231(c) of the bill makes technical amendments to Code sec. 55(c)(3), relating to carryover and carryback of certain credits in connection with the alternative minimum tax; sec. 381(c), relating to carryover items of the distributor or transferor corporation in certain corporate acquisitions; sec. 383, relating to special limitations on carryovers of certain credits, etc.; the table of Code sections relating to carryovers; sec. 6511(d)(4)(C), defining credit carrybacks in connection with refund claims; and sec. 6511, relating to quick refunds in respect to tentative carryback adjustments.

Also, sec. 231(d) of the bill makes technical and clerical amendments to Code sec. 6096(b), defining income tax liability for purposes of rules on payments to the Presidential Election Campaign Fund, and to the table of sections for subpart A of the Code.

paid or incurred during a taxable year in which a credit for research expenditures is allowable equal to the amount of credit allowable to the taxpayer for the taxable year. The deduction is disallowed by the full amount of the credit without regard to the tax liability limitation discussed above. The disallowed amount may not be deducted under Code secs. 162, 167, 172, or 174, or any other deduction provision; that is, the disallowance is not limited to deductibility pursuant to a section 174 deduction election.

In the case of persons whose research expenditures are aggregated pursuant to the rules discussed above (for purposes of computing the credit), the reduction in the allowable deduction is to be allocated under rules similar to those for allocation of the credit.

Effective date

The provision is effective for taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $214 million in fiscal 1981, $522 million in fiscal 1982, $622 million in fiscal 1983, $711 million in fiscal 1984, and $798 million in fiscal 1985. It will reduce 1981 calendar year tax liability by $475 million.

5. Liberalization of Individual Retirement Savings Provisions (sec. 301 of the bill and secs. 72, 219, 220, 402, 403, 2039, 2517, and 4973 of the Code)

Present law

Under present law, an individual is allowed a deduction from gross income for contributions to an IRA (secs. 219, 220). The maximum deduction with respect to contributions for a year generally is the lesser of 15 percent of compensation includible in gross income or $1,500. In the case of an individual whose spouse has no earned income, the maximum deduction is the lesser of 15 percent of compensation includible in gross income or $1,750, provided the individual shares the contribution equally with the spouse (spousal IRA).

Under present law, no deduction is allowed to an individual for a contribution to an IRA for a year if the individual (or the spouse in the case of a spousal IRA) for that year (1) is an active participant in a tax-qualified pension, profit-sharing, stock bonus, bond purchase, or annuity plan, (2) is an active participant in a governmental plan, or (3) has amounts contributed by his or her employer to a tax-sheltered annuity (secs. 219(b)(2), 220(b)(3)).

Also, under present law, employee contributions to an employer-sponsored plan are generally not deductible. An exception applies in the case of simplified employee pensions where employees are, under certain conditions, permitted to supplement employer contributions which fall short of the IRA limits by making deductible employee contributions.

Reasons for change

The $1,500 and $1,750 dollar limitations for IRAs and spousal IRAs, respectively, have been in effect for several years. The committee believes that due to inflation, these dollar limitations are no longer appropriate. Accordingly, the committee believes that each of these limits should be increased by $250.

The committee believes that the present-law rule which denies an IRA deduction to an active participant in a tax-qualified pension, etc.. plan and precludes the deduction of employee contributions to such a plan is unnecessarily restrictive. Many employees, while ostensibly covered by employer-sponsored plans, never derive substantial benefits from employer contributions to such plans for various reasons (*e.g.*, separation from service before full vesting, integration of the employer-sponsored plan with social security or coverage under a plan funded primarily with employee contributions). Accordingly, the committee has decided that individuals covered by a tax-qualified plan or tax-sheltered annuity should be provided with an opportunity to save additional amounts on a tax-favored basis. However, the committee has concluded that the level of deductible contributions allowable to these individuals should be less than the level of deductible contributions

available to individuals who are not active participants in a tax-qualified pension, etc., plan.

The committee believes that a deduction for retirement savings by individuals covered by employer-sponsored pension, etc., plans should be available both for IRA contributions and for employee contributions to the employer-sponsored plan. However, in the case of mandatory contributions to the employer-sponsored plan, the committee has concluded that a lower dollar limitation should apply. The committee has reached this decision because it desires to encourage new retirement savings rather than accord tax benefits where non-tax incentives or saving requirements are already provided.

The committee believes that where deductible employee contributions are made to the employer-sponsored plan, the funds in the plan representing these contributions should be held subject to rule similar to the rules which govern funds held in an IRA, as such contributions are an alternative to IRA contributions.

Explanation of provisions

a. Increase of IRA deduction limitations

The committee's bill would increase the IRA deduction limitation to the lesser of 15 percent of compensation includible in gross income or $1,750. In the case of a spousal IRA, the maximum deduction limitation would be increased to the lesser of 15 percent of compensation includible in gross income or $2,000.

b. Deduction for certain contributions by active participants in tax-qualifed pension, etc., plans

The committee bill would allow an individual who is an active participant in a tax-qualified pension, etc., plan to obtain a deduction for a contribution to the plan or to an IRA. The maximum annual deduction would be the lesser of 15 percent of compensation includible in gross income or $1,000. The deduction would not be available to employees who are active participants in a governmental plan, unless the plan is maintained by the Tennessee Valley Authority. In the case of mandatory employee contributions to a tax-qualified pension, etc., plan, only the first $100 of such contributions for a year would be eligible for the deduction. A mandatory contribution means any contribution which is required as a condition of employment, as a condition of participation in the plan, or as a condition of obtaining benefits under the plan attributable to employer contributions.

In the case of employee contributions to a tax-qualified pension, etc., plan only the contributions made by an employee during the taxable year would be deductible by the employee for that year. The bill would not, however, modify the present-law rule under which deductible IRA contributions may be made by an individual on or before the individual's tax filing deadline (including extensions) for the year the contributions are taken into account. In the case of employee contributions to a tax-qualified pension, etc., plan, the employee would notify the plan administrator on or before the employees tax-filing deadline (including extensions) for the taxable year for which the contributions are taken into account of the deductible amount. The notice would be given in the manner prescribed by regulations. The bill would not re-

quire an employer to permit employee contributions to its plan. Thus, in the case of an employee covered by a plan not permitting employee contributions, the employee could obtain a deduction for IRA contributions only.

Where deductible employee contributions are made to a tax-qualified pension, etc., plan, they would be treated as if held by an IRA in certain respects. Thus, they would be subject to a 10-percent additional income tax if distributed before age 59½ or disability, and would be deemed distributed in the case of certain loan or prohibited transactions with respect to the plan. In addition, the amounts would not be eligible for 10-year averaging or capital gains treatment as part of a lump sum distribution from a tax-qualified pension, etc., plan. The amounts would, however, be eligible for tax-free rollover treatment. The Secretary of the Treasury is to prescribe regulations providing for the allocation and separation of these deductible contributions in the case of rollovers to ensure that they retain their character as IRA-type amounts and do not become eligible for addtional tax benefits (e.g., 10-year averaging or capital gains treatment) or freed from IRA-type limitations through the use of rollovers.

Effective date

The amendments made by this provision apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision reduces budget receipts by $291 million in fiscal year 1981, by $725 million in fiscal year 1982, by $922 million in fiscal year 1983, by $1,099 million in fiscal year 1984, and by $1,236 million in fiscal year 1985.

6. Employee Stock Ownership Plan Tax Credit (sec. 302 of the bill and sec. 38A of the Code)

Present law

Under present law, a tax credit employee stock ownership plan (generally called a TRASOP or a tax credit ESOP) is a tax-qualified plan under which an employer is allowed an additional one percent investment tax credit for the contribution of employer securities (or cash, provided the cash is used to acquire employer securities) to the plan. In addition, an employer is allowed an extra investment tax credit of up to one-half of one percent for contributions to a TRASOP if the contributions are matched by equal employee contributions. Thus, an employer could get a total additional investment tax credit of up to one and one-half percent of its qualified investment for a year.

A tax credit employee stock ownership plan is subject to certain special rules. Employer contributions to a TRASOP for a plan year generally are to be allocated in accordance with the rules governing the allocation of contributions under tax-qualified defined contribution plans. However, the allocation of employer contributions to a TRASOP for a year must be made in proportion to the total compensation of all participants sharing in the allocation for the plan year, taking into account only the first $100,000 of compensation for an employee.

In addition, a participant in a TRASOP must have a nonforfeitable right to employer securities allocated to his account. The only types of employer securities which may be acquired and held by a tax credit employee stock ownership plan are (1) common stock of the issuing corporation, and (2) preferred stock of the issuing corporation which is readily convertible into its common stock. The shares acquired by a TRASOP, other than shares which are readily tradable on an established securities market must, in the aggregate, have a combination of (1) voting rights equivalent to rights possessed by shareholders of the class of common stock of the issuing corporation having the greatest voting rights, and (2) dividend rights equivalent to rights possessed by shareholders of the class of common stock of the issuing corporation having the greatest dividend rights.

Generally, a participant in a TRASOP must be allowed to direct the plan how the employer securities allocated to his account are to be voted. If the employer securities are not publicly traded, the participant has the right to direct the vote of stock allocated to his account generally only with respect to major corporate issues (e.g., corporate merger, liquidation or sale of substantially all the corporation's assets).

The additional investment tax credit for TRASOP contributions expires December 31, 1983.

Reasons for change

The committee finds it desirable to extend the availability of a tax credit for contributions to a TRASOP to corporations which would not

establish a TRASOP under present law because they have only a small amount of qualified investment or none at all. In recognition of the fact that many businesses are labor-intensive rather than capital intensive, the committee has determined to allow a tax credit based on payroll to a corporation which contributes its stock to a TRASOP as an alternative to the investment-based TRASOP credit.

Explanation of provision

Under the bill, an employer is allowed a tax credit based on a percentage of the employer's payroll for contributions of employer securities to a TRASOP. A sponsoring corporation will have the option of claiming either the tax credit based on payroll of employees participating in the plan or the additional investment tax credit provided under existing law.

The percentage of payroll eligible for this credit is as follows:

1981	½ of 1 percent
1982	¾ of 1 percent
1983	1 percent

For purposes of determining the amount of the tax credit available under the payroll-based alternative, an employer may take into account participants' total compensation from the employer for the year. However, in computing the allocation of employer contributions to participants' accounts for the year, an employer may take into account only the first $100,000 of compensation for each employee pursuant to the TRASOP requirements. The payroll-based credit, like the additional investment tax credit, expires December 31, 1983.

Generally, the present-law rules governing TRASOPs apply whether the employer elects a tax credit based on its payroll or based on its qualified investment for contributions to the TRASOP.

The payroll-based credit is an alternative to the investment-based credit, and as such, the present law rules relating to the carryback and carryforward of the investment-based credit are also applicable.

A member of a controlled group of corporations can elect the payroll-based credit only if no other member of the controlled group has elected the investment-based credit for the year. Thus, all members of a controlled group of corporations must elect the same type of tax credit (i.e., payroll-based or investment-based) for a year. Whether or not all such members have elected the same type of credit for a year is determined by looking to the corporation's taxable year which begins in the calendar year.

Effective date

The provision is effective for calendar years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $286 million in fiscal year 1981, $995 million in fiscal year 1982, $2,011 million in fiscal year 1983, $1,642 million in fiscal year 1984, and $266 million in fiscal year 1985.

7. Capital Gains Tax Cuts

a. Capital gains deduction for individuals (sec. 111 of the bill and secs. 55 and 1202 of the Code)

Present law

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain (the excess of net long-term capital gain over net short-term capital loss) for the taxable year. The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's entire net capital gain is 28 percent, i.e., 70 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain which is included in gross income.

Under present law, an alternative minimum tax is payable by noncorporate taxpayers to the extent that it exceeds their regular income tax, including the "add-on" minimum tax. The alternative minimum tax is based on the sum of the taxpayer's gross income, reduced by certain allowed deductions, and increased by two tax preference items: (1) "excess" itemized deductions and (2) the section 1202 capital gains deduction. The alternative minimum tax rate is 10 percent for amounts from $20,000 to $60,000; 20 percent for amounts from $60,000 to $100,000; and 25 percent for amounts over $100,000.

Reasons for change

The committee believes that the present taxes applicable to capital gains have contributed both to a slower rate of economic growth and to some taxpayers realizing fewer gains than they would have realized if the tax rates had been lower. Moreover, the committee believes that the present capital gains taxes have reduced the incentive to make investments, especially risky investments in relatively new firms and industries. As a result, the committee believes that changes are required in the tax provisions applicable to capital gains.

The committee believes that lower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue.

The committee believes that these conclusions are supported by the available, albeit incomplete, data on taxpayer response to the 1978 increase in the capital gains deduction.

In addition, the committee believes that an increased capital gains deduction will tend to offset the effect of inflation by reducing the amount of gain which is subject to tax. Thus, by increasing the deduction, taxable gain should be reconciled more closely with real gains, rather than merely inflationary gain.

The committee believes that the increased deduction, in conjuction with the bill's other tax changes and its reduction of the top tax rate, should contribute significantly to a more favorable economic climate by increasing the availability of capital to new businesses, and by providing incentives to realize gains and increase savings.

Explanation of provision

The bill provides that a noncorporate taxpayer may deduct from gross income 70 percent of the amount of any net capital gain for the taxable year. The remaining 30 percent of the net capital gain is includible in gross income and subject to tax at the otherwise applicable rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain will be 20.1 percent, i.e., 67 percent (the highest tax rate under the bill) times the 30 percent of the entire net capital gain which will be included in gross income.

The bill reduces the maximum rate of the alternative minimum tax from 25 percent to 20 percent.

The bill does not change the present law treatment of a noncorporate taxpayer's capital losses.

The bill also coordinates the increased capital gains deduction with the rules applicable to charitable contributions of property to private foundations and of tangible personal property where the use of the property by the donee is unrelated to its charitable purposes (sec. 170 (e) (1) of the Code). It provides that the deduction for these charitable contributions is to be reduced by 30, rather than 40, percent of the gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value.

Effective date

The provisions of the bill apply to taxable years ending after August 20, 1980, and to contributions made after that date. The reduction of the alternative minimum tax rate applies to taxable years beginning after August 20, 1980. The reason for the later effective date of the minimum tax change is that it would be very complex to make a change in the alternative minimum tax rate effective for only a part of a taxable year.

The bill provides a special transition rule for the taxable year which includes the date August 21, 1980. This rule is intended to provide the benefits of the additional deduction for gains attributable to the portion of the taxable year after August 20, 1980. Specifically, for a taxable year including the date August 21, 1980, the capital gains deduction will be the sum of: (1) 70 percent of the lesser of (a) the net capital gain for the entire taxable year, or (b) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year after August 20, 1980, plus (2) 60 percent of the excess of (a) the net capital gain for the taxable year, over (b) the net capital gain taken into account under (1). In applying this transition rule with respect to pass-through entities, the determination of the period for which gain or loss is properly taken into account is to be made at the entity level. For this purpose, pass-through entities are regulated investment companies, real estate investment trusts, electing small business corporations, partnerships, estates and trusts, and common trust funds.

Revenue effect

It is estimated that this provision will reduce budget receipts by $506 million in fiscal year 1981, $1,528 million in 1982, $1,815 million in 1983, $2,140 million in 1984, and $2,502 million in 1985. These estimates take into account revenue raised from additional sales of appreciated property resulting from the tax cut.

b. Corporate alternative tax for capital gains (sec. 202 of the bill and sec. 1201 of the Code)

Present law

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. (The highest regular corporate tax rate is 46 percent for taxable income over $100,000.) Present law also makes 28/46ths of a corporation's net capital gain, an item of tax preference, subject to the 15 percent "add-on" minimum tax. The capital gains deduction does not apply to corporations.

Reasons for change

The committee believes that the corporate capital gains tax rate should be the same as the maximum capital gains tax rate applicable to noncorporate taxpayers.

Explanation of provision

The bill reduces the corporate alternative tax rate from 28 to 20 percent.

The bill also coordinates the reduced capital gains rate with rules applicable to charitable contributions of property to private foundations and of tangible personal property where the use of the property by the donee is unrelated to its charitable purpose (sec. 170(e)(1) of the Code). For taxable years beginning after December 31, 1981, the bill provides that the deduction for charitable contributions of this property is to be reduced by 20/44ths, rather than 28/46ths, of the gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value. (For taxable years beginning in 1981, the fraction is to be 20/45ths.) In addition, the bill makes similar technical changes in the rules pertaining to additions to bad debt reserves by certain savings institutions, to the treatment of undistributed capital gains by shareholders of regulated investment companies, and to the computation of foreign source tax preference items.

Effective date

The provisions of the bill generally apply to taxable years ending after August 20, 1980, and to contributions made after that date.

The bill provides a special transition rule for taxable years which include the date August 21, 1980, intended to provide the reduced tax rate for gains attributable to the period after August 20, 1980. Specifically, for taxable years including August 21, 1980, the alternative capital gains tax will be the sum of: (1) 20 percent of the lesser of (a) the net capital gain for the entire taxable year, or (b) the net capital gain taking into account only gain or loss properly taken into account for the portion of the taxable year after August 20, 1980, plus (2) 28

percent of the excess of (a) the net capital gain for the taxable year, over (b) the net capital gain taken into account under (1). In applying this transition rule with respect to pass-through entities, the determination of the period for which gain or loss is properly taken into account is to be made at the entity level. For this purpose, pass-through entities are regulated investment companies, real estate investment trusts, electing small business corporations, partnerships, estates and trusts, and common trust funds.

In determining the amount of the capital gains tax preference for purposes of the minimum tax for the transitional year, a taxpayer shall use its average alternative capital gains rate computed under the special transitional rule.

Revenue effect

It is estimated that this provision will reduce budget receipts by $293 million in fiscal year 1981, $407 million in 1982, $447 million in 1983, $492 million in 1984, and $541 million in 1985.

8. Foreign Earned Income Exclusion (secs. 121–122 of the bill and secs. 911 and 913 of the Code)

Present law

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 510 days (approximately 17 months) out of a period of 18 consecutive months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.

The new excess living cost deduction (new Code sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14, step 1, regardless of the taxpayer's actual income. The housing element is the excess of the tax-

payer's reasonable housing expenses over his base housing amount (generally one-sixth of his net earned income.) The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under Code sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit is allowed for foreign taxes attributable to the excluded amount. For taxpayers electing the exclusion, the camp is treated as the employer's business premises so that the exclusion for employer-provided meals and lodging can also be claimed (provided the other requirements of Code sec. 119 are satisfied).

The 1978 Act liberalized the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extended the regular 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence to up to four years in the case of Americans working abroad.

Reasons for change

The committee believes that American business faces increasing competitive pressures abroad, and that, in view of the nation's continuing trade deficits, it is important to allow Americans overseas to remain competitive. The tax burdens imposed on these individuals, even under the liberalizations of the Foreign Earned Income Act of 1978, have made it difficult for U.S. businesses to utilize American employees abroad. In many cases, the policy of these businesses is to make their employees whole for any extra tax expenses the employees incur because of overseas transfers. Thus, an extra tax cost on the employees becomes a cost to the business, which often must be passed through to customers in the form of higher prices. In intensely competitive industries, such as construction, this has the immediate effect of higher, and thus often noncompetitive, bids for work by American firms. The impact is also felt in other export industries. As a result, some U.S. companies either have cut back their foreign operations or have replaced American citizens in key executive positions with foreign nationals. In many cases, these foreign nationals may purchase goods and services for their companies from their home countries, because they often would be more familiar with those goods and services, rather than from the United States.

The committee believes that it is necessary to provide a tax incentive to encourage Americans to work abroad in certain activities which serve important national interests. By reducing the tax burden on Americans working abroad in these activities, an incentive would reduce the costs borne by their employers and make them more competitive. One type of activity abroad which the committee feels should clearly be encouraged is the performance of export-related services. This would include, for example, the performance of services in connection with foreign construction projects because of the probability that foreign construction projects undertaken by U.S. firms will give rise to orders for U.S. materials and equipment. Another activity abroad which the committee feels should be encouraged is the performance of services related to the exploration for and the extraction of petroleum and other natural resources. The committee also believes it would be appropriate to extend the incentive to individuals performing charitable services abroad. Finally, the committee concluded that the tax incentive should be provided to Americans working abroad in developing countries without regard to the nature of the services performed by those individuals. Because Americans in these countries frequently are unable to maintain a life style comparable to that which they might expect to enjoy in the United States, it is unlikely that Americans would choose to work in these countries solely to take advantage of this incentive. However, since this new tax incentive could arguably make it more attractive to work in developed countries rather than in the United States, the committee decided to limit it to those Americans working in developed countries who are engaged in activities which serve important national interests.

The committee concluded that an appropriate incentive would be to allow qualifying Americans to elect, in lieu of the present excess foreign living cost deductions, a substantial exclusion from U.S. tax for their foreign earned income. The committee has, however, placed specific dollar limitations on the exclusion, in addition to an allowance for housing costs, a highly variable component of excess foreign living costs. This limitation is to prevent abuse of the exclusion by, for example, highly paid entertainers or athletes who could otherwise move abroad to escape large amounts of U.S. tax on their income.

Finally, the committee believes that the period of foreign presence required to qualify for the exclusion should be shortened, and that the residence or presence period should be waived in certain circumstances where civil unrest prevents individuals from meeting those requirements.

Explanation of provision

Amounts of exclusion

Individuals qualifying under the committee amendment would generally be permitted to exclude foreign earned income at the rate of $50,000 annually. The exclusion would increase to $65,000 annually after 2 years of *bona fide* residence in a foreign country or countries.

In addition to these flat dollar limitations, individuals could exclude foreign earned income in an amount which reflects their excess foreign housing costs. The additional excludible amount is equal to

the excess of the foreign housing costs over the base housing amount. For this purpose, the foreign housing costs are to be determined in the same manner as "housing expenses" under section 913(e) of the Code. However, the base housing amount for all taxpayers is to be 16 percent (currently, $5,554) of the annual salary of a Government employee at Step 1 of grade GS-14.

As under present law, no deduction or credit is allowed for taxes or other amounts attributable to the excluded income (other than moving expenses).

Period of foreign residence or presence

To be eligible for the exclusion, an individual must be a citizen or resident of the United States and must be physically present in a foreign country or countries for at least 330 days during any period of 12 consecutive months. This rule will also apply to eligibility for the deduction for excess foreign living costs under section 913. Alternatively, as under present law, an individual may qualify if he is a *bona fide* resident of a foreign country or countries for a period which includes an entire taxable year.

Under certain circumstances, the time limits of the eligibility requirements for the exclusion may be waived. (This rule would also apply to the deduction for excess foreign living costs under section 913.) Three conditions must be met for the waiver to apply. First, the individual actually must have been present in, or a *bona fide* resident of, a foreign country. Second, he must leave the foreign country after August 31, 1978, during a period with respect to which the Treasury Department determines, after consultation with the State Department, that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. It is anticipated, for example, that such determinations ordinarily would be made in situations where the State Department issues a travel advisory recommending that U.S. citizens avoid travel to a country because of unsettled conditions there. Third, the individual must establish to the satisfaction of the Treasury that he could reasonably have been expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions. An individual who could reasonably have been expected to be present in a foreign country for a period of 330 days out of 12 months would be considered to have his tax home in that country for purposes of the excess living cost deduction rather than being considered to be temporarily present in that country. If these criteria are met, the taxpayer would be treated as having met the foreign residence or presence requirements with respect to the period during which he was resident or present in the foreign country even though the relevant time limitation under existing law had not been met.

Country of presence or nature of services performed

U.S. citizens or residents who meet the foreign residence or presence requirements will be eligible to elect the exclusion in lieu of the present system of excess living costs if they perform certain specified services or, regardless of the type of services they perform, if they work in developing countries.

For purposes of this provision, developing countries are independent countries (and their dependencies) other than the following countries (and their dependencies):

Australia	Japan
Austria	Liechtenstein
Bahamas	Luxembourg
Barbados	Monaco
Belgium	Netherlands
Canada	New Zealand
Denmark	Norway
Finland	Portugal
France	San Marino
Federal Republic of Germany	Singapore
Greece	Spain
Grenada	Sweden
Iceland	Switzerland
Ireland	Turkey
Italy	United Kingdom

If the taxpayer is present in a developed country or a tax haven, he may nevertheless qualify for the exclusion with respect to income from certain charitable, extractive, and export-related services. Income received for the performance abroad of export-related services, or compensation for employment abroad with an employer (including a branch) substantially all of whose income is derived from the export of U.S. goods or the performance of export-related services will qualify for the exclusion as income attributable to export-related services. These services include:

(1) banking and financial services, a substantial portion of which are provided in connection with the export of U.S. goods and services;

(2) construction, architectural, engineering, or repair services performed in connection with agricultural, construction, or engineering projects located in a foreign country;

(3) services associated with the export of U.S. products (including, but not limited to, marketing and market analysis, advertising and promotional activities, sales and distribution services, packaging and assembly, warehousing, and documentation and customs clearing); and

(4) any other services performed overseas which are designated by the Secretary of the Treasury (after consultation with the Special Trade Representative and the Secretary of Commerce) as contributing significantly to U.S. exports.

Income received for services performed abroad in the exploration for or extraction of petroleum or other natural resources, or compensation for employment abroad with an employer (including a branch) substantially all of whose income is derived from those activities, will qualify for the exclusion as income attributable to extractive services. Services performed abroad by an employee for an employer which meets the requirements of section 501(c)(3) will qualify for the exclusion as income attributable to charitable services.

Effective date

The provisions generally are effective for taxable years beginning after December 31, 1980. However, the rules allowing waiver of the minimum time periods for qualification for the foreign earned income exclusion or deduction for excess foreign living costs will apply to taxable years beginning after December 31, 1976. The rules allowing charitable employees to qualify for an exclusion under section 911 will be effective for taxable years beginning after December 31, 1978, but, for taxable years beginning before January 1, 1981, the exclusion will be limited to $20,000 a year.

Revenue effect

It is estimated that this provision will reduce budget receipts by $240 million in fiscal year 1981, $360 million in fiscal year 1982, $389 million in fiscal year 1983, $420 million in fiscal year 1984, and $454 million in fiscal year 1985.

V. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING H.R. 5829

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of H.R. 5829, as reported.

Budget Receipts

The table below summarizes the estimates of decreases in budget receipts (net of the increased outlays under the refundable earned income credit) from the tax reduction provisions of the bill for fiscal years 1981–1985. The estimates are presented in greater detail in part III, Revenue Effects, of this report. In addition, the tariff provision (sec. 401 of the bill) is estimated to reduce budget receipts by $2,000 in fiscal year 1981.

SUMMARY OF TAX REDUCTION PROVISIONS

[In billions of dollars]

	Fiscal year—				
	1981	1982	1983	1984	1985
Individual income taxes	−11.0	−24.2	−31.0	−36.4	−42.3
Capital formation and productivity	−7.3	−22.0	−30.5	−32.0	−32.8
Total	−18.2	−46.2	−61.5	−68.4	−75.1

Budget Outlays

The bill will involve budget outlays (from the refundable portion of the earned income credit) of $77 million in fiscal year 1981, $541 million in 1982, $497 million in 1983, $458 million in 1984, and $421 million in 1985.

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill. H.R. 5829, as amended, was ordered favorably reported by a rollcall vote of 19 ayes and 1 no.

VI. REGULATORY IMPACT OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of this bill.

A. *Numbers of individuals and businesses who would be regulated.*—The bill does not involve new or expanded regulation of individuals or businesses.

B. *Economic impact of regulation on individuals, consumers and businesses.*—The bill does not involve economic regulation. Through the general tax rate reduction and targeted tax reductions for individuals and the several business tax reductions intended to stimulate capital formation and enhance productivity, the bill increases the amount of income after taxes that individuals and businesses will have available and will tend to increase their abilities to implement their own economic plans.

C. *Impact on personal privacy.*—This bill does not relate to the personal privacy of taxpayers.

D. *Determination of the amount of paperwork.*—The bill generally will not affect the current amount of paperwork for most individual taxpayers, and business taxpayers generally will be able to reduce their paperwork.

Individuals who earn income abroad will have more paperwork in taking into account the expanded exclusions and deductions from such income that reduce the amount of their incomes subject to tax. Two-earner married couples will have to compute an additional deduction that will reduce their taxable income.

The depreciation revisions will simplify significantly the depreciation computations of virtually all businesses. There will be additional paperwork for businesses that will use the provisions for the tax credit for research and experimental expenditures and the reserve for market-making activities.

The explanations of the provisions in the bill describe in more detail the amount of paperwork that will be generated.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates and agrees with the methodology used and the resulting dollar amounts.

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the

committee states that the bill does not create new budget authority but increases the budget authority under the refundable portion of the earned income credit by $77 million in fiscal year 1981, $541 million in 1982, $497 million in 1983, $458 million in 1984 and $421 million in 1985.

Allocations of Budget Authority

The decisions of the committee that have been made in H.R. 5829 allocate the increased budget authority to the income security function.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee makes the following statement.

The bill creates new tax expenditures in (1) the deduction for two-earner married couples, (2) the reserve for market-making activities, (3) the tax credit for research and experimental expenditures, and (4) the payroll-based tax credit for contributions to an employee stock ownership plan (TRASOP).

Increased tax expenditures include (1) the earned income credit, although its refundable character makes almost all of the increase a budget outlay, (2) the increase in the amount of used equipment eligible for the investment tax credit, (3) the incentive stock options, (4) the increased exclusions for contributions to IRAs or LERAs, (5) the increased exclusion for capital gains, and (6) the revisions in the exclusion for income earned abroad.

The revisions in the corporate income tax rate structure, the depreciation reform and the associated revisions in the eligibility rules for the investment tax credit involve elements of both increased tax expenditures and restructuring of basic business income tax provisions to provide a desired economic objective. The characterization of these provisions as tax expenditures will be reanalyzed before the next tax expenditures pamphlet is published by the Committee on Finance in 1981.

The estimated effects on budget receipts of each new or increased tax expenditure is presented in Part III of this report, Revenue Effects.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, H.R. 5829, as reported by the committee).

VIII. ADDITIONAL VIEWS OF SENATOR DOLE, SENATOR ROTH, SENATOR DANFORTH, SENATOR CHAFEE, SENATOR HEINZ, SENATOR WALLOP, AND SENATOR DURENBERGER

We believe that the Finance Committee has acted responsibly in proceeding with tax cut legislation this year. It has taken courage for many of the Members to ignore the politically motivated calls for delay by the current Administration. However, the dire condition of the economy could not and cannot be ignored.

NEED FOR TAX CUT NOW

Our nation is now suffering from the worst combination of inflation and unemployment in recent history. The Administration itself has estimated that unemployment for the last quarter of this year will be 8½ percent. It well may be higher yet next year. In human terms, the current unemployment rate means that more than 8 million Americans are out of a job.

In the second quarter of this year, real Gross National Product declined at a 9 percent annual rate. This represents a retrogression of the GNP to the level of Autumn 1978. Not surprisingly, after-tax corporate profits dropped by 18.2 percent in the second quarter. This reflects primarily the impact of the recession on the manufacturing sector.

While the economy has suffered this significant decline, induced in large part by conscious policies of the current Administration, inflation has not been reduced to an acceptable level. In the second quarter of this year, for example, the Consumer Price Index was still estimated to be 13.7 percent on an annual basis. While this is down from the 18.4 percent rate estimated for the first quarter, it is still far too high. All indications are that the CPI will get worse before it gets much better. The Producer Price Index for the last two months has been raging at an annual rate of 20 percent. This will soon translate into another surge in the CPI.

We believe that the most effective way to restore the vitality and stability to the American economy is to enact now a properly structured tax reduction to promote productivity without aggravating inflation.

The first point that should be made with respect to all the talk of a tax cut is the fact that neither the Republicans, the Finance Committee nor the President are advocating a reduction in revenues next year. What is being discussed is a moderation of the tax increase that is scheduled for next year. The Congressional Budget Office estimates that federal taxes will rise by $22 billion as a result of inflation driving taxpayers into higher tax brackets. Increased Social Security taxes

will account for another $16 billion. In total the President's mid-year budget estimated that taxes will increase by $86 billion from 1980 to 1981. The Republican proposal would reduce this enormous increase by $19.8 billion in fiscal year 1981. The Finance Committee's bill would eliminate $18.2 billion of this increase in fiscal year 1981.

Inflation is a major factor depressing our nation's productivity. Double-digit inflation undermines profit incentives and the motivation to save and invest. At high inflation levels, it becomes increasingly difficult to generate a fair rate of return over time. This problem is compounded by a tax system that fails to take account of inflation. Business profits are distorted by inflation and taxed as though they represented real gains. Similarly the personal income tax burden rises automatically as inflation pushes individuals into higher tax brackets.

The inevitable result of sustained, double-digit inflation is that the savings rate in the United States has declined precipitously in the last year. For several years the savings rate hovered at around 6 percent. In late 1979 and early 1980, however, the savings rate dropped as low as 3.4 percent. This should be contrasted with the savings rate in Japan which approaches 20 percent, and in West Germany, near 14 percent. A low savings rate indicates a lack of confidence in the future, and means less capital is available for new investment.

Inflation also causes replacement costs for business structures and equipment to far outstrip original costs. When new investment becomes financially difficult, companies are encouraged to pay out more in dividends rather than invest in the future.

REPUBLICAN TAX CUT PROPOSAL

We, along with our Republican colleagues in the Senate, concluded some time ago that the Administration's policy of fighting inflation with high interest rates, tight money, and record tax burden is ineffective and unacceptable. As an alternative on June 24, 1980 we introduced S. 2878, the Tax Reduction-Job Creation Act. This Republican tax cut bill was structured to provide a fundamental change in tax policy geared to increased personal incentive, stimulating economic growth and creating new jobs without fueling inflation.

The Republican proposal would reduce individual income tax rates across-the-board by 10 percent. This would restore to American workers the incentive for greater productivity which has been eroded by years of taxflation. In addition, the proposal would establish a uniform fixed depreciation schedule of 10 years for structures, 5 years for equipment and 3 years for vehicles. This faster recovery rate for productive assets would combat the inflation-induced distortion of physical capital costs and would result in increased investment in plants and equipment, improve our lagging productivity, and enable the United States to compete more effectively abroad.

In addition to reducing the serious erosion of capital due to the effects of inflation under existing law. the "10-5-3" approach would be a major simplification of depreciation calculations. Simplification would particularly benefit small businesses that have been unable to use the complex asset depreciation range system (ADR) under current law. According to the Treasury Department's own estimates, the

ADR system has been used by only .4 percent of all businesses with less than $500,000 in depreciable assets.

FINANCE BILL IS SIMILAR TO REPUBLICAN BILL

We are pleased that the tax cut bill reported by the Senate Finance Committee is remarkably similar to the Republican proposal. This is true in terms of both intent and specific provisions.

The intent of both the Republican proposal and the Finance Committee bill is to abate the record tax increases scheduled for 1981 in a manner that will encourage productivity without producing an artificial inflation stimulus to the economy.

INDIVIDUAL RATE CUTS

The most important feature of the Finance Committee's bill for individuals is an across-the-board reduction in income tax rates. Following the Republican proposal, the Finance Committee insisted that its bill include a reduction in the tax rate of every tax bracket. While the size of the rate reduction is not as great as that contained in the Republican proposal, it is significant that the Committee rejected the Administration proposal for a tax rebate to offset the increase in Social Security taxes.

DEPRECIATION REFORM

The central provision of the tax reduction for business in both the Republican and Finance Committee bills is accelerated capital cost recovery to encourage investment in new plant and equipment. The Republican depreciation proposal contained both a significant liberalization in depreciation and major simplification. The Finance Committee's provision is more complicated and contains less of a liberalization but it represents a vast improvement over current law on both counts.

OTHER INDIVIDUAL TAX REDUCTIONS

The Finance Committee bill also reduces the effective tax rate on capital gains, reduces the "marriage penalty" tax on two-wage earner families, and provides additional tax incentives to encourage savings for retirement. Each of these proposals is endorsed in the Republican Platform.

AMERICANS WORKING ABROAD

The Finance Committee bill also includes tax relief provisions for Americans working abroad. It has become painfully obvious that changes in the tax laws in 1976 and 1978 have seriously jeopardized the ability of American companies to employ Americans to help them compete overseas. Senate Republicans have for some time favored alleviation of this burden by enacting an exclusion of foreign earned income for Americans working abroad. We believe it is unfortunate that the original proposal has been complicated and made less attractive by the inclusion of certain rules tying the income tax exclusion to export-related activities in certain countries. These rules may be close to impossible to administer and are, without question, discriminatory in application.

RESEARCH AND DEVELOPMENT CREDIT

We also strongly support the research and development credit which the Committee has included in its tax cut bill. Superior technology has been the key to America's industrial and social achievements. This superior technology is the direct product of research and development activities. Since the mid 1960s, however, there has been a disturbing decline in industrial research and development. In 1964 R & D spending reached a high of 2.1 percent of the Gross National Product. By 1978 these expenditures had slumped to 1.6 percent of GNP. Because of this disturbing trend, this provision is timely and of great importance.

CORPORATE RATE CUTS AND SMALL BUSINESS INCENTIVES

We are pleased that the Committee has decided to include in the package a 2 percent reduction in the maximum corporate tax rate and a widening of the corporate tax brackets. This widening of the corporate tax brackets will particularly benefit small business.

INDIVIDUAL RETIREMENT ACCOUNTS

Finally, it is significant that the Committee has increased the maximum deductible amount for contributions to individual retirement accounts and has allowed employees who participate in qualified retirement plans to set aside additional deductible amounts to provide for their retirement. The necessity for long term savings to provide the investment capital necessary to improve this nation's industrial capacity is an integral portion of the Republican economic strategy. While we would hope that further incentives to encourage long-term savings could be enacted in the future, this provision provides a much needed first step. While not included in the Republican proposal, this and the other investment oriented provisions of the Finance Committee bill were included in our Party's Platform.

CONCLUSION

Although we still remain committed to the Republican tax cut proposal, we fully endorse and strongly support the Finance Committee bill. The Committee's product is an important restructuring of our tax system to encourage personal effort, productivity and job creation. It reduces the rising tax burden in a way that addresses our long-term economic problem. We believe that it should be passed as soon as possible.

ROBERT DOLE.

IX. ADDITIONAL VIEWS OF SENATOR DURENBERGER

The Senate Finance Committee bill begins the necessary process of reforming our tax system. I supported much of the bill, but, to be fair about it, this is a political year and the American worker won't be able to count on this bill to provide much tax relief unless the Congress combines tax reform with spending reform. We need to cut government spending as well as taxes if we are to revive the economy. Currently, the inflation tax is much worse than the income tax. The Finance Committee bill does open the door to some important job-creating tax changes. The bipartisan cooperation indicates a change in attitude by many Members of Congress. It's our intent to fight inflation with the production line instead of the unemployment line. I hope that as we move this tax bill to the floor of the Senate along with the second budget resolution, this bipartisan cooperation will carry over to my proposal to limit Federal spending and give every person relief from both inflation and taxes.

DAVID DURENBERGER.