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TAX SIMPLIFICATION IN THE INCOME TAX

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

This pamphlet presents background information on a number of proposals designed to simplify the income tax for individuals. The proposals described here are contained in the House-passed bill (H.R. 10612). Many other tax simplification proposals could be considered. Subsequent pamphlets will discuss other simplification proposals, alternatives, and modifications to the proposals presented here.

The matters discussed here include the revision and expansion of the tax tables to include many individuals now not eligible to use these tables, a revision in the treatment of alimony payments, a simplification and expansion of the retirement income credit, a simplification and modification of the child care provision in present law, a revision of the sick pay deduction and an expansion of the moving expense deduction. While simplification is the primary concern in most of these items, to some extent the changes made by the House were also designed to deal with what the House considered problems of tax equity.

In each of these areas, the pamphlet describes the present law and the issues that have been presented. The House provisions are also described briefly.

1. Revision of Tax Tables for Individuals

Present law

Under present law, a taxpayer whose adjusted gross income (AGI) is under $10,000 ($15,000 for 1975 only) and who takes the standard deduction is required to use the optional tax tables. These tables have AGI brackets as horizontal row designations; marital status and number of exemptions as vertical column headings; and the amount of tax in the resulting cell. A taxpayer whose income is greater than $10,000 ($15,000 for 1975 only) or who itemizes his deductions must compute his tax using the tax rates.

Issues

The present optional tax table set-up which provides a different table for each number of exemptions claimed by the taxpayer in order to provide for income of up to $10,000 has resulted in 6 pages of fine print, representing 12 optional tax tables in the instructions accompanying the income tax return. The 1975 tables extending up to $15,000 of AGI cover 10 pages in the instructions. In addition, a separate publication is required for taxpayers claiming 13 or more exemptions. The Internal Revenue Service has stated that this has been a considerable source of taxpayer error because taxpayers are not always sure which table to use or, because of the necessarily small size of the print, which is the proper tax figure to enter on their return.

House bill

The House bill (sec. 501) revises the optional tax tables for individuals so that taxpayers will use a simplified table. The new tables would be based on taxable income instead of adjusted gross income and, as a result, 4 tax tables would replace the 12 existing optional tax tables. This will make it possible to print the tax tables on two pages. In addition, the tax tables would apply to taxable incomes up to $20,000 (instead of $10,000 of adjusted gross income) and would be available to taxpayers who itemize and to those who take the standard deduction. However, the new tax tables will require the taxpayers to make two subtractions, one for their deductions (either standard or itemized) and one for their personal exemptions.

The new tables would apply to taxable years beginning after December 31, 1975.

2. Alimony Payments

Present law

Under present law, a deduction for alimony may be taken as an itemized deduction from adjusted gross income in the year paid in arriving at taxable income. The recipient of alimony must include such payments in his or her income and pay tax on them. Payments for the support of a spouse which are not required by a divorce or separation agreement and payments for the support of children are considered normal living expenditures on the part of a taxpayer. Such expenditures are not deductible and are not included in the income of the recipients.

Issues

It is argued that the splitting of income or assignment of income through the payment of alimony is not properly treated under current law since only an itemized deduction is allowed for alimony. The view often expressed is that the payment of alimony should be taken into account in determining net income. Items taken into account in determining net income are generally treated as deductions in arriving at adjusted gross income, rather than as itemized deductions which usually relate to personal expenses. As a deduction from gross income, the alimony deduction would be available to taxpayers who elect the standard deduction as well as to those taxpayers who elect to itemize their deductions.

House bill

The House bill (sec. 502) moves the deduction of alimony payments from an itemized deduction to a deduction from gross income in arriving at adjusted gross income (sec. 62). The bill also makes a change (sec. 3402(m)(2)) which includes the deduction for alimony as one of the deductions taken into account for determining withholding allowances in order to avoid overwithholding.

This provision is to apply to taxable years beginning after December 31, 1975.

3. Retirement Income Credit

Present law

Under present law, individuals 65 years of age or over are eligible for a tax credit based on the first $1,524 of retirement income. The credit is 15 percent of this retirement income. Each spouse who is 65 or over may compute his tax credit on up to $1,524 of his own retirement income. Alternatively, spouses 65 or over who file joint returns may compute their credit on up to $2,286 of retirement income (one and one-half times $1,524) even though one spouse received the entire amount of the retirement income.

To be eligible for the credit an individual must have received more than $600 of earned income in each of the prior 10 years. (A widow or widower whose spouse had received such earned income is considered to have met this earned income test).

Retirement income, for purposes of this credit, includes taxable pensions and annuities, interest, rents, dividends, and interest on Government bonds issued especially for the self-employed setting aside amounts under H.R. 10 or IRA retirement-type plans.

The maximum amount of retirement income an individual may claim ($1,524, or $2,286 for married couples) must be reduced by two broad categories of receipts. First, it must be reduced on a dollar-for-dollar basis by the amount of social security, railroad retirement, or other exempt pension income received by the taxpayer. Second, the maximum amount of retirement income eligible for the credit is further reduced by one-half of the annual amount of earned income over $1,200 and under $1,700 and by the entire amount of earned income in excess of $1,700. This reduction for earned income does not apply to individuals who have reached age 72.

Individuals under age 65 also are eligible for tax credits for retirement income but only with respect to pensions received under a public retirement system. Only income from a pension, annuity, retirement, or similar fund or system established by the United States, a State, or a local government, qualifies under this provision. This restriction of retirement income for purposes of the credit to income from a public retirement system applies only until the individual reaches the age of 65; thereafter he is entitled to take the credit on the same basis as other individuals who have reached that age.

Issues

Many believe that there is a need to redesign the present retirement income credit. One reason often given is that the credit needs updating. Most of the features of the present credit have not been revised since 1962 when the maximum level of income on which the credit is computed was set and when the current earnings limits were

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established.[1] Since then, there have been numerous revisions of the social security law which substantially liberalized the social security benefits. As a result, the present maximum amount of income eligible for the credit is considerably below the average annual social security primary benefit of $2,271 received by a retired worker and the average social security primary and supplementary benefit of slightly over $3,400 that could be received by a retired worker and his spouse (one and a half times the primary benefit).

Often it is also claimed that the complexity of the present retirement income credit prevents it from providing the full measure of relief it was intended to grant to elderly people. Some of the organizations representing retired people have estimated that as many as one-half of all elderly individuals eligible to use the retirement income credit do not claim this credit on their tax returns. It has been suggested that this complexity stems from an attempt to pattern the credit after the social security law. For example, to claim the credit on his tax return, a taxpayer must show that he has met the test of earning $600 a year for 10 years; he must also segregate his retirement income from his other income; he must reduce the maximum amount of retirement income eligible for the credit by the amount of his social security income and by specified portions of his earned income under the work test; a credit of one-half times the basic credit is available for a man and his wife; and a credit is available for each spouse separately if each spouse independently meets the eligibility tests.

The purpose of all these provisions is to provide individuals who receive little or no social security benefits the opportunity to receive tax treatment roughly comparable to that accorded those who get tax-exempt social security benefits. However, it is contended that the result has been to impose severe compliance burdens on large numbers of elderly people many of whom are not skillful in filing tax returns. Such individuals now compute their retirement income credit on a separate schedule, which fills an entire page in the tax return packet, with 19 separate items, some of which involve computations in three separate columns (see the form shown below).

Another argument sometimes made against the present retirement income credit is that it discriminates among individuals with modest incomes depending on the source of their income. As indicated above, the credit is available only to those with retirement income—that is, some form of investment or pension income in the taxable year. It is pointed out that elderly individuals who must support themselves by earning modest amounts and who have no investment or pension income are not eligible for any relief under the present credit. This has given rise to considerable criticism as to the fairness of the tax law; many elderly individuals who rely entirely on earned income maintain that they should be allowed the same retirement income credit as those who live on investment income. Under the present

[1] One other feature of the credit was adopted in the 1964 Revenue Act. This provision allowed spouses 65 and over who file joint returns to claim a credit on up to $2,286 of retirement income (one and one-half times the $1,524 maximum base for single people) even if one spouse receives the entire amount of the married couple's retirement income.

credit, elderly people who rely entirely on earned income are required to pay substantially higher taxes than individuals whose incomes come from investments. Another criticism sometimes made is that higher taxes on earnings than on retirement income serve as a disincentive to work.

Schedules E&R (Form 1040) 1975 **Schedule R—Retirement Income Credit Computation** Page 2

Name(s) as shown on Form 1040 (Do not enter name and social security number if shown on other side)	Your social security number

If you received earned income in excess of $600 in each of any 10 calendar years before 1975, you may be entitled to a retirement income credit. If you elect to have the Service compute your tax (see Form 1040 instructions, page 5), answer the question for columns A and B below and fill in lines 2 and 5. The Service will figure your retirement income credit and allow it in computing your tax. Be sure to attach Schedule R and write "RIC" on Form 1040, line 17. If you compute your own tax, fill out all applicable lines of this schedule.

Married residents of Community Property States see Schedule R instructions.

Joint return filers use column A for wife and column B for husband. All other filers use column B only. Did you receive earned income in excess of $600 in each of any 10 calendar years before 1975? (Widows or widowers see Schedule R instructions.) If "Yes" in either column, furnish all information below in that column. Also furnish the combined information called for in column C for both husband and wife if joint return, both 65 or over, even if only one answered "Yes" in column A or B.	A ☐ Yes ☐ No	B ☐ Yes ☐ No	C Alternative Computation (Combined information of husband and wife if joint return and both 65 or over)
1 Maximum amount of retirement income for credit computation	$1,524 00	$1,524 00	$2,286 00
2 Deduct:			
(a) Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities), and certain other exclusions from gross income			
(b) Earned income received (does not apply to persons 72 or over):			
(1) If you are under 62, enter the amount in excess of $900			R
(2) If you are 62 or over but under 72, enter amount determined as follows: if $1,200 or less, enter zero; if over $1,200 but not over $1,700, enter ½ of amount over $1,200; or if over $1,700, enter excess over $1,450			
3 Total of lines 2(a) and 2(b)			
4 Balance (subtract line 3 from line 1). If column A, B, or C is more than zero, complete this schedule. If all of these columns are zero or less, do not file this schedule.			
5 Retirement income: (a) If you are under 65: Enter only income received from pensions and annuities under public retirement systems (e.g. Fed., State Govts., etc.) included on Form 1040, line 15			
(b) If you are 65 or older: Enter total of pensions and annuities, interest, dividends, proceeds of retirement bonds, and amounts received from individual retirement accounts and individual retirement annuities that are included on Form 1040, line 15, and gross rents from Schedule E, Part II, column (b). Also include your share of gross rents from partnerships and your proportionate share of taxable rents from estates and trusts			
6 Line 4 or line 5, whichever is smaller			
7 (a) Total (add amounts on line 6, columns A and B)			
(b) Amount from line 6, column C, if applicable			
8 Tentative credit. Enter 15% of line 7(a) or 15% of line 7(b), whichever is greater			
9 Amount of tax shown on Form 1040, line 16c			
10 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 9, whichever is smaller. Note: If you claim credit for foreign taxes or tax free covenant bonds, skip line 10 and complete lines 11, 12, and 13, below			
11 Credit for foreign taxes or tax free covenant bonds			
12 Subtract line 11 from line 9 (if less than zero, enter zero)			
13 Retirement income credit. Enter here and on Form 1040, line 48, the amount on line 8 or line 12, whichever is smaller			

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House bill

The House bill (sec. 503) restructures the present retirement income credit and converts it to a 15-percent tax credit for the elderly, available to all taxpayers age 65 or over regardless of whether they have retirement income or earned income. The maximum amount on which the credit is computed is increased to $2.500 for single persons age 65 or over (or for married couples filing joint returns where only one spouse is age 65 or over) and to $3.750 for married couples filing joint returns where both spouses are age 65 or over.

The reduction for earnings over $1.200 is eliminated but the reduction for social security benefits and other tax-exempt pension income is retained. However, an income phaseout based on adjusted gross income (rather than just earned income) above $7.500 for single persons and $10.000 for married couples ($5.000 for a married person filing a separate return) is provided to limit the benefits of the credit to low- and middle-income elderly taxpayers.

An example of the type of form for taxpayers age 65 and over which these changes make possible is shown below. The form requires the taxpayer to select the appropriate amount on which to compute the credit and to deduct from this amount his social security and certain other tax-exempt income. It also requires the taxpayer to deduct adjusted gross income above specified levels. The credit is computed on the balance at a 15-percent rate and is entered on the basic form 1040 as a tax credit.

SCHEDULE R.—*Credit for taxpayers age 65 and over*

MAXIMUM AMOUNTS FOR CREDIT COMPUTATION

If you are: (check one box)	*Then your maximum amount for credit computation is—*
☐ Single	$2, 500
☐ Married filing jointly and only one spouse is 65 or over	2, 500
☐ Married filing jointly, both age 65 or over	3, 750
☐ Married filing a separate return and age 65 or over	1, 875

1. Enter (from above) your maximum amount for credit computation	
2. Amounts received as pensions or annuities under the Social Security Act, the Railroad Retirement Acts (but not supplemental annuities) and certain other exclusions from gross income	
3. Adjusted gross income reduction. Enter one-half of adjusted gross income (line 15 form 1040) in excess of $7,500 if single; $10,000 if married filing jointly; or $5,000 married filing separately	
4. Total of lines 2 and 3	
5. Balance (subtract line 4 from line 1); if more than zero complete this form; if zero or less, do not file this form	
6. Amount of credit; enter (here and on form 1040, line 49) 15 percent of line 5 but not more than the total income tax on form 1040, line 16	

Under this phaseout, the maximum amount on which the credit is computed would be reduced by $1 for each $2 of adjusted gross income (AGI) above the indicated AGI levels.

In addition, the provisions of present law that limit the credit based on the amount of a taxpayer's retirement income would be eliminated. Thus, the credit would also be allowed for earned income. The requirement that to be eligible for the credit, the taxpayer must have met the test of earning $600 a year for 10 years would be eliminated. Further, the variation in treatment of married couples depending on whether they are separately eligible for the credit would be removed.

Although the House bill generally retains present law for individuals under age 65 receiving public retirement pensions, the maximum amount on which the credit may be computed for those individuals would be increased to $2,500 for single persons and $3,750 for married couples. Also, for individuals under age 65, the 10-year $600 earnings requirement and the variation in treatment of married couples would be eliminated. In cases where one spouse is eligible for the new credit and the other is eligible for the public retiree credit, the couple must elect to claim only one of those two credits.

This provision would apply to taxable years beginning after December 31, 1975.

4. Credit for Child Care Expenses

Present law

Under present law, taxpayers are permitted an itemized deduction for expenses for the care of a dependent child, incapacitated dependent or spouse, or for household services when the taxpayer maintains a household for any of these qualifying individuals. An eligible dependent child must be under age 15 and the taxpayer must be able to claim a personal exemption for him. These expenses must be related to employment; that is, they must be incurred to enable the taxpayer to be gainfully employed.

Eligible expenditures are limited to a maximum of $400 a month. Services provided for children outside the taxpayer's home are further limited to $200 a month for one dependent, $300 for two, and $400 for three or more. (No deduction is allowed for the care of an incapacitated dependent over age 14 or spouse outside the taxpayer's home.) The amount of the eligible expenses which may be deducted is also reduced by one-half of adjusted gross income in excess of $35,000 a year for 1976 and thereafter ($18,000 prior to 1976).[1] No deduction is allowed, however, for payments to relatives.

To claim this deduction, a husband and wife must generally file a joint return. Both must be employed substantially full time, that is, three-quarters or more of the normal or customary workweek or the equivalent on the average. However, a spouse who has been deserted for an entire year may be able to file as a single person.

In the case of a disabled dependent, the deductible expenses are reduced by the dependents' adjusted gross income plus disability income in excess of $750.

Issues

It has been argued that the availability of the child and dependent care deduction under present law (sec. 214) is unduly restricted by its classification as an itemized deduction and by its complexity.

It is pointed out that treating child care expenses as itemized deductions denies any beneficial tax recognition of such expenses to taxpayers who elect the standard deduction. Many believe that such expenses should be viewed as a cost of earning income for which all working taxpayers may make a claim. One method for extending the allowance of child care expenses to all taxpayers, and not just to itemizers, would be to replace the itemized deduction with a deduction from gross income in arriving at adjusted gross income as is done with other costs of earning income. Alternatively, a credit could be allowed against income tax liability for a percentage of qualified expenses. While deductions and exclusions favor taxpayers in the higher marginal tax

[1] This change was made in the Tax Reduction Act of 1975.

brackets, a tax credit provides more help for taxpayers in the lower brackets and provides the same degree of relief for taxpayers in the lower income brackets as for those in higher tax brackets at a smaller revenue cost.

Another concern expressed with the present provisions is that because there is a $400 a month limit on the deduction under present law, a complex child care deduction form is necessary. It has been suggested that the child care allowance could be made simpler and the need for a separate form eliminated if it were computed on an annual instead of a monthly basis. Many also believe that additional, unnecessary complications result from the distinction between expenses for children incurred inside and outside the home and from the requirement that the allowable deductions be reduced by the dependent's disability income. It is pointed out that allowing the same amount for the expenses of caring for chidren whether inside or outside the home and replacing the $200, $300 and $400 monthly maximum deductions for such outside expenses for the care of one, two, or three children, with annual ceilings based on one and two or more dependents, would further reduce the complexity of the provision.

Questions have also been raised as to the appropriateness of the rule allowing the deduction in the case of joint returns only where both spouses work full time. The full-time earnings test was intended to prevent one spouse from working part time, perhaps in a nominal capacity, in order to obtain the benefits of a deduction which could amount to $4,800 a year. However, it has been suggested that this type of abuse could be prevented by an alternative rule limiting the allowable expenses to the earnings of the spouse with the smaller earnings.

It has also been suggested that child care expenses should be allowed when one spouse works and the other is a full-time student. It is pointed out that the spouse attending school cannot reasonably be expected to provide child care to enable the other spouse to work. In these circumstances, it is contended that the expenses incurred to pay for child care are, in fact, necessary for the taxpayer to be gainfully employed.

Others have suggested that the one-year waiting period before a deserted spouse may claim child care expenses is too long and believe that a shorter qualifying period to mitigate hardships would be appropriate.

Problems have also arisen as a result of limiting the deduction of child care expenses to parents who claim a child as a dependent. It is noted that this denies the deduction to a divorced or separated parent with custody of a child, who does not supply more than half of the child's support and cannot claim the child as a dependent, but who may nevertheless incur child care expenses in order to work. It is argued that the parent who has custody of the child for the greater period of the year should be allowed to treat the child care expenses as a cost of earning income, provided the parent who has custody for the shorter period does not claim these expenses.

Suggestions were also made that the bar on deducting payments to relatives for the care of children is overly restrictive.

Others view qualified child care expenses as a cost of earning income and believes that an income ceiling on those entitled to the allowance has minimal revenue impact, if the allowance is in the form of a credit. Therefore, it was argued that it is appropriate and feasible to eliminate the income phaseout and to allow all taxpayers to claim such expenses regardless of their income level.

House bill

The House bill (sec. 504) would replace the itemized deduction for household and dependent care expenses with a nonrefundable tax credit. The tax credit would equal 20 percent of the employment-related expenses incurred for the care of a child under age 15 or an incapacitated adult, in order to enable the taxpayer to work. The amount of employment-related expenses which may be taken into account would be limited to $2,000 for one dependent and $4,000 for two or more dependents. The income threshold of $35,000 over which the deduction is phased out would be eliminated.

The income tax return would be simplified by eliminating the need for a separate child care schedule. The present monthly maximum deduction ($200 for one dependent, $300 for two dependents and $400 for three or more dependents) would be replaced by the maximum annual credit of $400 for one dependent and $800 for two or more.

The credit would be extended to married couples in which the husband or wife, or both, work part time. (Presently, both are required to work full time.) The eligible expenses would be limited to the amount of earnings of the spouse earning the smaller amount, or in the case of a single person, to his or her earnings. The credit would also be available to married couples where one spouse is a full-time student and the other spouse works. The credit would be extended to a divorced or separated parent who has custody of a child even though the parent may not be entitled to a dependency exemption for the child. A deserted spouse would be eligible for the credit when the deserting spouse is absent for 6 months instead of an entire year. In addition, the distinction between care in the home and care outside the home would be eliminated. The requirement that the provision for the taxpayer be reduced by disability income received by his dependent would be eliminated. Finally, payments for services rendered by certain individuals who may be related to the taxpayer would be eligible for the credit if the related individual is not a resident of the same household as the taxpayer and if the related individual is not a dependent of the taxpayer or his spouse, provided such services constitute employment covered by the Social Security Act.

These changes would appply to taxable years beginning after December 31, 1975.

5. Sick Pay and Certain Military, etc. Disability Pensions

Sick Pay

Present law

Under present law, gross income does not include amounts received under wage continuation plans when an employee is absent from work on account of personal injuries or sickness. The payments that are received when an employee is absent from work are generally referred to as sick pay (under sec. 105(d)).

The proportion of salary covered by the wage continuation payments and any hospitalization of the taxpayer determines whether or not there is a waiting period before the exclusion applies. If the sick pay is more than 75 percent of the regular weekly rate, the waiting period before the exclusion is available is 30 days whether or not the taxpayer is hospitalized during the period. If the rate of sick pay is 75 percent or less of the regular weekly rate and the taxpayer is not hospitalized during the period, the waiting period is 7 days. If the sick pay is 75 percent or less of the regular weekly rate and the taxpayer was hospitalized for at least 1 day during the period, there is no waiting period and the sick pay exclusion applies immediately. In no case may the amount of sick pay exceed $75 a week for the first 30 days and $100 a week after the first 30 days.

During the period that a retired employee is entitled to the sick pay exclusion, he may not recover any of his contributions toward any annuity under section 72.[1]

Issues

Section 105(d) which provides the exclusion for sick pay is extremely complex. The provision's complexity requires a separate 28-line tax form which is sufficiently difficult that many taxpayers must obtain professional assistance in order to complete it and avail themselves of the exclusion. Many believe that elimination of the complexity in this area is imperative.

In addition, it is argued that the present sick pay provision causes some inequities in the tax treatment of sick employees compared to working ones and the treatment of lower-income taxpayers compared to those with higher incomes. The argument is made that excluding sick pay payments (received in lieu of wages) from income when an employee is absent from work, while taxing the same payments if made as wages while he is at work, is not justified. A working employee generally incurs some costs of earning income not incurred by a sick employee who stays at home. The latter may incur additional medical expenses on account of his sickness; but he may deduct such expenses as medical expenses if they exceed the percentage of income limitations.

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[1] Reg. sec. 1.72–15(b) and (c)(2).

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Under present law, low- and middle-income taxpayers receive, on a percentage basis, less benefit from the sick pay exclusion than do taxpayers in higher marginal tax brackets because of the progressivity of tax rates. As a result, more than 60 percent of the benefits from this provision currently goes to taxpayers with adjusted gross incomes plus sick pay over $20,000. Taxpayers who receive no sick pay, of course, receive no benefit at all. It is argued that the exclusion allowed by section 105 should not have a regressive effect and that the provision should be amended to direct a fairer share of its tax benefits to low- and middle-income taxpayers.

House bill

The House bill (sec. 505) significantly revised the sick pay exclusion provision and the treatment of military disability payments for future members of the armed services. The present sick pay exclusion which involves complicated time and percentage rules would be repealed. A maximum annual exclusion of $5,200 ($100 a week) would be provided for taxpayers under age 65 who are permanently and totally disabled. (After that age, these individuals will be eligible for the revised elderly credit.) However, the revised sick pay exclusion is to be reduced on a dollar-for-dollar basis by the taxpayer's income (including disability income) in excess of $15,000. These new rules would apply to both civilian and military personnel.

The sick pay revisions would apply to civilians and military personnel with respect to taxable years beginning after December 31, 1975.

Disability Pensions of the Military, etc.

Present law

Present law excludes from gross income amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country, as well as similar amounts received by disabled members of the National Oceanic and Atmospheric Administration (NOAA, formerly called the Coast and Geodetic Survey), the Public Health Service, or the Foreign Service (sec. 104(a)(4)).[1] In addition, payments of benefits under any law administered by the Veterans' Administration are excludable from gross income (section 3101(a) of Title 38 of the United States Code). Thus, disability benefits administered by the Veterans' Administration are exempt from tax under present law.

Issues

Concern has been expressed about two somewhat conflicting aspects of the exclusion of disability payments from gross income: on the one hand, the abuse of the exclusion in certain instances, particularly by retiring members of the armed forces, and on the other hand, the expectation and reliance of present members of the affected government services, especially the armed forces, on the government benefit avail-

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[1] Under present regulations (Reg. sec. 1.105—4(a)(3)(i)(a)), the portion of a disability pension received by a retired member of the armed forces which is in excess of the amount excludable under section 104(a)(4) is excluded as sick pay under a wage continuation plan subject to the limits of section 105(d) if such pay is received before the member reaches retirement age.

able to them when they entered government employment or enlisted in or were drafted into the military.

Criticism of the exclusion of armed forces disability pensions from income focuses on a number of cases involving the disability retirement of military personnel. In many cases, armed forces personnel have been classified as disabled for military service shortly before they would have become eligible for retirement principally to obtain the benefits of the special tax exclusion on the disability portion of their retirement pay. In most of these cases the individuals, having retired from the military, earn income from other employment while receiving tax-free "disability" payments from the military. Many question the equity of allowing retired military personnel to exclude the payments which they receive as tax-exempt disability income when they are able to earn substantial amounts of income from civilian work, despite disabilities such as high blood pressure, arthritis, etc.

However, in order to provide benefits to any present personnel who may have joined or continued in the government or armed services in reliance on possible tax benefits from this provision, many believe any changes in the tax treatment of military disability payments should affect only future members of the armed forces, NOAA, Public Health Service and Foreign Service.

House bill

The changes in the tax treatment of military disability payments would only affect payments made to members of the armed services who enlist after September 24, 1975. At all times, Veterans' Administration disability payments will continue to be excluded from gross income. In addition, even if a military retiree does not receive his disability benefits from the Veterans' Administration, he would still be allowed to exclude from his gross income an amount equal to the benefits he could otherwise receive from the Veterans' Administration. Otherwise future members of the armed services would be allowed to exclude military disability retirement payments from their gross income only if the payments are directly related to combat injuries. A combat-related injury is defined to be an injury or sickness which is incurred (1) as a direct result of armed conflict; (2) while engaged in extrahazardous service; (3) under conditions simulating war; or (4) which is caused by an instrumentality of war.

All persons who were members of the armed services or military retirees as of September 24, 1975, and who received or will receive military disability retirement payments which are excluded from gross income under present law, will continue to exclude such payments from gross income.

The military disability revisions would apply to individuals who enter the armed services on or after September 25, 1975.

6. Moving Expenses

Present law

An employee or self-employed individual may claim a deduction from gross income for the expenses of moving to a new residence in connection with beginning work at a new location (sec. 217). Any amount received directly or indirectly as a reimbursement of moving expenses must be included in a taxpayer's gross income as compensation for services (sec. 82), but he may offset this income by deducting expenses which would otherwise qualify as deductible items.

Deductible moving expenses are the expenses of transporting the taypayer and members of his household, as well as his household goods and personal effects, from the old to the new residence; the cost of meals and lodging enroute; the expenses for premove househunting trips; temporary living expenses for up to 30 days at the new job location; and certain expenses related to the sale or settlement of a lease on the old residence and the purchase of a new one at the new job location.

The moving expense deduction is subject to a number of limitations. A maximum of $1,000 may be deducted for premove househunting and temporary living expenses at the new job location. A maximum of $2,500 (reduced by any deduction claimed for househunting or temporary living expenses) may be deducted for certain qualified expenses for the sale and purchase of a residence or settlement of a lease. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts are halved.

In order for a taxpayer to claim a moving expense deduction, his new principal place of work must be at least 50 miles farther from his former residence than was his former principal place of work (or his former residence, if he had no former place of work).

During the 12-month period following his move, the taxpayer must be a full-time employee in the new general location for at least three-fourths of the following year, that is, 39 weeks during the next 12-month period. A self-employed person must, during the 24-month period following his arrival at his new work location, perform services on a full-time basis for at least 78 weeks, with at least 39 weeks of full-time work falling within the first 12 months. Even if the 39- or 78-week requirement has not been fulfilled at the end of a taxable year (but may still be fulfilled), the taxpayer may elect to deduct any qualified moving expenses which he has paid or incurred provided he has met all the other requirements. If he fails to meet the full-time employment period requirements in a subsequent taxable year, he must include the amounts previously deducted in his gross income for the subsequent year.[1]

[1] The 39- and 78-week tests are waived if the employee is unable to satisfy them as a result of death, disability, or involuntary separation (other than for willful misconduct).

Issues

The provisions for moving expenses reflect significant revisions made by the Tax Reform Act of 1969. Since 1969, the dollar limitations have been criticized, particularly by persons suggesting dollar adjustments to reflect inflation.

Proponents of simplification have urged that a single dollar limit be adopted instead of the $1,000 and $2,500 tests; that the 39- and 78-week rules be replaced by a general rule allowing the taxpayer to obtain work within two years in the new location or at a third location, if necessary. Instead of the allowance of 30 days' temporary living expenses at the new place of work, some would substitute a deduction for such expenses whether incurred at the former place of work, or enroute to or at the new place for a continuous 30 or 45 day period in the process of moving. Both employee and employer tax recordkeeping might be reduced, if the reimbursements for expenses which are deductible by the employee are not required to be included in the employee's gross income, provided the employee provides the employer with documentation of his expenses.

One suggestion for changing the $2,500 maximum on qualified expenses for the sale or purchase of a residence would replace the dollar limit with a deduction based on a percentage of the taxpayer's sales price in order to reflect inflation in real estate selling commissions.

Some argue that the 50-mile test restricts the deduction of expenses to a move to a new job location which is 50 miles farther from the taxpayer's former residence than was former principal place of work (or his former residence if he had no former place of work.) If a taxpayer's former residence was 30 miles from his former job, his new job location must be at least 50 miles farther from his former residence, that is, a total of at least 80 miles farther, if his moving expenses are to be deductible. In view of the increasing cost of commuting, the growing concern for gasoline conservation, and the continuing inadequacy of mass transportation in most areas of the country. It is urged that there be some reduction of the 50-mile test.

It has been indicated that certain changes made in the 1969 Act created unforeseen difficulties for the military. The Department of Defense and the Department of Transportation (with respect to the peacetime Coast Guard) have no procedure for identifying or valuing the in-kind reimbursements provided for each serviceman where the military pays a mover for the moving expenses, or does the moving itself. The Department of Defense, acting on behalf of all the services, indicated in discussions with the Internal Revenue Service that establishing such a system for identifying reimbursed moving expenses would involve substantial administrative burdens for the Department, as well as increasing its expenses, at no revenue gain to the Treasury. As a result of these administrative problems, the Internal Revenue Service in 1971 agreed to a moratorium for the reporting and reimbursement rules (except for cash reimbursements) in the case of the military. The Service extended this administrative moratorium through 1972 and 1973. In 1974 the armed forces were exempted from these requirements by legislation [2] effective through December 31, 1975.

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[2] P.L. 93–490, sec. 2, 88 Stat. 1466, 93rd Cong., 2d Sess., October 26, 1974.

Pursuant to this statutory authorization, the Secretary of the Treasury entered into agreements with the Secretary of Defense for members of the Army, Navy, and Air Force, and with the Secretary of Transportation for members of the Coast Guard to allow special treatment for servicemen's moving expenses for taxable years ending before January 1, 1976.

As a result, the Secretaries of Defense and of Transportation were not required to report or withhold tax on moving expense reimbursements made to members of the armed forces, nor were members of the armed forces required to include in income the value of in-kind moving services provided by the military. However, members of the armed forces could deduct moving expenses to the extent they exceed military reimbursements, and would otherwise qualify as deductible expenditures under section 217, without counting any military in-kind reimbursements against the dollar limitations.

As a result of the expiration of the moratorium legislation, the military will be required to devise complex and expensive administrative procedures because it is now required to report and withhold tax on reimbursed in-kind moving expenses and servicemen are required to include such reimbursements in income.

In addition, the military has found the 50-mile limitation and the 39-week rule a hardship for military personnel because many mandatory personnel moves are for less than 39 weeks and for less than 50 miles.

House bill

The House bill (sec. 506) modifies the present treatment of job-related moving expenses in a number of respects. The bill increases the $1000 maximum deduction for premove househunting and temporary living expenses at the new job location from $1000 to $1500 and increases from $2500 to $3000 the maximum deduction for qualified expenses for the sale, purchase or lease of a residence (reduced by any deduction claimed for premove househunting or temporary living expenses). As with the existing limitations, the new amounts are halved if a husband and wife file separate returns. The bill also reduces the 50-mile rule to 35 miles.

Several exemptions are provided for the Department of Defense, the Department of Transportation and members of the armed forces of the United States on active duty. The departments and servicemen are not required to report as income to the servicemen, nor to withhold tax on, any in-kind moving expenses provided by the military for moves pursuant to a military order and incident to a permanent change of station for which a change of residence is required. Members of the armed forces may, however, deduct any qualified moving expenses subject to the generally applicable dollar limitations to the extent such expenses exceed authorized in-kind military reimbursements without reducing the dollar limitations by the amount of any in-kind reimbursements provided by the military.

The House bill also exempts members of the armed forces from the 35-mile limitation and from the 39-week rule in the case of required moves incident to a permanent change of station when the military authorizes in-kind moving expense reimbursements.

The provision in the House bill is to apply to taxable years beginning after December 31, 1975.

7. Accumulation Trusts

General

A trust is generally treated as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of ordinary income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiary as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

Present law

Present law provides that beneficiaries are taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust.

This is referred to as the throwback rule under which distributions of accumulated income to beneficiaries are thrown back to the year in which they would have been taxed to the beneficiary if they had been distributed currently. The Tax Reform Act of 1969 revised the prior throwback rule to provide an unlimited throwback rule with respect to accumulation distributions.

The tax on accumulation distributions is computed in either of two ways. One method is the "exact" method, and the other is a "shortcut" method which does not require the more extensive computations required by the exact method. Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years when earned. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust and the taxes of the beneficiary can be determined for each year. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary is allowed a credit for his share of the taxes paid by the trust during his life. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect averages the tax attributable to the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 3 immediately prior years. The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust.

Capital gain throwback rule.—Present law provides an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision does not apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their income currently, until the first year they accumulate income. For purposes of this provision, a capital gains distribution is deemed to have been made only when the distribution is greater than all of the accumulated ordinary income. If the trust has no accumulated ordinary income or capital gains, or if the distribution is greater than the ordinary income or capital gain accumulations, then to this extent it is considered a distribution of corpus and no additional tax is imposed.

Issues

It is agreed that the progressive tax rate structure for individuals is avoided if a grantor creates a trust to accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

The throwback rule (as amended by the Tax Reform Act of 1969) theoretically prevents this result by taxing beneficiaries on distributions they receive from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. The 1969 act made a number of significant revisions in the treatment of accumulation trusts. In applying the throwback rule to beneficiaries with respect to the accumulation distributions they receive, the act provided two alternative methods, as indicated above, the exact method and the shortcut method. It is contended that a number of administrative problems have resulted in the application of these alternative methods for both the Internal Revenue Service and the beneficiaries.

For example, trustees are under an obligation to the beneficiaries of the trust to compute the throwback under the rule which results in the least tax: thus, the short-cut method, which was intended to simplify calculations and eliminate recordkeeping problems involved with the exact method has not achieved this result because trustees must compute the tax under both methods. As a result, it is contended that it would be more desirable to have one simplified method rather than having two alternative methods in applying the throwback rule.

In addition, a number of questions have been raised as to whether the capital gains throwback rule, which was enacted in the 1969 act, presents more complexity in its application than is warranted by the concerns raised in 1969 with respect to capital gains. It is contended that it would be more appropriate for the capital gains throwback rule to be repealed and instead a rule provided to deal more directly with the transferring of appreciated assets by grantors into trusts. Other concerns have been raised with respect to other modifications dealing with accumulation trusts, such as, the treatment of minors, the election of simple trust treatment for a year in which all income is to be paid out currently, and certain other technical modifications of the trust rules.

House bill

Under the House bill (sec. 701), a single method, a revision of the present "short-cut" method, would be substituted for the two alternative methods used in computing the throwback rule for accumulation distributions. This method throws the average accumulation distributions (as determined under present law) back to the 5 preceding years of the beneficiary (rather than the 3 preceding years under present law). However, with respect to these 5 preceding years, the year with the highest expanded taxable income and the year with the lowest would not be considered (in effect, the computation of the additional tax on the accumulation distribution under this short cut method would continue to be based on a 3-year average basis). The average amount for the 3 years would be added to the beneficiary's taxable income for these years (rather than requiring the recomputation of his tax returns as under present law). In other respects, the present rules under the short cut method would continue to be applicable, except that no refunds would be available.

Income accumulated by a trust prior to the beneficiary's attaining the age of 21 and the years a beneficiary was not in existence would not be subject to the throwback rule. A special rule would be provided for three or more trusts which accumulate income in the same year for a beneficiary.

The House bill repeals the capital gains throwback rule. A special rule would be provided to cover the possible tax abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure. In this case, the property would have a new 2-year holding period which would apply to the unrealized appreciation in the property at the time it is placed in trust. The appreciation in the property during the time it is held in trust would come under the normal holding period rules. This special rule would not apply to property placed in charitable remainder trusts or pooled income funds.

These changes would apply to accumulation distributions made in taxable years beginning after December 31, 1974.

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