

[JOINT COMMITTEE PRINT]

**SUMMARY OF REVISED ADMINISTRATION
TAX REDUCTION PROPOSAL**

PREPARED FOR THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
AND THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
BY THE STAFF OF THE
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INTRODUCTION

This pamphlet summarizes the revised tax reduction proposals made by the Reagan Administration. These recommendations are embodied in H.R. 3849. Part I of the pamphlet is a brief overview of the proposal. Part II summarizes relevant aspects of present law and the specific proposals. Part III shows the Administration's estimates of the revenue effects of the proposals.

I. OVERVIEW OF ADMINISTRATION PROPOSAL

Individual tax rate reductions

There would be across-the-board reductions in individual income tax rates which would reduce tax liability by approximately 1¼ percent in 1981, 11 percent in 1982, 18 percent in 1983 and 23 percent in 1984 and future years. These reductions in tax liability would be reflected in reductions in withheld taxes of 5 percent on October 1, 1981, a further 10 percent on July 1, 1982, and another 10 percent on July 1, 1983.

In addition, the top tax rate would be reduced to 50 percent in 1982 and subsequent years.

Marriage penalty deduction

Married couples would receive in 1982 a deduction of 5 percent of the first \$30,000 of the earnings of the spouse with the lesser amount of earnings. For 1983 and subsequent years, the deduction would be 10 percent.

Interest and dividend exclusion

The \$200 interest and dividend exclusion, now scheduled to expire after 1982, would be made permanent.

Individual retirement accounts

The limits on deductible contributions to individual retirement accounts (IRAs) would be raised from the lesser of 15 percent of earnings or \$1,500 to the lesser of 100 percent of earnings or \$2,000 (\$2,250 for a spousal IRA).

Active participants in qualified pension plans would be made eligible for IRAs, with a \$1,000 limit on deductible contributions (\$1,125 for a spousal IRA).

Self-employed retirement plans

The limit on deductible contributions to self-employed retirement plans (H.R. 10 plans) and profit-sharing plans of subchapter S corporations would be increased from \$7,500 to \$15,000.

Income earned abroad

The present deductions and exclusions for income earned abroad would be replaced by an exclusion for the first \$50,000 of such income plus 50 percent of the next \$50,000. There would also be a deduction for excess housing costs.

Accelerated cost recovery system

The Administration has proposed a complete revision of the Federal income tax treatment of depreciation and the investment tax credit.

The cost of tangible personal property generally would be recovered using a prescribed accelerated depreciation method over a 10-year, 5-year, or 3-year period, depending on the type of property.

The cost of most real property would be recovered over a 15-year recovery period, using a prescribed accelerated depreciation method. The proposal would allow a full investment credit for all eligible 10-year and 5-year recovery property and a 6 percent credit for all eligible 3-year recovery property.

Investment tax credit for rehabilitation

The present 10-percent investment credit for rehabilitation of industrial and commercial structures and the rapid amortization provisions for certified historic structures would be replaced by a 15-percent credit for rehabilitation of structures 30 or 40 years old, a 20-percent credit for structures at least 40 years old, and a 25-percent credit for certified historic structures.

Research and development tax credit

There would be a tax credit equal to 25 percent of wages paid or incurred for services in conducting research and development in excess of such wages in a base period.

Windfall profit tax credit for royalty owners

For 1981 and subsequent years, there would be a credit for royalty owners equal to the first \$2,500 of windfall profit tax liability.

Estate and gift taxes

The credit against the estate and gift tax would be increased to a level that raises the size of a taxable estate at which the estate and gift tax begins from \$175,000 to \$600,000, phased in over 4 years.

The marital deduction for gifts and bequests to spouses would no longer be limited.

The present \$3,000 annual gift tax exclusion for gifts to any one donee would be raised to \$10,000.

II. SUMMARY OF ADMINISTRATION PROPOSAL

1. Individual Income Tax Rate Reductions

Present Law

Tax rates

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. 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 married couples filing joint returns is shown in table 1.

Maximum tax

Under present law, a maximum tax rate of 50 percent generally applies to earned income. This provision applies to single individuals with taxable earned income above \$41,500 and married couples with taxable earned income above \$60,000, since these are the levels at which present tax rates rise above 50 percent.

Alternative minimum tax (capital gains)

Under present law, 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 net capital gain is 28 percent (70 percent top tax rate on the 40-percent includible capital gain). Under present law, taxpayers are liable for an alternative minimum tax to the extent that it exceeds their regular income tax. The base for this tax includes all net capital gain, and the top rate is 25 percent.

Administration Proposal

Reduction in tax rates

By 1984, all tax rates in current tax rate schedules would be reduced by approximately 23 percent. Moreover, the top marginal tax rate would be reduced from 70 percent to 50 percent on January 1, 1982. Thus, when the rate cuts are fully phased in, the range of tax rates would be 11 to 50 percent instead of the 14 to 70 percent range under present law.

Table 1.—The Administration's Proposed Tax Rate Schedules for 1982, 1983, and 1984 (Joint Returns)

[In percent]

Taxable income bracket	Present law	Administration proposal		
		1982	1983	1984 and subsequent years
0 to \$3,400.....	0	0	0	0
\$3,400 to \$5,500.....	14	12	11	11
\$5,500 to \$7,600.....	16	14	13	12
\$7,600 to \$11,900.....	18	16	15	14
\$11,900 to \$16,000.....	21	19	17	16
\$16,000 to \$20,200.....	24	22	20	19
\$20,200 to \$24,600.....	28	25	23	22
\$24,600 to \$29,900.....	32	28	25	24
\$29,900 to \$35,200.....	37	33	30	28
\$35,200 to \$45,800.....	43	39	35	33
\$45,800 to \$60,000.....	49	44	40	38
\$60,000 to \$85,600.....	54	49	44	42
\$85,600 to \$109,400.....	59	50	48	45
\$109,400 to \$162,400.....	64	50	50	49
\$162,400 to \$215,400.....	68	50	50	50
\$215,400 and over.....	70	50	50	50

The tax reduction would be accomplished in four stages. For calendar year 1981, there would be a tax credit equal to $1\frac{1}{4}$ percent of tax liability before other credits. For 1982, there would be rate reductions averaging about 11 percent below present law. For 1983, there would be rate reductions averaging about 18 percent below present law. For 1984, the permanent rate schedules, embodying across-the-board reductions of about 23 percent below present law, would take effect. The proposed rate schedules for married couples filing joint returns under the proposal are shown in table 1.

Withholding changes

There would be three changes in income tax withholding rates. The initial reduction would be 5 percent, effective October 1, 1981. Effective July 1, 1982, there would be a 10-percent reduction, for a cumulative reduction of $14\frac{1}{2}$ percent. (The cumulative reduction is less than 15 percent because the 10-percent reduction applies to the withholding rates in effect after the 5-percent reduction.) Finally, on July 1, 1983, there would be a further 10-percent reduction, for a total cumulative reduction of 23 percent.

Elimination of maximum tax

Because the top tax rate on all types of income would be reduced to 50 percent, as of January 1, 1982, the special 50-percent maximum tax rate on earned income would be redundant and, therefore, would be eliminated.

Reduction in alternative minimum tax (capital gains)

The maximum rate of the alternative minimum tax would be reduced from 25 percent to 20 percent, as of January 1, 1982. This would conform the alternative minimum tax to the reduction in the maximum regular tax on capital gains.

The deduction for net capital gains would remain at 60 percent. However, since the maximum regular tax rate would be reduced from 70 percent to 50 percent, the maximum tax rate on capital gains would be reduced from 28 percent to 20 percent (*i.e.*, 40 percent x 50 percent).

2. Marriage Penalty Deduction

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 a couple's total income is allocated between the two individuals more evenly than 80 percent-20 percent, then the couple's income tax liability will increase when they marry.

Administration Proposal

A new deduction would be provided for couples in which both spouses have earned income. For 1982, the deduction would be 5 percent of the first \$30,000 of earnings of the spouse with the lower earnings (maximum of \$1,500). For 1983 and after, the rate of the deduction would be 10 percent (maximum of \$3,000). This deduction would be allowable whether or not the taxpayer itemizes deductions.

3. Exclusion for Interest and Dividend Income

Present Law

Under present law, there is a partial exclusion for interest and dividends received by individuals. Under this provision, which is effective for 1981 and 1982, individuals may exclude from gross income up to \$200 (\$400 on a joint return) of interest and dividends. After 1982, this exclusion is scheduled to revert to prior law, under which the exclusion was limited to \$100 of dividends received by an individual (\$200 on a joint return, if each spouse had at least \$100 of dividends).

Administration Proposal

The Administration proposes to make permanent the interest and dividend exclusions presently applicable for 1981 and 1982.

4. Individual Retirement Savings

Present Law

An individual generally is entitled to deduct the amount contributed to an individual retirement account, annuity or bond (referred to collectively as "IRAs"). The limitation on the deduction for a year is generally the lesser of 15 percent of compensation or \$1,500. If (1) the contribution is equally divided between an individual and the spouse of the individual and (2) the spouse has no compensation for the year, referred to as a "spousal IRA", the \$1,500 limit is raised to \$1,750. However, no IRA deduction is allowed for a taxable year to an individual who is an active participant during any part of the year in a qualified plan, a tax-sheltered annuity, or a governmental plan.

Administration Proposal

In the case of an individual who is not an active participant in a qualified plan (*i.e.*, one who is currently eligible to make deductible IRA contributions), the current limit would be raised to the lesser of \$2,000 (\$2,250 for a spousal IRA) or 100 percent of compensation.

In the case of an employee who is an active participant in a plan (*i.e.*, one who is not currently eligible for an IRA deduction), a deduction would be allowed for IRA contributions limited to the lesser of \$1,000 (\$1,125 for a spousal IRA) or 100 percent of compensation. No deduction would be allowed for voluntary or mandatory contributions to a plan by an employee. (Employee contributions are considered mandatory if they are required (1) as a condition of employment, (2) as a condition of plan participation, or (3) as a condition of obtaining additional benefits derived from employer contributions.)

The requirement that contributions to a spousal IRA be equally divided between spouses would be deleted.

Effective date.—The proposal would apply for taxable years beginning after December 31, 1981.

5. Self-employed Retirement Savings

Present Law

Overview

A pension or profit-sharing plan is a qualified plan only if it is established by an employer for the benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and the employer, and a partnership is considered the employer of each partner. A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an H.R. 10 plan or Keogh plan, and is subject to special rules which are in addition to the Code's other qualification requirements. These special rules include limits on the deductible contributions and the benefits which can be provided for a self-employed individual. These limits are generally lower than the overall limits applicable with respect to all employees under qualified plans.

Limitation on contributions and benefits for self-employed individuals

H.R. 10 plans generally are defined contribution plans.¹ Under a defined contribution H.R. 10 plan, deductible contributions on behalf of a self-employed individual generally are limited annually to the lesser of \$7,500 or 15 percent of earned income from self employment. Corresponding limits apply to defined benefit H.R. 10 plans,² and to pension or profit-sharing plans maintained by subchapter S corporations.

Employee borrowing from qualified plans

An employee, other than an owner-employee under an H.R. 10 plan (a sole proprietor or a partner whose partnership interest exceeds 10 percent), generally may borrow from an employer's retirement plan if the plan so provides and certain requirements are met.³ If an owner-employee participates in an H.R. 10 plan and borrows from the plan or uses plan benefits as security for a loan, the amount of the loan or security interest is treated as a plan distribution and the usual tax rules for distributions apply. The rules automatically treating loans

¹ Defined contribution plans are plans under which each participant's benefit is based solely on the balance in the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants (e.g., a profit-sharing plan or a money purchase pension plan).

² A defined benefit plan specifies a participant's benefit independently of an account for contributions, etc. (e.g., an annual benefit of 2 percent of average pay for each year of employee service).

³ Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

from an H.R. 10 plan to an owner-employee as distributions do not apply to a common-law employee or to a partner whose interest in the partnership does not exceed 10 percent.

Administration Proposal

The proposal generally would increase the annual limit on deductible contributions to a defined contribution H.R. 10 plan on behalf of a self-employed individual to the lesser of \$15,000 or 15 percent of net earnings from self-employment. A corresponding increase would be made in the maximum annual benefit accrual for a self-employed individual under a defined benefit H.R. 10 plan or subchapter S plan. The income exclusion for contributions to pension or profit-sharing plans of subchapter S corporations would be increased to the lesser of \$15,000 or 15 percent of compensation.

Under the proposal, the present tax treatment of a loan to an owner-employee from an H.R. 10 plan or secured by an interest in an H.R. 10 plan would be extended to all partners.

Effective date.—The proposals would be effective for taxable years beginning after December 31, 1981.

6. Income Earned Abroad

Present Law

United States citizens and residents are taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. U.S. citizens who are present in a foreign country for 17 out of 18 months or who are *bona fide* residents of a foreign country for a period which includes an entire taxable year may be allowed to deduct certain expenses which relate to the excess cost of living overseas or, in certain cases, may be entitled to exclude certain foreign source earned income from U.S. taxation.

The excess living cost deduction consists of separate elements for the general cost of living, housing, education, and home leave:

General cost of living.—This is 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.

Housing.—This is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net earned income).

Education.—This is the reasonable schooling expense for the education of the taxpayer's dependents at the elementary and secondary levels.

Home leave.—This is 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.

Employees who reside in camps in hardship areas and employees of charitable organizations who are employed in less developed countries may exclude up to \$20,000 of earned income in lieu of the 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.

Administration Proposal

The proposal would replace the present deductions from, and exclusion of, foreign earned income with an exclusion of the first \$50,000 of foreign earned income per year plus 50 percent of the next \$50,000. No foreign tax credit or any deductions, would be allowed for taxes attributable to the excluded amount. In addition, the proposal would provide an exclusion of expenses incurred for reasonable housing in excess of a base amount. The base amount would be 16 percent of the salary of a U.S. Government employee at civil service grade GS-14, step 1 (currently \$6,059). These amounts would be prorated on a daily basis for individuals eligible during only part of a tax year.

The exclusions provided would be elective. Qualifying individuals could choose to be taxable on their full foreign earnings and claim the ordinary foreign tax credit.

The proposal would also shorten the required period of physical presence in a foreign country to 11 out of 12 months rather than 17 out of 18 months.

The benefits of the proposed exclusions would be extended to include individuals whose foreign earned income is paid by the U.S. Government but who do not qualify for the benefits provided under section 912 of the Internal Revenue Code.

The proposal would also clarify the cases in which a further exclusion would be provided with respect to meals and lodging furnished in certain camps in a foreign country.

Effective date.—The proposal would apply to taxable years beginning after December 31, 1981.

7. Capital Cost Recovery

Present Law

Under an income tax system, a deduction (or recovery) of capital costs is generally allowed for costs incurred in one year which help to generate income over a number of years. Present law provides a variety of methods of capital cost recovery for different kinds of assets. The most important of these is depreciation, which requires that the deduction for capital costs be spread over the estimated useful life of the asset. Recovery of capital costs over an asset's useful life permits the measurement of net income produced from use of the asset by matching income with expenses incurred to produce the income. Under amortization, the recovery of capital costs occurs over some fixed, arbitrary period of time unrelated to the asset's useful life. Certain assets (like movies) are depreciated under other methods.

Depreciation

The three main determinants of the amount of the annual depreciation deductions are the useful life of an asset (the number of years over which depreciation deductions are spread), the method of allocating the deductions over that period and the salvage value of the asset (if any). Another aspect of capital cost recovery is the treatment of gain realized upon the disposition of assets.

Personal Property

Useful life.—The principal method used to determine useful lives for personal property is the Asset Depreciation Range (ADR) system. Assets eligible for ADR are grouped into more than 100 classes, and guideline lives for each class are determined by the Treasury. Taxpayers may claim a useful life up to 20 percent longer or shorter than the ADR guideline life. For assets not eligible for ADR and for taxpayers who do not elect ADR, useful lives are determined according to the facts and circumstances pertaining to each asset.

Method.—Taxpayers are allowed to use the straight-line method of depreciation for all depreciable assets. Under the straight-line method, the recovery of capital costs is spread evenly over the asset's useful life. However, the capital costs of most assets also can be recovered using accelerated methods, which allocate a greater share of the deductions to the early years of the asset's useful life. (Because a dollar today is worth more than a dollar in the future, taxpayers generally will prefer to accelerate depreciation deductions.) Accelerated depreciation probably corresponds to the decline in the real value of most assets better than straight-line depreciation. The most generous accelerated methods are the 200-percent declining balance method and the sum of the years digits (SYD) method.¹

¹ Under the 200-percent declining balance method, depreciation is taken at twice the straight-line rate on the capital costs that have not yet been recovered through depreciation deductions. For example, for an asset with a 5-year life, the first year's deduction is 40 percent of the cost, the second year's deduction is 24 percent (40 percent of the remaining 60 percent of cost), and so forth. Taxpayers using the 200-percent declining balance method typically switch to straight-line or SYD at some point in the useful life.

Gain on disposition.—When personal property is sold, any gain is treated as ordinary income to the extent of any depreciation previously taken. Any gain that exceeds previously taken depreciation generally is capital gain.

Real Property

Useful life.—ADR does not apply to most kinds of real property. Therefore, useful lives of most real property are based on the facts and circumstances pertaining to each individual building. The IRS has published guideline lives which will not be challenged on audit, but most taxpayers claim shorter lives than the guidelines. Taxpayers also may claim separate useful lives for the building shell and for each of the various components of the structure (elevators, plumbing, etc.), thereby achieving a relatively short useful life for the building as a whole.

Method.—Allowable methods of depreciation for real property depend on the use of the property. New residential buildings may be depreciated using the most generous method, which is 200-percent declining balance depreciation. New nonresidential buildings may be depreciated using the 150-percent declining balance method (150 percent of the straight-line rate applied to unrecovered costs). Used residential property may be depreciated using 125 percent declining balance depreciation (125-percent of the straight-line rate applied to unrecovered costs). All other used buildings are limited to straight-line depreciation.

Gain on disposition.—When real property is sold, any gain is treated as ordinary income to the extent the total depreciation taken exceeds the depreciation that would have been allowable had the straight-line method been used. Thus, if the straight-line method is used, all gain would be capital gain. This rule is more generous than the rule for personal property, under which gain is ordinary income to the extent of all prior depreciation. For low income housing, recapture is phased out based on the period of time the property was held by the taxpayer.

Investment tax credit

For most kinds of tangible personal property, taxpayers may claim an investment tax credit (ITC) in addition to their depreciation deductions. The ITC is generally 10 percent of the cost of the asset, but this rate is reduced to 6½ percent for assets depreciated over a 5- or 6-year life and 3½ percent for assets depreciated over a 3- or 4-year life.

Administration Proposal

The Administration has proposed, as a complete revision of the Federal income tax treatment of depreciation and the investment tax credit, the Accelerated Cost Recovery System (ACRS). This pamphlet describes the basic features of the proposal. Details will be presented in subsequent pamphlets.

The proposal generally would be effective for property placed in service after December 31, 1980.

Depreciation

Personal property

Recovery period.—The cost of tangible personal property generally would be recovered over a 10-year, 5-year, or 3-year period, depending

on the type of property. However, the taxpayer could elect to use a 25-year recovery period for 10-year property, a 12-year recovery period for 5-year property, or a 5-year recovery period for 3-year property. Theme park structures and other real property for which the taxpayer may use an ADR useful life of 10 years or less would be treated as personal property.

Method.—Taxpayers would use a prescribed accelerated method, but only if the regular recovery period is used. The straight-line method may be elected if either the regular or optional longer recovery period is used. For the years 1981–1984, the prescribed accelerated method would approximate the benefits of using the 150-percent declining balance method for the early years with a switch to the straight-line method in later years. For 1985, the prescribed accelerated method would approximate the benefits of using the 175-percent declining balance method with a switch to the SYD method. In 1986 and thereafter, the prescribed accelerated method would approximate the benefits of using the 200-percent declining balance method with a switch to SYD. The retirement-replacement-betterment method for railroads would be repealed.

3-year Class.—Automobiles, light-duty trucks, and machinery and equipment used in connection with research and development would be assigned to the 3-year class. In addition, all other machinery and equipment with an ADR mid-point life of 4-years or less as of January 1, 1981, would be placed in this class.

5-year Class.—The 5-year class would include all tangible personal property, other than property included in the 10-year or 3-year recovery classes.

10-year Class.—Public utility property with an ADR mid-point life, as of January 1, 1981, of more than 18 years would be placed in the 10-year class. Also, the 10-year class would include theme park structures and other real property for which the taxpayer may use an ADR useful life of 10 years or less.

Equipment leasing.—The bill would provide liberalized rules for determining if a transaction involving new personal property owned by corporations is a lease. In general, the present requirement that the lessor must have made a minimum at-risk investment of 20 percent of cost would be lowered to 10 percent. In addition, a transaction would not be denied treatment as a lease merely because the lessor can show a profit and a positive cash flow from the lease only if tax benefits are taken into account.

Real property

Recovery period.—Under the Administration's proposal, real property (other than real property included in the 10-year class) would have a 15-year recovery period. A taxpayer would have the option to use a 35-year recovery period instead of the 15-year recovery period.

Method.—The cost of real property would be recovered using a prescribed accelerated method, but only if the regular 15-year recovery period is used. The straight-line method could be elected if the taxpayer used either the regular recovery period or the optional longer recovery period. The prescribed accelerated method would approximate the benefits of using the 200-percent declining balance method with a switch to the straight-line method.

Gain on disposition.—If nonresidential property in the 15-year class is depreciated under the prescribed accelerated method, all gain would be ordinary income to the extent of all depreciation previously taken. However, if the straight-line method were elected, all gain would be capital gain.

For all residential real property, gain would be ordinary income only to the extent the depreciation allowed exceeds the depreciation that would have been allowable if the straight-line method had been used. Therefore, if the straight-line method were elected, all gain would be capital gain.

Other matters

There are additional rules relating to the following issues:

- (1) Depreciation of property used predominantly outside the U.S.;
- (2) Computation of earnings and profits;
- (3) Computation of minimum tax preference items;
- (4) Public utility property;
- (5) Certain railroad property; and
- (6) Property used before, and sold after, the effective date.

Investment credit

The proposal would allow a full 10-percent investment credit for all eligible 10-year and 5-year recovery property and a 6 percent credit for all eligible 3-year recovery property. Thus, the amount of credit would no longer depend on the estimated useful life of the property. A percentage of the credit for the 10-year and 5-year recovery property would be recaptured if the property is disposed of before 5 years. Recapture of a percentage of the credit for 3-year recovery property would be required if the property is disposed of within 3 years.

At-Risk limitation on the investment credit.—The cost of property used to compute the investment credit generally would not include borrowed amounts the taxpayer is not personally required to repay or amounts for which the taxpayer is guaranteed against loss. There would be an exception to this rule for amounts owed to banks, savings and loan associations, and insurance companies. The limitation would not apply to property placed in service before February 19, 1981, or property acquired under a binding contract entered into before February 19, 1981. The limitation also would not apply to certain other property that was acquired or constructed before February 19, 1981.

8. Investment Credit for Rehabilitated Buildings

Present Law

Under present law, a 10-percent investment tax credit is available for the rehabilitation of nonresidential buildings which are held for business or investment purposes and are over 20 years old. In general, this credit may not be taken more often than once every 20 years.

Present law also allows taxpayers to amortize, over a 60-month period, the capital expenditures incurred in a certified rehabilitation of a certified historic structure. When taxpayers elect this 60-month amortization, they are not eligible for the investment tax credit.

Administration Proposal

The current 10-percent investment tax credit for rehabilitated buildings would be replaced with a new credit with the following three-tier structure: (1) a 15-percent credit for rehabilitations of buildings that are 30 to 40 years old; (2) a 20-percent credit for rehabilitations of buildings that are at least 40 years old; and (3) a 25-percent credit for rehabilitations of certified historic buildings. The 25-percent credit would be available for rehabilitations of all income-producing certified historic structures, whether residential or nonresidential. However, the 15-percent and 20-percent credits would be limited, as under present law, to nonresidential industrial and commercial structures.

The present 60-month amortization and accelerated depreciation provisions for certified historic structures would be repealed. Other allowable accelerated depreciation would not be permitted to be used in conjunction with the rehabilitation credit. Moreover, a taxpayer would not be permitted to claim both the energy credit and the rehabilitation credit with respect to the same rehabilitation expenditures.

Effective date.—These proposals would be effective for qualifying rehabilitation expenditures incurred after December 31, 1981.

9. Credit for Incremental Research and Development Expenditures

Present Law

Overview

As a general rule, business expenditures to develop or create an asset which has a useful life extending beyond the taxable year, such as expenditures to develop a new consumer product or improve a production process, normally must be capitalized and cannot be deducted in the year paid or incurred. However, Code section 174 permits the taxpayer to elect to deduct currently the amount of research or experimental expenditures paid or incurred during the taxable year in connection with the taxpayer's trade or business. Alternatively, the taxpayer generally may elect to deduct such research costs ratably over a period of not less than 60 months.

Definition of qualifying research expenditures

In general, Code section 174 does not specifically define qualifying research or experimental expenditures, but that term is interpreted by Treasury regulations 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," and also the costs of obtaining a patent on such property.

The cost of land and the full costs of buildings or equipment used for research are excluded from the elections; *i.e.*, they cannot be expensed. However, under a section 174 election, depreciation deductions and investment credits for research buildings and equipment can be taken to the same extent as if such property were used for business (*e.g.*, manufacturing) purposes.

Administration Proposal

Overview

The Administration proposes to provide a 25-percent income tax credit for wages paid or incurred for services performed in conducting research and experimentation. The credit would apply only to the extent research wage expenditures for the taxable year exceed the average amount of research wage expenditures in the specified base period. Under the proposal, the credit would be allowed only for research wage expenditures made in carrying on a trade or business of the taxpayer. (The "in carrying on" rule is narrower than the "in connection with" rule under section 174.)

Definition of qualifying research wages

The definition of "research and development" for purposes of the proposed incremental credit would generally be the same as the definition used for the section 174 deduction elections. The credit would not

be available for wages paid for research conducted outside the United States or for research in the social sciences or humanities, or to the extent research is funded from a government grant or contract for research.

The credit would be available to a taxpayer for research wages paid by the taxpayer to its employees, and also to the extent the taxpayer reimburses another person (such as a research firm or a university) for wages paid for services in conducting research on behalf of the taxpayer. If substantially all services performed by an individual for or on behalf of the taxpayer are performed in conducting research, the total of wages paid by the taxpayer to the individual during the year for both research and other services would enter into the credit computation. Otherwise, only that portion of wages which was paid for research services would be eligible.

Computation of credit

In general, the credit would apply to the amount of research wage expenditures for the year which exceeds the average of such expenditures in the preceding three taxable years.¹ A new organization would be treated as having research wage expenditures of zero for base period years in which it was not in existence.

The amount of research wage credit which could be used in a particular taxable year generally would be limited to the taxpayer's income tax liability. (For individual taxpayers, the credit could only offset tax attributable to income from the taxpayer's interest in the trade or business with respect to which the research wage expenditures were incurred.) If the amount of allowable credit exceeds the tax liability limitation, the excess credit could be carried back three years and carried forward seven years, beginning with the earliest year.

Effective date.—The credit would apply to research wages paid or incurred after June 30, 1981, in taxable years ending after that date.

¹ For an existing taxpayer's first taxable year ending after June 30, 1981, base period expenditures would be the taxpayer's research wages for the preceding taxable year, as adjusted for annualization purposes. For his second taxable year ending after June 30, 1981, the credit would apply to the amount of research wage expenditures during that year which exceeds the average of research wage expenditures in the preceding two taxable years.

10. Windfall Profit Tax Royalty Owner Credit

Present Law

Under the Crude Oil Windfall Profit Tax Act of 1980, an excise tax is imposed on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification in one of three tiers; lower rates apply to up to 1,000 barrels a day of tier one and tier two oil produced by independent producers. Royalty owners, and persons holding similar non-operating mineral interests, are not independent producers eligible for lower rates.

Present law also provides qualified royalty owners with a credit (or refund) of up to \$1,000 against the windfall profit tax imposed on the removal of their royalty oil during calendar year 1980. The credit is available only to individuals, estates, and qualified family farm corporations.

Administration Proposal

Under the proposal, the royalty owner credit would be made permanent and would be increased from \$1,000 to \$2,500 for royalty oil removed from the premises after calendar year 1980.

The credit would not be available for royalty interests transferred after June 9, 1981, unless those interests are eligible for one of the exceptions to the percentage depletion transfer.

11. Estate and Gift Taxes

A. Unified Credit

Present Law

Under present law, the estate and gift taxes are unified so that a single progressive rate schedule is applied to cumulative gifts and bequests. The estate and gift tax rates range from 18 percent for the first \$10,000 in taxable transfers to 70 percent on taxable transfers in excess of \$5 million. Generally, the estate or gift tax liability is determined by first computing the gross gift or estate tax and then subtracting the unified credit to determine the amount of the gift or estate tax.¹ The amount of the present unified credit is \$47,000. With a unified credit of \$47,000, there is no estate or gift tax on transfers of up to \$175,625.

The unified credit applicable to the estates of non-resident aliens is \$3,600.

Administration Proposal

The proposal would increase the amount of the unified estate and gift tax credit from \$47,000 to \$192,800 over a four-year period. With a unified credit of \$192,800, there would be no estate or gift tax on transfers aggregating \$600,000. The phased-in amounts of the credit would be as follows:

Year	Credit	Aggregate amount of tax-free transfers
1982-----	\$70, 800	\$250, 000
1983-----	96, 300	325, 000
1984-----	121, 800	400, 000
1985 and later-----	192, 800	600, 000

No change would be made to the unified credit for nonresident aliens.

¹ However, the amount of estate tax would be reduced further by other credits allowed to an estate.

B. Unlimited Marital Deduction

Present Law

Present law allows a limited deduction for gifts and bequests between spouses. Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of interspousal lifetime transfers in excess of \$200,000. In addition, an estate tax marital deduction equal to the greater of \$250,000 or one-half of the decedent's gross estate is generally allowed for the value of property passing from a decedent to the surviving spouse. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interests generally do not qualify for either the gift or estate tax marital deductions.

Administration Proposal

The Administration proposes to remove the limits on the marital deduction for both estate and gift tax purposes. There would be no change in the present rule that transfers of terminable interests do not qualify for the marital deduction. However, transfers of community property would qualify for the marital deduction.

In addition, the Administration would provide that for property held by spouses in joint tenancy with the right of survivorship, each spouse would be deemed to own one-half of the value of the property, regardless of which spouse furnished the consideration. This change would be relevant in determining the qualification for special use valuation under section 2032A and deferred payment under either section 6166 or 6166A.

Effective date.—The changes would apply with respect to gifts made or decedents dying after December 31, 1981.

C. Annual Gift Tax Exclusion

Present Law

Present law allows an annual exclusion of \$3,000 per donee with respect to gifts of present interests in property. In addition, a husband or wife may consent to split their gifts so that a couple may give up to \$6,000 per donee per year without gift tax.

Administration Proposal

The Administration proposes to increase the gift tax annual exclusion to \$10,000 per donee. With gift-splitting, spouses would be able to transfer \$20,000 per donee per year without gift tax.

Effective date.—The change would be effective with respect to transfers made after December 31, 1981.

D. Basis of Property Acquired From a Decedent

Present Law

Under present law, the cost or basis of property acquired from or passing from a decedent generally is its fair market value at the date of death (or, if the executor so elects, at the alternate valuation date). Accordingly, if the fair market value of the property had appreciated, the appreciation would never be subject to income tax or, if the property had decreased in value, the loss could never be deducted for income tax purposes. This “step-up” is applicable regardless of the date on which the decedent acquired the property or the manner of acquisition.

Thus, an heir could transfer appreciated property to a decedent immediately prior to death. The donor-heir would pay gift taxes on the fair market value of the gift (unless it qualified for the marital deduction or the unified credit) but would pay no income tax on the appreciation. Upon the death of the donee-decedent, the donor-heir would receive back the property with a stepped-up basis equal to its fair market value.

Administration Proposal

Because the Administration proposal provides an unlimited marital deduction and increased unified credit, there would be even greater incentive to plan such deathbed transfers to a donee-decedent. Accordingly, the bill would provide that the step-up basis rules would not apply with respect to property acquired by the decedent through gift within three years of death.

Effective date.—The change would apply with respect to decedents dying after December 31, 1981.

III. Estimated Revenue Effects of the Revised Administration Tax Reduction Program, Fiscal Years 1981-86

[In billions of dollars]

Item	1981	1982	1983	1984	1985	1986
Personal tax reduction program						
Across-the-board tax rate reduction of 5 percent on Oct. 1, 1981 with additional reductions of 10 percent on July 1, 1981 and 10 percent on July 1, 1983-----	-25.7	-64.4	-104.3	-121.1	-139.0	
Lower top rate to 50 percent on Jan. 1, 1982 and thereafter-----	-1.1	-2.2	-1.1	-0.8	-1.0	
Marriage penalty relief (5 percent exclusion up to \$1,500 in 1982, 10 percent exclusion up to \$3,000 in 1983 and thereafter) (Jan. 1, 1982)-----	-0.4	-3.8	-7.0	-7.8	-8.7	
Phased-in increase in the unified estate and gift tax credit to \$192,800, allow an unlimited marital deduction, and increase the annual gift tax exclusion to \$10,000 (Jan. 1, 1982)-----	-0.1	-1.9	-3.0	-4.0	-5.8	
Increase IRA limit to \$2,000 (\$2,250 spousal) and increase the percentage limit to 100 percent (Jan. 1, 1982)-----	-0.1	-0.2	-0.2	-0.2	-0.3	
Extend IRA eligibility to covered persons with a \$1,000 (\$1,125 spousal) limit (Jan. 1, 1982)-----	-0.1	-0.7	-1.0	-1.3	-1.4	
Increase Keogh plan limit to \$15,000 (Jan. 1, 1982)-----	(1)	-0.1	-0.2	-0.2	-0.2	

See footnotes at end of table.

[In billions of dollars]

Item	1981	1982	1983	1984	1985	1986
Make permanent the \$200/\$400 interest and dividend exclusion			-0.8	-2.5	-2.7	-3.0
\$2,500 windfall profit tax credit for royalty owners (Jan. 1, 1981)	(¹)	-0.8	-0.7	-0.6	-0.6	-0.6
Subtotal, personal tax reduction program ..	(¹)	-28.3	-74.8	-119.8	-138.7	-159.9
Business tax reduction program						
Accelerated cost recovery system	-2.1	-8.9	-17.3	-28.3	-41.9	-63.9
25-percent incremental credit for direct wages for research and development (July 1, 1981)	(¹)	-0.4	-0.6	-0.7	-0.7	-0.7
Allow an exclusion of \$50,000 plus 50 percent of next \$50,000 of foreign earned income with a housing allowance (Jan. 1, 1982)		-0.3	-0.5	-0.5	-0.6	-0.6
Investment tax credit for rehabilitation expenditures (15 percent for 30 years, 20 percent for 40 years, and 25 percent for historic structures) (Jan. 1, 1982)		-0.1	-0.2	-0.2	-0.3	-0.4
Subtotal, business tax reduction program ..	-2.1	-9.7	-18.6	-29.8	-43.5	-65.6
Total, Revised Administration tax reduction program	-2.1	-38.0	-93.4	-149.6	-182.2	-225.6

¹ Less than \$50 million.

Source: Office of the Secretary of the Treasury Office of Tax Analysis.