[COMMITTEE PRINT]

RETIREMENT INCOME CREDIT, CHILD CARE DEDUCTION, QUALIFIED STOCK OPTIONS, AND SICK PAY EXCLUSION

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEPTEMBER 22, 1975

U.S. GOVERNMENT PRINTING OFFICE
58-619 WASHINGTON : 1975 JCS-33-75

CONTENTS

	Page
A. Retirement income credit	1
Present law	1
Problem	1
Alternative approaches	4
B. Child care deduction	5
Present law	5
Problem	5
Alternative approaches	6
C. Qualified stock options	8
General	8
Present law	8
Problem	10
Proposals	10
D. Sick pay exclusion	14
Present law	14
Problem	14
Alternative approaches	16

A. RETIREMENT INCOME CREDIT

Present Law

Under present law, individuals who are 65 years of age or over may receive 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 (whether they file separate or joint returns). 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 this credit, however, an individual must have received more than $600 of earned income in each of 10 years prior to the taxable year. (A widow or widower whose spouse had received such earned income is considered to meet 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" retirement type plans.

The maximum amount of this retirement income which an individual may claim ($1,524, or $2,286 for certain married couples) must be reduced for 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 that can be 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 exess of $1,700. This reduction for earned income does not apply, however, in the case of individuals who have reached the age of 72.

Those under 65 receiving pensions from public retirement systems.—Under present law, individuals under the age of 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.

Problem

There is a need to redesign the present retirement income credit for several basic reasons. One reason is that the credit needs up-

dating. 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 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).

In addition, 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. 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 wife; and a credit is available for each spouse separately if each spouse independently meets the eligibility tests.

The purpose of all of 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 to those who get tax-exempt social security benefits. However, 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 must now compute their retirement income credit on a separate schedule, which occupies a full page in the tax return packet, with 19 separate items, some of which involve computations in three separate columns (see the form shown below). It is these complexities which undoubtedly account for the fact that 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.

The present retirement income credit discriminates between 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. Elderly individuals who must support themselves entirely by earning modest amounts of income 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 modest amounts of earned income maintain that they should be allowed

[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.

the same retirement income credit as those who live on the investment incomes. They point out that under the present credit elderly people who rely entirely on earned income are required to pay substantially higher taxes than individuals who are comparable in every respect except that they have significantly larger incomes which come from investments. Another criticism is that higher taxes on earnings than on retirement income also serve as a disincentive to work.

Schedules E&R (Form 1040) 1974 **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 1974, you may be entitled to a retirement income credit. If you elect to have the Service compute your tax (see Form 1040 instructions, page 4), 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 1974? (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			
(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 and dividends 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 16			
10 Retirement income credit. Enter here and on Form 1040, line 49, 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 49, the amount on line 8 or line 12 whichever is smaller			

U.S. GOVERNMENT PRINTING OFFICE: 1974—O-549-370 220427710

Alternative Approaches

1974 committee bill

Last year the committee increased the size of the retirement income credit and also restructured it to remove many complications in the existing provision. It was made a tax credit 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 would be increased to $2,500 for single persons age 65 or over and to $3,750 for married couples filing joint returns where both are 65 or over. (Under present law, the maximum amount on which a credit is computed is $1,524 for a single person, $2,286 for a married couple where only one has retirement income and $3,048 where both have retirement income.)

The maximum amounts for computing the credit would be reduced, as under present law, by social security benefits and other exempt pension income. Also, the amount on which the credit is based would be phased out above income levels of $7,500 for single persons and above $10,000 of income for married couples in order to limit the benefits of the credit to low and middle income elderly taxpayers. Above these income levels, the amount on which the credit is computed would be reduced by $1 for each $2 of adjusted gross income above the indicated levels.

An example of the type of simplified tax credit form for taxpayers age 65 and over which these changes make possible is shown below. This form is less than one-third as long as the present form and involves only one column instead of three. It requires the taxpayer to select the appropriate amount on which to compute the credit and to deduct from this social security or certain other tax-exempt income. It also requires the taxpayer to deduct adjusted gross income above specified levels. On the balance, the credit is computed at a 15 percent rate, and this is then 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	------

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

B. CHILD CARE DEDUCTION

Present Law

Under present law, taxpayers are permitted an itemized deduction for expenses for the care of a dependent child or incapacitated dependent or spouse or for household services when the taxpayer maintains a household for one 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. Child care services provided outside the taxpayer's home are further limited to $200 a month for one dependent, $30 for two, and $400 for three or more. 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]

To claim this deduction, a husband and wife must generally file a joint return. However, a spouse who has been deserted for an entire year may be able to file as a single person. 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.

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.

Problem

Experience with the child and dependent care deduction, which was significantly restructured in 1971, has indicated that changes to simplify and to make the deduction more generally applicable are appropriate. For example, the limitation of the deduction to $400 a month made a special child care deduction tax form necessary. Additional complications result from the distinction between expenses incurred inside and outside the home. Reducing the allowable deduction by disability income may create more complexity than any improvement in equity warrants.

The limitations on the availability of the provision have aroused criticism. Allowing the deduction in the case of joint returns only where both spouses are employed substantially full time appears unduly restrictive. The purpose of the full-time earnings test was 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. An alternative rule limiting the deduction to the earnings of the spouse with the smaller earnings would probably prevent

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

this type of abuse. At the same time, the latter rule would make the deduction available when one spouse works part time and the child care expense is appropriately deductible as a cost of earning income. This rule also appears appropriate for allowing single persons to take the deduction, while preventing its abuse.

In addition, it appears undesirable not to allow the deduction when one spouse works and the other is a full-time student. The spouse attending school cannot reasonably be expected to provide child care to enable the other spouse to work. In these circumstances, the expenses incurred to pay for child care are, in fact, necessary for the taxpayer to be gainfully employed.

Alternative Approaches

1974 committee bill

Last year the committee revised the child care deduction to broaden the overall application of the provision and to simplify it. The deduction for child (or disabled dependent) care expenses would be extended to married couples where the husband or wife, or both, work part-time. (Presently both spouses are required to work full time.) The deduction 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 deduction would also be made available in the case of married couples where one is a full-time student and the other spouse works. (The committee's bill last year also would have raised the income level at which the deduction starts to phase out from $18,000 to $30,000, but in the Tax Reduction Act of 1975, this level was raised to $35,000.)

Additional child care changes would include eliminating the distinction between care in the home and care outside the home, making the deduction available to a divorced or separated parent who has custody of a child even though not entitled to a dependency exemption for the child, and making a deserted spouse eligible for the deduction where the deserting spouse is absent for more than 6 months rather than an entire year.

Several changes would also be included in the proposal to simplify the tax return form by eliminating the need for a separate child care schedule. One such change would replace the present monthly maximum deduction ($200 for one dependent, $300 for two dependents, and $400 for three dependents) with a maximum annual deduction of $2,400 for one dependent and $4,800 for two or more dependents. Finally, the requirement that the deduction for the taxpayer be reduced by disability income received by his dependent would be eliminated.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

Messrs. Stark and Steiger and Mrs. Keys

Their proposal would move the deduction for child care expenses from an itemized deduction to a deduction from gross income in arriving at adjusted gross income.

Mr. Jones

The proposal would allow deductions for payments to family relatives who provide day care for a child.

Mr. Frenzel

He wants the committee to consider moving the child care deduction from the itemized deduction category to a deduction from gross income. He also would like to see a change in the income cap over which no deductions would be allowed.

C. QUALIFIED STOCK OPTIONS

General

An employee stock option is a right, which is limited in time, granted by a corporate employer to one or more employees to purchase a stated amount of stock in the corporation at a stated price. An option is a relatively low risk means of acquiring an equity interest in a corporation, since the option need not be exercised unless the value of the stock increases during the option period. If the value of the stock drops below the price at which the stock may be purchased (i.e., below the option price), the employee can allow the option to lapse with no adverse tax consequences (although ordinarily the employee would lose the amount which he may have originally paid for the option, if any).

Under present law, employee stock options fall broadly into two categories: "qualified" and nonqualified options. The former category is governed by specific statutory rules which set forth conditions which the option must meet in order to receive the favorable tax treatment accorded "qualified" stock options under present law. Employee options which do not satisfy these requirements (often called "nonqualified" or "nonstatutory" options) are govered by rules set forth in the income tax regulations and by certain statutory rules which apply generally to property transferred to employees in connection with their performance of services.

Qualified stock options are generally granted by corporations (and most typically by publicly held companies) to their top-level executives and key personnel as a reward for services performed, and as an incentive for continued future services to the company. The theory is that if the executive has a "stake" in the business, he will work hard to make the corporation successful, thus enhancing its profits and the valve of its stock.

On the other hand, it may be argued that stock options are simply another form of compensation, and that much of the value of the option as an incentive device lies less in the fact that the employee is acquiring a stake in the business than in the opportunity for the corporation to compensate its key personnel with income which is subject to an eventual tax at capital gain rates (see discussion below).

Present Law

Under present law, no income is recognized on the grant to a corporate employee, or on his exercise of, a "qualified" option to receive stock in the employer corporation (sec. 421 of the Code). The stock acquired by the exercise of the option is a capital asset in the hands of the employee and the income realized from the eventual sale of the stock is generally treated as long term capital gain or less.[1]

[1] Generally similar tax treatment is also available in the case of "restricted" stock options, but restricted stock options are no longer being granted, and most restricted options which were granted in the past have now been exercised or have lapsed.

No deduction is available to the employer under section 162 with respect to either the granting of a qualified stock option or the transfer of stock to the employee when he exercises a qualified option.

As a result of this treatment, qualified options have the advantage that an executive is not required to pay any regular income tax on the value of the option as such when the company grants it to him, or on any "bargain element" which may exist if and when he decides to exercise the option and purchase stock in the company. (The bargain element is the amount by which the fair market value of a share of stock exceeds the purchase price paid for it by the employee.) The employee is only required to pay tax when he sells the shares purchased under the option. Further, if he holds the shares for at least 3 years, he is entitled to pay tax at capital gain rates on the full amount of his gain (if any) over the price which he originally paid to buy the shares.

Although an employee does not have to pay tax under the qualified stock option rules at the time he exercises the option and receives stock worth more than he paid for it, the bargain element is treated as an item of tax preference under present law. This means that the excess of the fair market value of the share at the time of exercise over the purchase price paid by the employee is subject to the 10-percent minimum tax under present law (sec. 57(a)(6)).

Example. To illustrate the qualified stock option rules, suppose that a publicly held company grants to one of its vice presidents (pursuant to a qualified stock option plan approved by the board of directors and by the shareholders of the company) an option to buy 100 shares in the company at $10 per share. The employee might thereafter exercise the option at a time when outstanding shares of the stock are selling for $15 per share. Assuming that all of the requirements applying to qualified stock options are otherwise satisfied, the employee would not have to pay any tax when he exercises the option on the $5 bargain element—that is, on the excess of the fair market value of the shares at that time ($15) over the purchase price ($10).

If the employee thereafter retains the shares for at least 3 years, and if (for example) he then sells them at a price of $21 per share, he may treat his entire $11 gain ($21 sale proceeds less $10 cost basis) as capital gain. No portion of his gain need be treated as ordinary compensation income.

If the employee sells the shares before holding them for at least 3 years, part of his gain will be ordinary income, i.e., the amount equal to the bargain element when he exercised the option. Only the balance of his gain will be capital gain.

Specific requirements for qualified stock options.—An employee stock option is "qualified" if it meets certain requirements set forth under section 422 of the Internal Revenue Code. In general, a qualified option must be granted pursuant to a plan approved by the shareholders of the corporation. The option must, by its terms, be exercised within 5 years from the date it is granted and the purchase price of the shares (option price) may not be less than the fair market value of the company's stock on the date when the option is granted to the employee.

In addition, any stock acquired under an option may not be disposed of within 3 years after it is transferred to the employee. The option must also be exercised while the option holder is an employee of the corporation, or within three months after the termination of his employment.

A qualified stock option may not be granted to any employee who owns more than 5 percent of the company's stock. (This ceiling is raised to 10 percent on a graduated scale for relatively small corporations whose equity capital is between $1 million and $2 million.)

Another important requirement applying to a qualified stock option is that the employer cannot, in effect, "reset" the option price when the market price of the company's stock drops. In such situations, the employer might be expected to want to grant new options to management personnel permitting them to buy stock at the current depressed price, and also permitting them to exercise the new options before they exercise existing options which the executives may hold to buy the shares at a higher purchase price. The law prevents such a resetting, in effect, of the option price by preventing any new option from being exercised until previously-granted options to buy stock at a higher price have been fully exercised (or have expired without having been exercised).

Employer stock purchase plans.—As a practical matter, qualified stock options are granted to top-level management executives (although by law they need not be so limited). Present law does permit similar benefits to be granted to rank-and-file employees of a corporation under a "employee stock purchase plan." Under this provision (sec. 423), the employer may not discriminate among those employees to whom he grants options (as he can do with a "qualified" option). The employer must generally grant employee stock purchase options to all of his employees. Employees who receive stock under the plan are not taxable when they buy the shares but become taxable only when they sell the shares. An employee, however, must hold the shares for at least two years after the option was granted to him and for at least six months after he exercised the option.

Problem

The principal reason for the present tax treatment of qualified stock options is said to be that such treatment allows corporate employers to provide "incentives" to key employees by enabling these employees to obtain an equity interest in the corporation. However, it seems doubtful whether a qualified stock option gives key employees more incentives than do any other form of compensation, especially since the value of compensation in the form of a qualified option is subject to the uncertainties of the stock market. The market price of a company's stock is subject to many variables and the connection between an employee's own efforts and the value of the stock is, at best, speculative, particularly in the case of a large publicly traded corporation with many employees. Moreover, to the extent there is an incentive effect resulting from stock options, it could be argued that present law discriminates in favor of corporations (which are the only kind of employers who can grant qualified options) as opposed to all other forms of business organization.

Qualified stock options have become less attractive as a compensation technique in recent years because of the generally declining stock market of recent years. The market price of stocks of many publicly held companies has dropped substantially in the recent recession. As a result, many qualified stock options granted in previous years at purchase prices which seemed attractive on an assumption that the price of the company's stock would rise became unattractive as the price of the outstanding stock fell. Many executives thus had no incentive to exercise their options which were "under water," i.e. options whose exercise price was higher than the current level of the company's stock in the open market. Because of this loss-of-incentive feature (and the prohibition against "resetting" the option price downward, as explained earlier), many companies have turned to other techniques and plans as a way to compensate their executives.

Many companies, however, have gone ahead and granted new qualified options to their executives at the currently depressed market prices of their stock. The rationale has been that the executives may still be able to benefit by the new options if the price of the stock does increase in the years ahead and if the executives do not have to wait too long to exercise the new options (under the anti-price resetting rule). In some cases, such new grants of qualified stock options to executives in the recession has produced increasing criticism from the shareholders of the companies. Some such shareholders have argued that the grant of new qualified options enables the companies' executives to avoid taking the same business risks that the shareholders generally are taking with regard to the company's fortunes.

Proposals

1974 Committee bill

The committee tentatively agreed to repeal the present tax treatment of qualified stock options so that in the future, all employee stock options except employer stock purchase plans granted under sec. 423 would be subject to the rules of section 83 of the Internal Revenue Code (which applies today in the case of most nonqualified stock options granted after June 1969).

Generally, under section 83 the value of the option itself would constitute ordinary income to the employee if it had a readily ascertainable fair market value at the time it was granted (and was not nontransferable and subject to a substantial risk of forfeiture). If the option did not have a readily ascertainable value, it would not constitute ordinary income at the time it was granted; when the option is exercised, however, the spread between the option price and the value of the stock would constitute ordinary income to the employee.

By contrast, the qualified stock option rules would not impose a tax until a later date when the employee eventually disposes of the shares and, even then, if he satisfies the 3-year holding period his entire gain is capital gain.

To illustrate these rules, consider the earlier example of a qualified option granted to a corporate vice president to buy 100 shares at $100 per share. The employee exercises the option in full when the shares are setlling at $15 per share in the open market. Under the committee's

1974 bill, this transaction would be treated as follows under section 83 of present law:

(a) At the time that the company grants the option to the executive, if the option as such has a readily ascertainable fair market value, the executive is taxable as ordinary compensation income on value of the option (less any amount which he may have paid for it).

(b) If the option itself does not have an ascertainable market value, the executive will become taxable when he exercises the option and acquires the shares under option to him. In this example, the employee will be taxable on the $5 bargain element per share at the time he exercises his option. This income will be treated as compensation taxable at ordinary income rates.

The above rule in (b) applies if the executive receives the shares free of a "substantial risk of forfeiture" and if the shares are transferable by the employee. If the shares are burdened by a transfer or forfeiture restriction, the employee is not taxable when he buys the shares.[1] Instead, he becomes taxable when he satisfies the restrictions which the employer has imposed on his rights to the shares.[2] When the tax is imposed, however, it is still at ordinary income rates and is measured by the excess of the fair market value of the shares at the time that the restrictions are satisfied and the amount which the employee originally paid for the shares.

(c) After the executive pays tax at ordinary income rates on the compensation portion of the transaction, he is entitled to add the amount of ordinary income to his basis in the shares and to report any further gain (when he sells the shares) as a capital gain, provided that he holds the shares for more than 6 months after the date on which he realized the compensation income.

(d) The employer corporation is entitled to a deduction in an amount equal to the ordinary income realized by an employee under the above rules. The employer's deduction accrues at the time that the employee is considered to have realized compensation income.[3]

The above rules of section 83 of present law make clear that a principal effect of repealing the qualified stock option provisions is that executives will generally become taxable when they exercise options and receive stock in their employer. Employers would still be able, however (as they can presently do with "nonqualified" options), to discriminate among employees to whom they grant options. There would be no restrictions on the term of the option, the option price, the exercise of later granted options before earlier granted options, or the holding period of shares purchased under options.

---

[1] One example of a restriction imposing a substantial risk of forfeiture is a condition that the employee must resell the shares to the employer at his original cost if he leaves the company for any reason during a 10-year period after he exercises the option and acquired the shares. (Proposed Regs. § 1.83–3(c)(2), example 1.)

[2] Under section 83, an employee who receives stock (or other property) in his employer corporation burdened by restrictions which would free him from paying a tax at that time may, nevertheless, elect to pay tax on the bargain element existing at that time. If the employee makes this election and pays tax when he exercises the option, any later increase in value of the shares will be taxable to him as capital gain (rather than compensation income) when he disposes of the shares.

[3] As indicated earlier, this deduction permitted to an employer contrasts with the rule applying to qualified stock options. An employer who grants a qualified option is not entitled to a deduction at any time for the bargain element in the stock purchase which he has made available to the employee.

In general, the new rules in the committee's 1974 bill would have applied to options granted after May 8, 1974, but would not have applied to options granted on or before that date. In addition, the committee agreed to include transition rules for options granted after May 8, 1974, pursuant to a written plan adopted and approved before May 9, 1974; for options granted after May 8, 1974, under a qualified plan adopted by a board of directors before May 9, 1974, even if the plan was approved by the shareholders after that date; and for substitute options granted after May 8, 1974, as a result of a corporate reorganization or similar transaction provided that no modification of the former option occurs. The transition rules would have covered these options so long as they are exercised before May 9, 1979 (no matter when the option was granted in accordance with the plan).

The committee did not revise the rules with respect to employee stock purchase plans (sec. 423) which provide that stock under the plan must be made avaliable to all the employees on a nondiscriminatory basis.

Mr. Ullman

Mr. Ullman's proposal is the same as the 1974 committee bill.

D. SICK PAY EXCLUSION

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.

Present law also 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 (sec. 104(a)(4)).[3] 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.

Problems

The "sick pay" exclusion provision is extremely complex. The excludable amount of sick pay varies depending on whether it is greater or less than 75 percent of the taxpayer's regular weekly rate and whether or not it exceeds $75 or $100 a week during various periods in which the sick pay is received. In addition, waiting periods before the exclusion becomes effective vary depending on whether or not the taxpayer is hospitalized.

The complexity of this provision necessitates a separate tax form of 28 lines which taxpayers find difficult to complete. Apparently

[3] 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.

many taxpayers who are entitled to a sick pay exclusion must obtain paid assistance in order to fill out their tax return, especially for the sick pay forms.

Form **2440**
Department of the Treasury
Internal Revenue Service

Sick-Pay Exclusion

▶ Attach to Form 1040.

1974

Name of taxpayer | Social Security Number

Period of absence from work (see instruction B) From ...., 19......, to ...., 19......

Were you hospitalized (bed patient) at least one day during this period? . . . ☐ Yes ☐ No

Regular weekly rate of wages (see instruction F) ▶ $

Number of workdays in your normal workweek ▶

Nature of illness or injury

Name of employer

Payer of sick pay, if other than employer

Part I — General (Disability Retirees See Part IV and Instruction J)

1 Total workdays for which you were paid during this period of absence (see instruction C) . . . .
2 Number of workdays in the first 30 calendar days for which you were paid . . .
3 Number of workdays after the first 30 calendar days for which you were paid (if any)
4 Total amount received as "sick pay" . . . . $
5 Daily rate of "sick pay" (line 4 divided by line 1) (see instruction E) . . . . $

Part II — Use this Part if Your Weekly Sick Pay Rate for the First 30 Calendar Days of Absence is 75% or Less of Your Regular Weekly Wage Rate

6 Number of workdays from line 2 . . . .
7 Limitation: If you were not hospitalized, enter the number of workdays for which you were paid in the first 7 calendar days of absence. If you were hospitalized, enter ZERO . . . .
8 Balance (line 6 less line 7) . . . .
9 $75 divided by the number of workdays in a normal workweek (maximum daily rate) . . . . . . $
10 Enter the amount on line 5, or line 9, whichever is smaller . . . . $
11 Multiply the amount on line 10 by the number of days on line 8 . . . . $
Note: *Omit lines 12, 13, 14, and 15, if your period of absence was 30 calendar days or less.*
12 $100 divided by the number of workdays in a normal workweek (maximum daily rate after the first 30 calendar days) . . . . $
13 Enter the amount on line 5, or line 12, whichever is smaller . . . . $
14 Enter the number of workdays from line 3 . . . .
15 Multiply the amount on line 13 by the number of days on line 14 . . . . $
16 Enter the amount shown on line 11 . . . . $
17 Total (line 15 plus line 16) . . . . $
18 "Sick pay" for that period of absence listed in Part I received in another taxable year (see instruction D) $
19 Total "sick pay" exclusion (line 17 less line 18). Enter here and on Form 1040, line 39 . . . . . $

Part III — Use this Part if Your Weekly Sick Pay Rate for the First 30 Calendar Days of Absence is More Than 75% of your Regular Weekly Wage Rate

20 Daily rate of "sick pay" from line 5 . . . . $
21 $100 divided by the number of workdays in a normal workweek (maximum daily rate) . . . . . . $
22 Enter the amount on line 20 or 21, whichever is smaller . . . . $
23 Number of workdays from line 3 . . . .
24 Multiply the amount on line 22 by the number of days on line 23 . . . . $
25 "Sick pay" for that period of absence listed in Part I received in another taxable year (see instruction D) $
26 Total "sick pay" exclusion (line 24 less line 25). Enter here and on Form 1040, line 39 . . . . . $

Part IV — Disability Retirees

You need to complete only line 27 or line 28 below to claim your "sick pay" exclusion if none of these four conditions apply: (1) you were retired within the last month of the preceding taxable year and the "waiting period" extended into this taxable year; (2) there was a change in the rate of your annuity during the year whereby some payments were made at a rate less than $100 a week, while other payments were made at a rate of $100 or more a week; (3) your disability pension or annuity was paid to you for less than the entire taxable year; or (4) your "sick pay" exclusion exceeds $5,200. If any of these four conditions apply, you must complete Parts I and II or III, whichever is applicable, to claim any "sick pay" exclusion.

27 If total disability payments received this taxable year were less than $5,200, enter the total received here and on Form 1040, line 39 . . . . $
28 If total disability payments received this taxable year were $5,200 or more, enter $5,200 here and on Form 1040, line 39 . . . . $

Form **2440** (1974)

The rationale for excluding sick pay payments (which are in lieu of wages) when an employee is absent from work, while taxing the same payments if made as wages while he is at work, is questionable. 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 if his expenses exceed the percentage of income limitations, the excess expenses would be deductible as medical expenses.

Because of the progressivity of tax rates, lower income taxpayers receive, on a percentage basis, smaller benefits from the sick pay exclusion than do taxpayers who are in higher marginal tax brackets. As a result, more than 60 percent of the benefits from this provision inures to taxpayers with adjusted gross incomes (including sick pay) over $15,000.

In the case of the exclusion from income for armed forces disability pensions, criticism has focused on a number of cases where the exclusion has been abused. In many cases, armed forces personnel have been classified as disabled 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. Questions have been raised as to whether retired military personnel should be allowed 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.

The repeal of the special exclusion for a pension, annuity, or similar allowance for personal injuries or sickness as a result of active service in the Armed Forces would treat military personnel in the same manner as all other individuals with respect to any payments on account of sickness or disability.

No change is contemplated in the present exclusion for those members of the military who are receiving disability or any other benefits administered by the Veterans' Administration. These payments would continue to be fully exempt from tax as under present law.

If the exclusion for individuals who are permanently and totally disabled is to be a low- and middle-income relief provision, a phaseout of the exclusion to the extent an individual has outside income in excess of some amount (such as $15,000) could be provided.

Alternative Approaches

1974 committee bill

Last year the committee repealed the sick pay exclusion. However, the exclusion for disability income would continue to be available to taxpayers under age 65 who are permanently and totally disabled. (After that age they would be eligible for the revised elderly credit.) The maximum amount of income that may be excluded as disability income in this case, as under the present law sick pay exclusion, would be limited to $100 a week ($5,200 a year). The maximum amount excludable would be reduced on a dollar-for-dollar basis by the taxpayer's income (including the disability income) in excess of $5,200. For this purpose, permanently and totally disabled means unable to engage in any substantial gainful activity by reason of any

medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. These limitations would be applicable to both military and civilian retirement disability payments but not to payments by the Veterans' Administration.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill except that he would reduce the maximum exclusion of $5,200 only when the individual's income exceeds $15,000 (instead of $5,200) and would not apply the limitations to individuals receiving military disability payments which are directly related to combat injuries (in addition to the exclusion for payments by the Veterans' Administration).

○