[COMMITTEE PRINT]

DESCRIPTION OF S. 2738

RELATING TO

ADJUSTING THE INCOME, ESTATE, AND GIFT TAXES FOR INFLATION

LISTED FOR A HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

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I. INTRODUCTION

The bill described in this pamphlet, S. 2738, has been scheduled for a hearing on April 24, 1978 by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bill relates to indexing the income, estate and gift taxes for inflation.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bill. The description indicates the present law treatment, the issues involved, an explanation of what the bill would do, its revenue effect, and the Treasury Department position.

II. PRESENT LAW

Under present law, the income, estate and gift taxes are based on fixed dollar amounts and do not take into account changes in the value of the dollar resulting from inflation. For example, the personal exemption in the individual income tax equals $750; and, as inflation occurs, the amount of the exemption becomes relatively smaller in real terms (that is, in terms of purchasing power for goods and services).

Only a few provisions of the Internal Revenue Code are adjusted (or "indexed") for inflation. The pension provisions impose limits on the amount of contributions which can be made on behalf of any employee under a qualified plan and limits on annual retirement benefits for which any employee may qualify. These limits are indexed to rise at the rate of inflation. As a result, the limit on annual contributions has risen from $25,000 to $30,500; and the limit on annual benefits has risen from $75,000 to $90,150.[1]

A second relevant feature of present income tax law is that the definition of income does not take inflation into account. Thus, capital gains are included in income even to the extent that the appreciation merely reflects inflation and, therefore, does not represent any increase in real income or purchasing power for the owner of the asset. Similarly, interest on bonds or savings accounts is included in income, but no adjustment is made for the effect of inflation in reducing the purchasing power represented by the bond or the savings account.

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[1] The indexing of these pension provisions was enacted in the Employee Retirement Income Security Act of 1974 (ERISA).

The energy tax bill, now pending in conference, contains a tax on business use of oil and gas, the rates of which would be indexed for inflation.

III. DESCRIPTION OF S. 2738

S. 2738 would partially index the income, estate and gift taxes for inflation. The adjustment would be for two-thirds of the increase in the consumer price index. The President would have the authority to suspend these automatic inflation adjustments, subject to an either-house congressional veto, if he finds that they will have a substantial adverse effect on the U.S. economy.

Individual income tax

S. 2738 would adjust for inflation many of the significant fixed dollar amounts used in derermining individual income tax rates, exemptions, deductions and credits. These would be the following:

(1) the tax rate brackets;

(2) the $750 personal exemption;

(3) the general tax credit (both the $35 per capita credit and the $180 limit on the 2-percent-of-taxable-income alternative credit);

(4) the floors under itemized deductions and corresponding zero rate brackets, which have replaced what used to be the standard deduction ($2,200 for single persons and $3,200 for married couples);

(5) the $4,000 limit on the amount of earned income eligible for the earned income credit and the income phaseout range (generally $4,000 to $8,000);

(6) the limits on the amount of income eligible for the tax credit for the elderly ($2,500 for single persons and $3,750 for married couples) and the income phaseout of the credit;

(7) the limits on the amount of child care expenditures eligible for the child care credit ($2,000 for one child and $4,000 for two or more children);

(8) the $25,000 limit on the amount of tax which can be offset by the investment tax credit without regard to the 50-percent limitation;

(9) The $10,000 exemption from the minimum tax;

(10) the $35,000 limit on the sales price of a home, the gain on the sale of which by a person age 65 or over is exempt from tax,

(11) the $1,500 and $1,750 limits on annual contributions to an individual retirement account; and

(12) the $7,500 limit on the annual contribution to a self-employed person's pension plan.

In each case, the fixed dollar amount for a given year would be increased by two-thirds of the increase in the level of consumer prices during the preceding year over the level of the second preceding year. Thus, in 1979 there would be an adjustment for two-thirds of the extent to which the average price level in 1978 exceeded the average for 1977. The dollar amounts so determined would then be rounded to the nearest $10.

Other fixed dollar amounts in the Code would not be adjusted for inflation under S. 2738. These include the limits on the credit and deduction for political contributions, the $1 checkoff for public financing of presidential campaigns, the $3,000 limit on the amount of ordinary income against which capital losses may be deducted, and the $10,000 limit on deduction of excess investment interest.

In addition, S. 2738 provides that the basis of property for purposes of computing gain or loss is to be adjusted upward for two-thirds of the inflation occurring between the time the asset is purchased and the time it is sold. (However, there is to be no adjustment for inflation occurring before 1979.)

S. 2738 would also extend the general tax credit and the earned income credit, scheduled to expire at the end of 1978, through the end of 1983.

Corporate income tax

The bill would make inflation adjustments to the graduated corporate rate schedule similar to those made for individuals. Currently, there is a 20-percent tax rate bracket for the first $25,000 of corporate taxable income and a 22-percent bracket on taxable income between $25,000 and $50,000. These bracket amounts would go up by two-thirds the rate of inflation in the same manner that the individual rate brackets would be indexed.

The inflation adjustments relating to the investment tax credit and the minimum tax, described above under the individual income tax, would also apply to corporations.

While the bill itself does not do this, the staff understands that the sponsors intend to extend through 1983 the increase in the corporate surtax exemption to $50,000 and the cut in the corporate tax rate on the first $25,000 of corporate income from 22 percent to 20 percent, which expire at the end of 1978.

Estate and gift taxes

The following provisions of the estate and gift taxes would be adjusted for two-thirds the rate of inflation:

(1) the $3,000 per donee gift tax exclusion, and

(2) the credit against the unified estate and gift tax (which under present law will be $38,000 in 1979, $42,500 in 1980, and $47,000 in 1981 and subsequent years).

The bill does not index the rate schedule of the estate and gift tax.

Effective Date

The income tax amendments apply to taxable years beginning after December 31, 1978, and before January 1, 1984. The indexation of the per donee exclusion applies to gifts made after December 31, 1978, and before January 1, 1984. The indexing of the estate and gift tax credit applies to gifts made or decedents dying after December 31, 1980, and before January 1, 1984.

Revenue Effect

It is estimated that the indexing provisions of S. 2738 would decrease tax receipts by about $5 billion in fiscal year 1979 and about $12 billion in 1980. The revenue impact of the bill, of course, cannot be forecast precisely because the future rate of inflation is uncertain. This tax cut would be more than offset by the automatic tax increases resulting from inflation.

Departmental Position

The Treasury Department opposes the bill.

IV. DISCUSSION OF ISSUES

Indexing the U.S. tax system raises several very important issues, and this section will only summarize the principal ones. A more comprehensive study of indexing is being conducted by the Joint Committee staff pursuant to the Tax Reform Act of 1976.

General effects of inflation on taxes

Inflation affects taxes in two ways. First, whenever something in the tax system is expressed as a fixed dollar amount, inflation causes its real value (its value in relation to purchasing power over goods and services) to decline. This impact could occur with any type of tax provided that the tax rate or the size of deductions, exemptions or credits depends on fixed dollar amounts. For example, inflation causes the 4-cent-per-gallon gasoline tax to decline in real terms; and it raises the real burden of the income and estate and gift taxes.

The second impact of inflation is idiosyncratic to an income tax—individual or corporate—and relates to the way inflation distorts the measurement of income from capital. This distortion occurs because, in measuring capital income, the tax system does not take into account the declining value of the dollar. If the price of an asset rises by 10 percent during a period in which the overall price level has also risen by 10 percent, the owner has experienced no increase in his purchasing power; however, under present law the 10-percent price increase must be reported as a capital gain. The owner of a bond or a savings account must pay tax on his interest income but does not get any offsetting deduction for the decline in the real value of the bond or savings account resulting from inflation. Conversely, a debtor may deduct his interest payments but need not include in income his gain which results from the inflation-induced erosion in the real burden of the debt he owes. Finally, businesses now claim depreciation deductions based on the historical cost of an asset, not based on prices prevailing in the year in which the depreciation deduction is taken, even though the dollar may be worth less when the depreciation deduction is claimed than it was when the asset was purchased.

The net result of the way income is defined under current law is that inflation acts as a personal wealth tax in which each person's wealth tax rate equals his effective marginal income tax rate multiplied by the rate of inflation. (A direct wealth tax would be unconstitutional because the Constitution prohibits direct Federal taxes, except for an income tax, unless the tax revenues derived from each State are proportional to that State's population.)

Different inflation adjustments would be needed to offset each of these two impacts of inflation on the tax system. So-called "type 1" indexing would adjust the fixed dollar amounts in the tax rates, exemptions, deductions and credits by the rate of inflation. "Type 2" indexing would adjust the definition of income from capital to take account of inflation. (Inflation causes no distortion in the measurement of wages, salaries and other forms of noncapital income so there would be no "type 2" indexing for these kinds of income.) The arguments for and against each type of indexing are quite different, and the two are logically separate issues. The argument for doing either type of indexing does not depend at all on whether one has done the other type of indexing.

S. 2738 deals mainly with type-1 indexing for the income, estate and gift taxes, although not all fixed dollar amounts in those taxes would be indexed under the bill. The bill would adjust the definition of income (type-2 indexing) only for one type of capital income—gain or loss upon sale of an asset.

Many foreign countries engage in some form of indexing. Canada employes type 1 indexing for the individual income tax for all inflation. Other countries index for a fraction of the inflation rate or only when inflation exceeds a certain percentage.

Type 1 indexing—Adjusting fixed dollar amounts

The debate about the desirability of automatic adjustments of fixed dollar amounts in the tax system for inflation depends in part upon one's view of the ability of Congress to make the appropriate discretionary adjustments in the absence of indexing. Someone who believes that Congress is likely to make discretionary adjustments for inflation on a current basis, and that the necessity of making these adjustments is not unduly burdensome for Congress, will usually not think that type-1 indexing is necessary. A person is likely to favor type-1 indexing, however, if he thinks that Congress is not likely to make the right *ad hoc* adjustments or that making these adjustments takes too much of Congress' time and effort.

Under a fully indexed system in the type-1 sense, real tax burdens would stay the same for a given real tax base, so that if the real tax base (real income in the income tax, gasoline consumption in the gasoline tax, and so forth) stayed constant during a period of 10-percentinflation, tax liability would rise by exactly 10 percent so that the real tax burden would notc hange. Thus, Congress would have to make a conscious decision to change real tax burdens and could not count on inflation to change them automatically. Without indexing, inflation changes real tax burdens, raising some and lowering others, and Congress must make a conscious decision to keep them unchanged.

Most Federal revenue comes from taxes whose yields tend to increase in real terms in response to inflation, particularly the graduated individual income tax and the estate and gift taxes. There is a mild tendency for the corporate income tax to increase with inflation because there is some graduation in the rate schedule. Many Federal excise taxes, however, decline in real terms during periods of inflation, including the 4-cent-per-gallon gasoline tax and the alcohol and cigarette taxes. A question may be raised about whether it would be appropriate to index the taxes which rise automatically in real terms because of inflation without also indexing those taxes which fall in real terms because of inflation.

In the past Congress has paid little attention to the effect of inflation on the real rates of Federal excise, estate and gift taxes. Estate and gift tax rates did not change at all between 1948 and 1976 despite more than a doubling of consumer prices. The rate of the 4-cent gasoline tax rate has not changed since 1959.

In contrast, Congress has made frequent changes in the individual income tax which have kept the overall income tax burden at approximately the same percentage of personal income. However, some taxpayers have been overcompensated for inflation and others undercompensated. If 1960 is used as the base year, taxpayers with incomes below $20,000 and above $200,000 have generally done better with the discretionary adjustments actually enacted than they would have done had the 1960 tax law been indexed and no discretionary changes made. Taxpayers with income between $20,000 and $200,000 have done worse under the actual discretionary adjustments than they would have under automatic indexing.[2] Of course, the pattern of discretionary adjustments by the Congress in the future may be different than it has been in the past.

The overall Federal tax structure is such that the real level of Federal taxation will rise as a result of inflation because the excise taxes that fall in real terms with inflation represent a small fraction of total Federal revenues. This feature of the tax system now gives Congress an opportunity to lower taxes periodically and, in effect, biases the system towards "fiscal responsibility." However, the current unindexed system may also make it easier to increase government spending because higher spending can be financed from the inflation-induced increases in revenues without new tax legislation. In an indexed system, except for temporary tax cuts during recessions, Congress could generally only cut taxes in a fiscally responsible manner if it also cut spending, and some feel this pressure would lead to less spending. Others feel it would only lead to larger government deficits.

Some argue that the current pattern of automatic inflation-induced tax increases and occasional, discretionary tax cuts creates instability in people's expectations about future tax rates, which may be detrimental to the economy.

Type 2 indexing—Definition of income

The failure to have a proper definition of income (type 2 indexing) clearly has significant economic effects. The overstatement of taxable income from capital tends to reduce saving and investment. It also makes the income tax less equitable in the sense that certain kinds of income from capital are taxed more heavily than income from labor.

A full program of redefining taxable income to take proper account of inflation, however, would result in a significant complication of the tax system. The complexity would be especially severe for the changes needed to adjust for the decline in the real value of bonds, savings accounts, and checking accounts which results from inflation and those needed to tax the real gain which debtors receive during periods of inflation.

Some economists have argued, however, that a simpler partial program of type 2 indexing would achieve essentially the same economic effects as the complete program. If borrowers and leaders have the same tax rates, if all inflation is anticipated and in interest rates are free to rise without legislated ceilings, then it will suffice to make only one inflation adjustment: indexing for inflation the basis of assets for purposes of computing gain or loss and depreciation. If this adjust-

[2] See Emil M. Sunley, Jr., and Joseph A. Pechman, "Inflation Adjustment of the Individual Income Tax," in Henry J. Aaron, ed., *Inflation and the Income Tax*, Brookings, 1976.

ment were made and the other assumptions are correct, interest rates on debt would rise in response to expected inflation as much as is needed to compensate lenders for their additional tax burden and to offset fully the tax benefit now received by debtors. Unfortunately, the assumptions are not entirely valid, so that some inequities and inefficiencies would result from a program to make inflation adjustments for some kinds of capital income (like capital gains) and not for others (like savings accounts) or to adjust for income and not for debt. It is not clear, then, whether only a partial program of type 2 indexing for certain kinds of capital income would represent a gain or a loss in terms of economic efficiency and tax equity.

The income tax now contains some provisions which might be considered *ad hoc* adjustments for inflation. Under present law, one-half of long-term capital gains are excluded from income (but subject to the minimum tax), there is a maximum rate of 25 percent on the first $50,000 of long-term capital gains, and the tax on a gain is deferred from the time it occurs until the time the asset is sold. These provisions, however, do not relate very closely to the adjustment to basis which would be needed to compensate for inflation. For depreciable assets, accelerated depreciation can be viewed as a compensation for the failure to have an inflation adjustment, although at current inflation rates the adjustment may not be large enough for equipment. Consideration of inflation adjustments for capital gains and depreciation could be done in conjunction with a review of the existing provisions relating to these items.

Technical issues

There are a number of technical issues which would have to be dealt with under a program of indexing. These include the choice of an appropriate price index and establishment of a procedure which allows enough time for withholding schedules to be adjusted by January 1 of each year so that they would match the new tax rates for that year.

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