[JOINT COMMITTEE PRINT]

SUMMARY OF ADMINISTRATION TAX AND BUDGET REDUCTION PROPOSALS

(As Announced in the President's Message of February 18, 1981)

PREPARED FOR THE

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HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY THE STAFF OF THE

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I. INTRODUCTION

This pamphlet summarizes the tax proposals made by President Reagon on February 18, 1981. These proposals include a 3-year reduction in individual income tax rates, liberalization in depreciation and the investment tax credit, and excise tax and user fee increases. The pamphlet contains a brief summary of the Administration's overall economic program, a detailed outline of its tax proposals and the Administration's estimate of the budget effects of the proposals.

II. SUMMARY

A. Tax changes

Individual income tax reductions

There would be a sequence of reductions in income tax rates of approximately 5 percent in 1981, 10 percent in 1982, 10 percent in 1983, and 5 percent in 1984. Thus, by 1984, rates would be approximately 30 percent less than present levels. These cuts would be reflected in lower income tax withholding starting July 1, 1981.

Depreciation and investment tax credit

The present rules for depreciating personal property, including the ADR system, would be replaced by a new mandatory system. Generally, personal property would be depreciated over 5 years. However, cars, light trucks, and equipment used in research and development would be depreciated over 3 years, and long-lived public utility property over 10 years. There would be accelerated depreciation over these recovery periods. The investment tax credit would be 6 percent for property in the 3-year class and 10 percent for other equipment.

The present rules for depreciating real property also would be replaced by a new system. Owner-occupied industrial structures and wholesale and retail distribution facilities would be depreciated over 10 years using an accelerated method. Other nonresidential structures and low-income housing would be depreciated over 15 years using the straight line composite method. Residential structures would be depreciated over 18 years using the straight-line composite method.

Excise taxes

The excise tax on fuel used in inland waterways and the airport and airway excise taxes would be increased. User fees would be imposed to cover the costs of services provided by the Coast Guard to owners of boats and yachts.

B. Outlay changes

The Administration has proposed specified reductions in outlays for a wide variety of government programs. These total $34.8 billion in fiscal year 1982 and rise to $77.3 billion in 1986. The Administration intends to propose additional reductions in outlays of $6.7 billion in fiscal year 1982 and $46.5 billion in fiscal year 1986 and additional defense spending. Of the specified outlay reductions, about one-fifth are within the jurisdiction of the tax-writing committees.

III. ADMINISTRATION TAX PROPOSALS

A. Individual Income Tax 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 30 percent. Thus, the range of tax rates would be 10 to 50 percent instead of the 14 to 70 percent range under present law. Interim reductions for 1981, 1982 and 1983 would be approximately 5, 15 and 25 percent, respectively. These tax cuts would be reflected in lower income tax withholding and estimated tax payments starting July 1, 1981. Rate schedules for married couples filing joint returns under the proposal are shown in table 1.

TABLE 1.—ADMINISTRATION'S PROPOSED TAX RATE

Taxable income bracket	Present law		1981	
	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket
$0–$3,400	$0	0%	$0	0%
$3,400–$5,500	0	14	0	13
$5,500–$7,600	294	16	273	15
$7,600–$11,900	630	18	588	17
$11,900–$16,000	1, 404	21	1, 319	20
$16,000–$20,200	2, 265	24	2, 139	23
$20,200–$24,600	3, 273	28	3, 105	27
$24,600–$29,900	4, 505	32	4, 293	30
$29,900–$35,200	6, 201	37	5, 883	35
$35,200–$45,800	8, 162	43	7, 738	41
$45,800–$60,000	12, 720	49	12, 084	47
$60,000–$85,600	19, 678	54	18, 758	51
$85,600–$109,400	33, 502	59	31, 814	56
$109,400–$162,400	47, 544	64	45, 142	61
$162,400–$215,400	81, 464	68	77, 472	65
$215,400 and over	117, 504	70	111, 922	66

[1] Compared with present law, tax rates are reduced approximately 5 percent in 1981, 15 percent in 1982, 25 percent in 1983, and 30 percent in 1984.

Elimination of maximum tax

Effective in 1984, the current maximum tax rate of 50 percent on earned income would be eliminated. This provision would be redundant because the maximum tax rate applying to all types of income would be 50 percent, as specified above.

SCHEDULES FOR 1981, 1982, 1983, AND 1984: JOINT RETURN

Administration proposal					
1982		1983		1984 and subsequent years	
Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket
$0	0%	$0	0%	$0	0%
0	12	0	11	0	10
252	14	231	12	210	11
546	15	483	14	441	13
1, 191	18	1, 085	16	1, 000	15
1, 929	21	1, 741	19	1, 615	18
2, 811	24	2, 539	22	2, 371	21
3, 867	27	3, 507	24	3, 295	23
5, 298	31	4, 779	28	4, 514	27
6, 941	37	6, 263	33	5, 945	32
10, 863	42	9, 761	38	9, 337	36
16, 827	47	15, 157	42	14, 449	40
28, 859	50	25, 909	45	24, 689	43
40, 759	55	36, 619	49	34, 923	47
69, 909	58	62, 589	52	59, 833	49
100, 649	60	90, 149	53	85, 803	50

Reduction in alternative minimum tax

Under the proposal, the maximum rate of the alternative minimum tax would be lowered in 1982, 1983 and 1984 to 24, 21 and 20 percent, respectively. These rates would be approximately equal to the maximum rate on capital gains under the regular rate schedule which would be in effect in that year. The deduction for net capital gains would remain at 60 percent. Because the maximum regular tax rate would be reduced from 70 percent to 50 percent over 4 years, the maximum tax rate on capital gains would be reduced from 28 percent to 20 percent.

B. Changes in Depreciation and the Investment Tax Credit

Present law

Depreciation overview

Under present law, if a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property subject to wear and tear, decay or decline from natural causes, exhaustion or obsolescence, the adjusted basis generally can be depreciated over the asset's useful life.

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

Personal Property

Useful lives.—Prior to 1971, useful lives were based on the facts and circumstances relevant to each asset, although the Treasury published guideline lives which would not be challenged by the IRS.

In 1971, the asset depreciation range system (ADR) was established. Generally, property which is eligible for the election under ADR is new or used depreciable property for which an asset class and an asset guideline period have been prescribed by the Treasury Department for the taxable year.

Under ADR, a taxpayer may use a depreciation life within a range of 20 percent below or above the useful life established for each asset class. Under the ADR system, there are 14 asset classes based on the kind of property and 115 asset classes grouped by the type of activity in which the property is used.

Methods of depreciation.—For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method and the sum-of-the-years-digits method. Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property. Taxpayers may use either straight-line or units-of-production depreciation for any depreciable property.

Additional first-year depreciation.—Present law allows an additional first-year depreciation deduction amounting to 20 percent of the cost of tangible personal property with a useful life of 6 years or more. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).

Salvage value.—Salvage value is the amount that the taxpayer estimates (at the time of acquisition) will be realized upon sale or other disposition of an asset when it is no longer useful in the tax-

payer's trade or business. An asset may not be depreciated below a reasonable salvage value.

Recapture.—When gain is realized on the sale or other disposition of tangible personal property, the gain is treated as ordinary income to the extent of all depreciation previously allowable.

Start of depreciation.—Depreciation deductions can be claimed once the property is placed in service by the taxpayer.

Real Property

Useful lives.—Under present law, depreciation for real property may be determined by estimating useful lives under a facts and circumstances test or by using guideline lives published by the Treasury for certain structures. Real property is generally not covered under ADR.

Methods of depreciation.—Special rules limit the use of accelerated depreciation methods for real estate. A new residential rental building may be depreciated under the 200-percent declining balance method or the sum-of-the-years-digits method.

New nonresidential buildings may be depreciated under the 150-percent declining balance method. If used residential rental property has a useful life of 20 years or more, it can be depreciated under the 125-percent declining balance method. Other used real property can be depreciated only under the straight-line method.

Five-year amortization is provided for certain low-income housing rehabilitation expenditures, pollution control facilities, child care facilities, and rehabilitation expenditures for certified historic structures.

Component depreciation.—A taxpayer may allocate the cost of a building to its component parts and compute depreciation on the basis of the useful lives of the component parts (such as the plumbing system, roof, and building shell) instead of on the basis of the useful life of the entire building (i.e., on a composite basis).

Recapture, minimum tax and maximum tax.—Under special rules, accelerated depreciation on, and rapid amortization of, real property in excess of straight-line depreciation is generally subject to recapture as ordinary income. In addition, this excess is treated as a tax preference item for minimum tax purposes and reduces the amount eligible for the 50-percent maximum tax rate on personal service income. For subsidized low-income rental housing, accelerated depreciation subject to recapture as ordinary income is phased out by one percentage point for each month the property is held for more than 100 months.

Investment tax credit

Present law provides a 10-percent regular investment credit for investments in certain tangible property. To be eligible for these credits, property must be depreciable or amortizable and must have a useful life of at least three years. If the property has a useful life of three or four years, a credit of 3⅓ percent is allowed; if the useful life is five or six years, a credit of 6⅔ percent is allowed; and if the useful life is 7 years or more, a full 10-percent credit is allowed. This determination is generally made on the basis of the useful life which is used for purposes of depreciation or amortization. These useful life limitation

rules are also applied where the credit has been claimed and the property is later disposed of by the taxpayer before the end of the useful life that determined the amount of credit. In such situations, the credit is recomputed on the basis of its actual useful life in the hands of the taxpayer and any excess credit is recaptured from the taxpayer.

Generally, the investment credit is claimed for the taxable year in which qualifying property was placed in service. However, in cases where property is constructed over a period of two or more years and has a useful life of 7 years or more, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 80 percent in 1981 and will increase to 90 percent for 1982 and later years. Excess credits from a taxable year may be carried back to apply against tax liability for the three preceding and carried over to apply against the tax liability for the seven succeeding years.

In the case of used property, the regular investment credit is only allowed for up to $100,000 of property.

Generally, buildings and their structural components are not eligible for the investment credit. The 10 percent credit is allowed, however, for certain single purpose agricultural structures and for qualified rehabilitation expenditures for buildings, other than those used for residential purposes, held for business or investment purposes.

Administration Proposal

Depreciation on equipment and certain real property (10–5–3)

Eligibility

The capital cost of tangible personal property and owner-occupied industrial structures and wholesale and retail distribution facilities would be recovered in 10-year, 5-year, or 3-year recovery periods. The system would be mandatory for all eligible property. Eligible property would include both new and used property. Public utility property would be eligible, but only if the taxpayer used a normalization method of regulated accounting. Intangible property and property that, under present law, is amortized in lieu of depreciation or depreciated under a method not expressed in terms of years (e.g., the unit of production method) is not included in the proposed recovery system.

Computation of recovery deduction

The recovery deduction would be determined by applying a statutory percentage to the capital cost of the recovery property. For the 10-, 5-, and 3-year recovery classes, the statutory percentage would result in a deduction approximating the deduction that would result from using (1) double declining balance depreciation for the earliest years of the recovery period, (2) sum-of-the-year's-digits depreciation for later years, (3) the half-year convention (under which all capital cost is treated as added to capital account on the first day of the second half of the taxable year), and (4) no salvage value.

10-year recovery property

Under the proposal, the capital cost of owner-occupied industrial structures and wholesale and retail distribution facilities and public utility property with an ADR midpoint life of over 18 years would be recovered over a period of 10 recovery years. The applicable percentages would range from 10 percent in the first recovery year (reflecting the combination of a 20 percent recovery percentage and the use of the half-year convention) to 2 percent in the tenth year.

5-year recovery property

The capital cost of tangible personal property, other than property included in the 10-year or 3-year recovery classes, would be recovered over a period of 5 years. The applicable percentages for property in the 5-year recovery class range from 20 percent in the first recovery year (reflecting the combination of a recovery rate of 40 percent and the use of the half-year convention) to 8 percent in the fifth recovery year.

3-year recovery property

Under the proposal, the capital cost of automobiles, taxis, light-duty trucks, and research and development equipment would be recovered over a 3-year recovery period. The applicable recovery percentages would be 33 percent (reflecting the combination of a 66 percent recovery percentage and the use of the half-year convention), 45 percent and 22 percent.

Phase-in

Under the proposal, the cost recovery system for 5-year and 10-year property would be phased in over five years. The cost recovery system for 3-year property would become effective immediately. The proposal would provide that taxpayers could make an annual election to apply the fully phased-in system for the first $100,000 of 5-year property for each year of the transition period.

Commencement of cost recovery period

In general, the recovery period begins when the property is placed in service. However, for property with at least a 2-year normal construction period, the recovery period begins when construction commences. Under this special rule, a recovery deduction would be allowed for expenditures made during the taxable year, subject to a limitation based on construction progress during the year.

Salvage value

The proposal would allow taxpayers to recover the entire cost of property, including salvage value.

Additional first-year depreciation

Under the proposal, recovery property would not be entitled to additional first-year depreciation which is allowed under present law for tangible personal property with a useful life of 6 years or more.

Recapture

Under the proposal, all depreciation allowed with respect to recovery property, whether personal or real property, would be subject to depreciation recapture under the present law rules applicable to

personal property. Thus, gain on the disposition of recovery property would be treated as ordinary income to the extent of all allowable recovery amounts.

Earnings and profits

Under present law, earnings and profits of corporations are generally computed by taking into account only straight-line depreciation. Under the proposal, earnings and profits would be computed by taking into account only straight-line capital recovery over extended recovery periods.

Carryovers

Under present law, net operating losses, investment credits, and energy credits (other than residential energy credits) can be carried over for 7 taxable years. Under the proposal, this carryover period would be extended to 10 years.

Audit-proof lives for real property

Under the proposal, the depreciation allowance for real property not included in the 10-year recovery class would be based on shortened audit-proof useful lives. The proposed useful lives would be mandatory. Capital costs would be recovered over the useful life on a straight-line basis. Recapture of depreciation on sale would be eliminated.

Nonresidential real property (other than owner-occupied industrial structures and distribution facilities) and low-income housing would have useful lives of 15 years.

Under the proposal, a transitional rule would provide a phase-in for the depreciation of nonresidential real property and low-income housing. For capital costs added to depreciation accounts in 1981 and 1982, the useful lives are 18 years and 16 years, respectively.

Residential real property, other than low-income housing, would have a useful life of 18 recovery years.

Changes in the investment credit

Overview

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. Thus, the amount of credit would no longer depend upon 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 rule

The proposal would extend "at-risk" rules to the investment credit, limiting the amount of credit for property financed with non-recourse loans.

Effective date

The proposed accelerated cost recovery system would generally apply to capital investments made after December 31, 1980.

C. Excise Tax Changes

Waterway user taxes

Under present law, an excise tax is imposed on fuel used in a vessel in commercial waterway transportation. The amount of tax is determined from the following table:

If the use occurs in fiscal year—	*The tax is— (cents per gallon)*
1981	4
1982–3	6
1984–5	8
1986 and thereafter	10

Under the proposal, the amount of tax would be determined from the following table:

If the use occurs in fiscal year—	*The tax is— (cents per gallon)*
1981	4
1982	6
1983	30
1984	31
1985	32
1986 and thereafter	34

Airport and airway taxes

Under present law, an excise tax is imposed on air passenger transportation within the United States. The amount of tax is 5 percent of the amount of the airfare. There is no special tax on the air transportation of property or on fuels used in noncommercial (general) aviation. (On October 1, 1980, the 8-percent passenger ticket tax was reduced to 5 percent and the following aviation excise taxes expired: (1) the 5-percent tax on the air transportation of property; (2) the 7-cents-per-gallon tax on nongasoline fuels used in noncommercial aviation; (3) the 3-cents-per-gallon tax on gasoline used in noncommercial aviation; (4) the $3-per-passenger international departure tax; and (5) the aircraft use tax.)

Under the proposal, the excise tax on air passenger transportation would increase to 9 percent of the amount of the airfare. In addition, a 5 percent tax would be imposed on the amount paid for air transportation of property and a 20 percent tax would be imposed on aviation fuels used in noncommercial aviation. There would be other increases in airport and airway taxes yet to be specified.

Boat and yacht owner fees

Under present law, there are no special taxes on boat and yacht owners to finance services provided to such owners by the United States Coast Guard. Such services include licensing, inspection, operating aids to navigation, icebreaking and other services.

Under the proposal, fees would be levied on owners of commercial and noncommercial boats to finance services provided to such owners by the Coast Guard. The proposal indicates that fee schedules are being prepared by the Department of Transportation.

D. Other Proposals Affecting the Internal Revenue Code

Child support enforcement

The Administration proposes that the Internal Revenue Service intercept Federal income tax refunds to collect child support arrearages from liable absent parents where a court judgment has already been obtained.

Taxation of Federal employees injury compensation (FECA) payments

The Administration proposes to include in gross income workers' compensation benefits paid to Federal employees under the Federal Employee Compensation Act (FECA).

Black lung trust fund

The Administration proposes to eliminate the deficit in the black lung disability trust fund by reducing benefits paid out of the trust fund and by increasing the income of the trust fund. This could involve an increase in the present excise tax on coal.

Table 2.—Administration's Estimates of Budget Effects of Proposals [1]

[Fiscal years, in billions of dollars]

	1981	1982	1983	1984	1985	1986
Proposed Tax Legislation						
Individual income tax reductions	−6.4	−44.2	−81.4	−118.1	−141.5	−162.4
Depreciation reform	−2.5	−9.7	−18.6	−30.0	−44.2	−59.3
Proposed user charges		+2.0	+2.6	+3.0	+3.5	+3.9
Total revenue effect	**−8.9**	**−51.9**	**−97.4**	**−145.1**	**−182.2**	**−217.8**
Proposed Outlay Changes						
Specified outlay reductions	−4.8	−34.8	−50.1	−61.4	−70.2	−77.3
Reductions to be presented		−6.7	−29.6	−43.1	−47.4	−46.5
Added Defense funds	+1.3	+7.2	+20.7	+27.0	+50.2	+63.1
Total outlay change	**−3.5**	**−34.2**	**−59.0**	**−77.4**	**−67.4**	**−60.7**

[1] These estimates are the ones included in the Administration's fact sheet. They have not been reviewed by the staff.

Source: U.S. Treasury Department, Office of Management and Budget.

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