[JOINT COMMITTEE PRINT]

DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
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COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

This pamphlet, prepared by the staff of the Joint Committee on Taxation in conjunction with the staff of the House Committee on Ways and Means, provides descriptions of possible options to increase revenues, for the information of the Committee on Ways and Means in connection with consideration of possible revenue-increase legislation.

The first part of the pamphlet is a description of areas addressed by the Administration's revenue proposals. The second part is a description of additional areas addressed by Administration-endorsed revenue proposals which were included in H.R. 4961 as reported by the Senate Committee on Finance on July 12, 1982. The third part is a description of other possible options to increase revenue that have been proposed by Members or that the Committee on Ways and Means may wish to consider. (For each proposal in parts I, II, and III, the description includes present law, the provision (if any) in the Senate Finance Committee bill, possible alternative options, pros and cons, and estimated revenue effects, where available.) The fourth part is a tabulation of the estimated revenue effects of the options described in parts I, II, and III of this pamphlet (except where not available at this time). Finally, an Appendix presents data, by income class, of estimated taxable returns, total tax liability, average tax liability, and percentage of taxpayers itemizing deductions in calendar years 1983 and 1984 (under present law).

The revenue estimates shown in this pamphlet for provisions which were included in the Senate Finance Committee bill may differ from those shown in the committee report on that bill (Sen. Rpt. No. 97-494, Vol. 1). The reason for any such difference in estimates is that the estimates in the report take account of any interaction among provisions of the Senate Finance bill, while the estimates shown in this pamphlet have been made under the assumption that the specific proposal for which an estimate is shown is the only change to be made in present law.

The options described in this pamphlet are not proposals or recommendations of the staff of the Joint Committee on Taxation or of the staff of the Committee on Ways and Means, but rather options which the Committee on Ways and Means may wish to consider in connection with legislation relating to revenue targets set by the First Congressional Budget Resolution for fiscal year 1983.

I. AREAS ADDRESSED BY ADMINISTRATION PROPOSALS

A. Accounting for Long-Term Contracts

Present Law

Overview

A taxpayer which enters into long-term contracts may elect to use one of four accounting methods to account for the income and expenses attributable to such contracts. Long-term contracts generally are building, installation, construction, or manufacturing contracts that are not completed by the end of the taxable year in which they were entered into. A manufacturing contract is not a long-term contract unless it involves the manufacture of either (1) unique items of a type not normally carried in the finished goods inventory of the taxpayer or (2) items that normally require more than 12 months to complete.

The four methods used to account for long-term contracts are the cash method, the accrual method, the percentage of completion method, and the completed contract method. The cash and accrual methods are methods applicable to all types of income of all taxpayers generally. The percentage of completion method and the completed contract method apply only to long-term contracts.

Cash method

Under the cash method, income is reported for the year in which it is actually or constructively received. Deductions generally are taken for the year in which actually paid. Therefore, a taxpayer who uses the cash method to account for income and expenses for long-term contracts includes payments in income when received (either before or after completion of the contract) and takes deductions for expenses when actually paid.

Accrual method

Under the accrual method, income is generally reported when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when it is received. Where the taxpayer accrues income on shipment, delivery, or acceptance under the accrual method, advance payments under a long-term contract are also includible at the time of shipment, delivery, or acceptance.

If an accrual basis taxpayer does not use inventories in connection with a long-term contract, deductions generally are allowed for the year in which all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. If the taxpayer uses inventories, costs allocable to inventory are accumulated until the inventory is shipped, delivered, or accepted.

Percentage of completion method

Under the percentage of completion method (which is used only for long-term contracts), income is recognized according to the percentage of the contract that is completed during each taxable year. The computation of how much of the contract is completed during a taxable year may be made by comparing (1) the costs incurred during the year to the total estimated costs of the contract or (2) the physical work performed on the contract during the year to the total estimated work to be performed. Expenses of the long-term contract are deductible for the year in which paid or incurred.

Completed contract method

Overview

Under the completed contract method (which is used only for long-term contracts), income and costs from the contract generally are reported for the year in which the contract is completed.

Completion of the contract

Present Treasury regulations (§ 1.451–3) provide that a contract will not be considered completed until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay completion of a contract for the principal purpose of deferring Federal income tax. For a subcontractor who completes his work on a long-term contract before completion of the entire contract, "final completion and acceptance" of the contract is deemed to occur for the subcontractor when the subcontractor's work has been completed and has been accepted by the party with whom he has contracted. In cases where there is a contract dispute after the taxpayer has tendered the subject matter of the long-term contract to the purchaser, special rules are provided to determine when income and costs are to be taken into account.

The Treasury has announced it proposes to amend these regulations. The revised regulations would provide that the completion of a contract will not be delayed by reason of (1) contingent payment of amounts based upon the performance of the item or (2) a provision to provide replacement parts or to supervise installation.

Severing and aggregating contracts

Present Treasury regulations also provide that it may be necessary to treat one agreement as several contracts or several agreements as one contract in order to clearly reflect the income of the taxpayer. Whether one agreement is severed or several agreements are aggregated depends on all the facts and circumstances. Generally, one agreement will not be treated as several contracts unless either (1) the agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract or (2) there is no business purpose for entering into one agreement rather than several. Generally, several agreements will not be treated as one contract unless either (1) the several agreements would be treated as a single agreement under customary commercial practice in the taxpayer's trade or business or (2) there is no business purpose for entering into several agreements rather than one. The fact that one agreement would not have been made on the agreed-upon terms if the same parties had not made a second agreement is evidence that the two agreements should be treated as a single contract.

The Treasury Department has announced that it proposes to amend these regulations to provide a more detailed set of rules for determining when agreements should be treated as one contract or more than one contract.

The Treasury Department has stated that the revised regulations would provide that agreements to produce items which are independently priced would be treated as separate contracts. In addition, the exercise of an option to acquire additional items or the issuance of a change order to increase the number of items would be treated as a new contract.

Deduction of expenses

Under the completed contract method, expenses allocable to the contract (commonly referred to as "contract costs") are deductible for the year in which the contract is completed. Expenses that are not allocated to the contract (commonly referred to as "period costs") are deductible for the year in which they are paid or incurred.

Under existing regulations, contract costs include all direct expenses and indirect expenses that are incident and necessary to the performance of the contract, with the following exceptions (which are currently deductible as period costs):

(a) Marketing and selling expenses, including bidding expenses;

(b) Advertising expenses;

(c) Other distribution expenses;

(d) General and administrative expenses which benefit the taxpayer's business as a whole;

(e) Interest;

(f) Research and development expenses;

(g) Losses;

(h) Percentage depletion in excess of cost depletion;

(i) Depreciation on idle equipment and, for other equipment, tax depreciation in excess of book depreciation;

(j) Income taxes;

(k) Pension and profit-sharing contributions and other employee benefits;

(l) Costs attributable to strikes, rework, scrap, and spoilage; and

(m) Officer compensation which benefits the taxpayer's activities as a whole.

The Administration has proposed modifying these regulations. Under the revised regulations, all costs of the taxpayer would be allocated to the contract other than the following expenses (which could continue to be deducted currently as period costs):

(1) General marketing, selling, and advertising expenses;

(2) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;

(3) Research and experimental expenses neither directly attributable to particular long-term contracts in existence at the time such expenses are incurred nor incurred under an agreement to perform such research and experimentation;

(4) Losses;

(5) Depreciation and amortization on idle equipment and facilities;
(6) Income taxes attributable to income received from long-term contracts;
(7) Pension contributions to the extent representing past service costs; and
(8) Costs attributable to strikes.

Example

The operation of the four accounting methods for long-term contracts may be illustrated by the following example. Assume that a company has constructed a building under a 3-year contract, which is the company's only business activity. The company had the following items of receipts and expenditures:

	Year 1	Year 2	Year 3	Total
Receipts	40	25	35	100
Contract costs	10	20	20	50
Period costs	5	10	15	30

The taxpayer would account for income and expenses under present law accounting methods as follows:

	Year 1	Year 2	Year 3	Total
1. Cash method:				
Gross income	40	25	35	100
Allowable expenses (all costs)	(15)	(30)	(35)	(80)
Net income or (loss)	25	(5)	0	20
2. Accrual and completed contract method:				
Gross income	0	0	100	100
Allowable expenses [1]	(5)	(10)	(65)	(80)
Net income or (loss)	(5)	(10)	35	20
3. Percentage of completion method:				
Gross income	20	40	40	100
Allowable expenses (all costs)	(15)	(30)	(35)	(80)
Net income or (loss)	5	10	5	20

[1] Period costs are deductible in the year the costs are incurred; contract costs are deductible in the year income is recognized.

Administration Proposal

Taxpayers having long-term contracts would be required to account for income from those contracts under the percentage of completion method or the progress payment method. The cash method, the completed contract method, and the accrual method could not be used to account for income and expenses under long-term contracts. The percentage of completion method would be the method described in present law.

The progress payment method would be a new method, which would be similar to the cash method. Under the progress payment method, the taxpayer would include in income all payments when received or when the taxpayer has a right to receive the payment. Payments received prior to the commencement of work on the contract would be treated as received over a 12-month period (or longer period with the approval of the Internal Revenue Service).

Under the progress payment method, costs allocable to the contract generally would be deductible only when, and to the extent, the taxpayer includes payments in income. Costs exceeding payments could be deducted only when, and to the extent, the cumulative costs exceed the total amount the taxpayer has a right to receive under the contract. The determination of how much income or expenses are to be recognized would be made on a contract-by-contract basis. Thus, costs from one contract could not offset income from another contract. Costs allocable to the contract would be those costs allocated to the contract under the revised regulations.

Senate Finance Committee Bill

The Treasury Department would be instructed to amend its regulations relating to the completed contract method of accounting for long-term contracts. The amended regulations would address certain problems relating to the determination of when a contract is considered completed and the determination of whether certain multi-unit contracts should be treated as one or several contracts.

The amended regulations also would require that taxpayers generally must allocate costs which either directly benefit, or are incurred by reason of, the taxpayer's long-term contract activities to long-term contracts with an estimated completion date of more than 2 years. Thus, a reduced amount of expenses would be considered to be period costs. However, a taxpayer engaged in the construction of a permanent improvement to real property or the installation of integral components thereof would not be subject to the new cost allocation rules if either the contract is expected to be completed within 3 years or less, or the taxpayer's average annual gross receipts are $25 million or less for the 3 preceding taxable years.

The new period cost rules would apply to taxable years beginning after 1982 for contracts entered into after 1982 and would be phased in over a 3-year period. All other changes would be effective for taxable years ending after December 31, 1982. Moreover, any contract of a taxpayer which would be treated as having been completed prior to the first taxable year ending after December 31, 1982, by reason of the new rules will be treated as having been completed on the first day of such taxable year.

Possible Modifications to Administration Proposal

1. Modified completed contract method

Under a modified completed contract method, the income and expenses allocated to the contract could be taken into account in the year that the contract is completed (as under present law), but an interest charge could be imposed to compensate for the delayed reporting of income or loss inherent in the completed contract method. This could be accomplished most easily by allocating the income or loss from the contract to each year of its life on the basis of total costs, direct labor, or other reasonable method, then increasing that income or loss by an interest charge, and reporting the total increased income or loss in the year the contract is completed. Alternatively, on completion of a contract, the taxpayer could allocate its profit from the contract to each taxable year of the contract in accordance with the percentage of the contract completed in each year and recompute its tax liability for each such year and pay interest at the statutory rate on the amount of additional tax attributable to each such year. If a contract accounted for under this method results in a loss, the taxpayer would be entitled to a refund with interest computed in this same manner.

The interest rate could be set at the present law rate for deficiencies, in which case any additional tax attributable to the interest charge on a contract profit would be treated as a deductible interest expense. As a corollary, when taxes are reduced because a loss is increased by an interest charge, the reduction in tax attributable to the "interest" portion of the loss would be treated as interest income. Alternatively, the interest rate could be set at the equivalent of an after-tax deficiency rate (e.g., 50 percent of the present law deficiency rate), in which case increases or decreases in tax would not be treated as interest expense or income.

2. Progress payment method

It could be decided not to adopt the progress payment method under the Administration proposal, or the method could be adopted with restrictions so that it would not apply to the first 2 taxable years in which a long-term contract is in effect. Under the latter alternative, all payments received in excess of cost incurred during the first 3 taxable years of a contract would be includible in income for the third taxable year.

3. Partial use of completed contract method

Under this modification, all taxpayers could be permitted to defer a portion of their profits on long-term contracts until the contract is completed as if the completed contract method were used to account for a portion of each long-term contract. For taxpayers using the safe-harbor rule under the percentage of completion method, only a fraction of the safe-harbor percentage would be used to compute the amount included in gross income in any year. For taxpayers using the modified completed contract method, there would be no interest charge for any income or loss on the portion of the contract accounted for under this modification.

4. Phase-in

If the increase in tax payments resulting from the Administration proposal (or any modifications to the proposal) is considered too severe, the Administration proposal (or modifications) could be phased in over a specified period.

5. Regulatory approach

The regulations relating to the completed contract method of accounting could be codified, except that rules relating to severance of agreements and completion of contracts would be amended to prevent abuse. The other rules relating to the completed contract method, including the cost allocation rules, would be codified as they are in present regulations. A variation of this proposal would codify the cost allocation rules only for building, construction, and installation contracts, and the treatment of cost allocation for long-term manufacturing contracts would not be addressed.

Pros and Cons

Arguments for the proposals

In general.—For financial accounting purposes, the percentage of completion method is the method generally used to account for income from long-term contracts. This is because that method most closely matches income and costs, and thereby reflects the amount of income earned in each accounting period. By contrast, a method that does not currently recognize income until completion of the contract—such as the completed contract method—defers recognition of income beyond the accounting periods to which income properly belongs and results in a mismatching of income and expense. This is particularly true of the present rules for the completed contract method which allow substantial amounts of costs properly allocable to long-term contracts to be deducted currently.

Administration proposal.—The proposal would prevent the deferred reporting of income from long-term contracts by requiring current recognition of income under either the percentage of completion method or the progress payment method. The progress payment method requires payment of taxes on cash income of a taxpayer and should ensure that the taxpayer has the cash with which to pay the tax.

Modified completed contract method.—The modified completed contract method would allow all of the advantages of the completed contract method (e.g., assurance that the contract is profitable before imposition of a tax) while removing the benefits of deferral implicit in the regular completed contract method.

Two-year grace period for progress payment method.—This modification would ensure that the progress payment method would not unfairly tax advance payments and would effectively exempt most contracts of small businesses.

Partial use of completed contract method.—This possible modification would allow a partial removal of the benefits of deferral by providing that a percentage of income for each year could be deferred until completion of the contract.

Phase-in.—This modification would provide a gradual transition to more current income reporting.

Finance Committee bill approach.—This approach would permit continued use of the completed contract method, but would provide a clearer reflection of income for affected contracts by deferring the deduction of costs properly allocable to the contract and clarifying when contracts are completed.

Arguments against the proposals

1. It is not generally accepted accounting theory that the percentage of completion method is the only method which can be used to account for the income from long-term contracts. Therefore, any comparison of other methods to the percentage of completion method cannot show that such other methods result in "deferral" of income recognition, any more than it can show any "acceleration"of income recognition under the percentage of completion method.

2. The cash and completed contract methods are simple methods that are often used by small businesses for both tax and financial purposes. To require small businesses to use more complex methods for tax purposes would be unduly burdensome.

3. Until a contract is completed, it may not be possible to know whether there is a profit or loss or the amount of any profit or loss. To require use of the percentage of completion method could result in the taxation of nonexistent profit before the contract is completed.

4. The legislative proposals would have an inflationary impact because the increased administrative cost of the more complex accounting methods and the cost of earlier or increased tax payments would tend to raise the purchaser's cost under the contract. Some of these costs would be borne directly by the Federal Government in the form of higher defense procurement costs.

5. The progress payment method provides a tax on cash flow, not income. As such, the amount of the tax depends on the bargaining strength by the parties over whether amounts must be borrowed or advanced by the buyer; it has no relationship to income.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal:					
Legislation and regulations	2.0	4.4	4.5	3.9	3.8
Regulations only	1.9	4.2	4.3	3.7	3.6
Senate Finance bill	.9	2.2	2.5	2.4	2.6

B. Tax-Exempt Bonds for Private Activities

Present Law

General rule

Interest on State and local government obligations generally is exempt from Federal income tax. However, subject to certain exceptions, interest on State and local issues of industrial development bonds (IDBs) is taxable. An obligation is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization (described in sec. 501(c)(3)), and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

Exceptions for certain financings

Under present-law exceptions, interest on IDBs that are issued to finance the following types of facilities is exempt from Federal income tax: (1) projects for low-income residential rental property, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass commuting facilities, and parking facilities, (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electricity or gas, (6) air or water pollution control facilities, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, and (9) qualified mass commuting vehicles. In addition, the interest on certain obligations issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Tax-exempt financing also is allowed for student loans and for organizations that qualify for tax exemption under section 501(c)(3), such as private, nonprofit hospitals and private, nonprofit educational institutions. In addition, mortgage revenue bonds to finance certain owner-occupied housing are eligible for tax-exempt financing throught 1983.

"Small issue" exception

Present law also provides an exception to the general rule of taxability for interest paid on IDBs for certain "small issues". The interest on small issue IDBs is exempt if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property. This exception applies to issues of $1 million or less or, at the election of the issuer, the limitation may be increased to $10 million, subject to certain restrictions.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding small issues for all facilities used by the same or related principal users which are

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located within the same county or same incorporated municipality. In addition, the $10 million limitation is reduced to the extent that principal users of the facilities incur certain capital expenditures in the same county or same incorporated municipality.

Other rules

Under present law, facilities financed with tax-exempt IDBs may be depreciated under the Accelerated Cost Recovery System (ACRS). The Internal Revenue Service recently held that certain industrial development bonds will be treated as a single small issue (and thus exceed the $1 million or $10 million limits for exempt small issues) when multiple lots of obligations are pooled and issued under "umbrella" or "composite" bond programs (Rev. Rul. 81-216; Proposed Reg. § 1.103-7(b)(6)).

Arbitrage bonds

Interest on State and local government obligations generally is taxable if the bond proceeds are used to acquire other securities with a materially higher yield ("arbitrage bonds"). However, an obligation is not characterized as an arbitrage bond merely because bond proceeds are invested in securities with a materially higher yield during a temporary construction period or become part of reasonable reserve funds. Present law is unclear whether the proceeds of the issue should be reduced by issuance costs in determining the yield on the bonds.

Administration Proposals

Restrictions on private-purpose bonds

New restrictions would be imposed on the issuance of tax-exempt bonds for private purposes (IDBs, bonds financing Federally guaranteed student loans, and bonds issued for section 501(c)(3) organizations):

(a) An issue would have to be approved, after a public hearing, by either the highest elected official or legislative body of the governmental unit which issued the bonds (or on whose behalf the bonds are issued) and the governmental unit(s) in which the facilities financed by the bonds are located, or by the public in a voter referendum.

(b) A governmental unit issuing bonds after December 31, 1985, would be required to make a financial contribution of one percent of the cost of the project that is financed with the bond proceeds (such as excepting the project from property taxes) or to provide a financial commitment (such as a guarantee or surety for the bonds).

(c) Private purpose bonds would be required to be in registered form and their issuance reported by the State or local government to the Internal Revenue Service.[1]

(d) Taxpayers would be required to recover the costs of depreciable assets financed with any IDBs using straight-line de-

[1] A requirement that all bonds, including both public and private purpose state and local government bond, be issued in registered form is discussed as a part of the compliance provisions reviewed in section IIA.

preciation over the extended recovery periods used for earnings and profits computation purposes. These extended recovery periods are 5 years for property in the 3-year class, 12 years for property in the 5-year class, 25 years for property in the 10-year class, and 35 years for property in the 15-year class.

Additional limitations on small issue IDBs

The use of tax-exempt small issue IDBs would be eliminated for large businesses, defined as businesses with total capital expenditures of more than $20 million worldwide during the period beginning 6 years before the issuance of the bonds. In addition, bonds would not qualify as exempt small issue IDBs if the business would have more than $10 million of industrial development bonds outstanding after issuance of the bonds. With these restrictions, small issue IDBs would be allowed as a part of a composite or umbrella issue of bonds.

Arbitrage bonds

The exception from classification as an arbitrage bond for reserve funds and funds held for a temporary construction period for private purpose bonds would be eliminated. In addition, the proposal would clarify that the yield on the bonds would be computed on the basis that the issuance price of the bonds is not reduced by issuance expenses.

Senate Finance Committee Bill [2]

The bill would impose a number of restrictions on the use of tax-exempt bonds for private activities intended to improve the use of such bonds.

Reporting would be required for all post-1982 private-purpose bonds. Also, public hearing and elected official or legislative approval would be required for all post-1982 IDBs.

The cost of IDB-financed property placed in service after December 31, 1982 (except for property financed by bonds issued before July 1, 1982 or certain rollovers of such bonds, or property which is part of a facility under construction by July 1, 1982) generally would be required to be recovered under the straight-line cost recovery method over present law minimum tax lives with a 25-year life for nonresidential structures. Exceptions would be provided for low-income housing, for municipal solid waste facilities, for new pollution control equipment to be used in connection with a plant or other property in operation on or before July 1, 1982, and for

[2] Also under the Finance Committee bill, tax-exempt IDBs would be allowed for local district heating or cooling facilities which use water or steam and for facilities that provide gas to a service area comprised of no more than a city and one contiguous county.

The following changes would be made by the Finance Committee bill to the restrictions on the use of tax-exempt bonds for single family housing imposed by the Mortgage Subsidy Bond Tax Act of 1980: (1) the arbitrage limitations would be increased from 1.0 percentage points to 1 1/16 or 1 1/8 percentage points depending upon the size of the bond issue; (2) distributions of arbitrage on nonmortgage investments would not be required to the extent that they require recognition of a loss in excess of undistributed arbitrage on nonmortgage investments at such time; (3) the first-homebuyer rule would be applied to 80 percent (rather than 100 percent) of the bond proceeds; and (4) the purchase price limitations would be increased from 90 percent (110 percent in targeted areas) of area average purchase price to 110 percent (120 percent in targeted areas).

facilities with respect to which a UDAG grant is made. Bonds would not be permitted under the $1 million small issue limit as part of an issue which includes bonds which are tax-exempt under other provisions. Certain composite issues would be permitted in certain circumstances. Certain research and development expenditures would not be treated as capital expenditures for purposes of the $10 million capital expenditure limit on small issue IDBs.

The present-law exception for small issue IDBs would be repealed with respect to obligations issued after 1985.

Alternative Proposals

1. Volume limitations

The dollar volume of tax-exempt bonds for all private purposes (IDBs, student loan bonds, hospital bonds, etc.) that are permitted to be issued within any State could be limited. For example, the maximum volume of private purpose bonds that any State could issue during any calendar year could be limited to $200 per capita.

2. Approval requirement

The approval rule could be deleted for some or all types of private purpose bonds. For example, the requirement could be modified so that it would not apply to student loan bonds.

3. Financial contribution requirement

The financial contribution requirement in the Administration proposal could be deleted with respect to certain types of bonds. Alternatively, the amount of the required financial contribution could be reduced below the one-percent requirement of the Administration proposal.

4. Anti-double dip requirement

The Administration proposal that requires the cost of assets financed with tax-exempt bonds to be recovered using the straight-line method over the extended recovery periods used for earnings and profits computations (referred to as the "anti-double dip requirement") could be modified so that it would not apply to certain types of bonds in cases where extraordinary levels of subsidy are deemed appropriate. For example, the requirement could be deleted for bonds for multi-family rental projects or for solid waste disposal facilities that process municipal waste. As a further example, the requirement could be applied only to small issue bonds.

Alternatively, the effect of the anti-double dip requirement can be reduced by providing cost recovery methods that are more generous than the straight-line, earnings and profits lives methods of the Administration proposal, but less generous than the entire benefits of ACRS. For example, the Finance Committee bill would provide that facilities financed with tax-exempt bonds would be depreciated over lives used in computing the cost recovery deductions under the minimum tax (i.e., 5 years for 3-year property, 8 years for 5-year property, 15 years for 10-year property, 22 years for 15-year public utility property, 15 years for 15-year residential real property, and 25 years for 15-year nonresidential real property).

This alternative could be combined with the first alternative to provide various levels of subsidy for different types of bonds.

As a third alternative, the anti-double dip requirement could be relaxed or eliminated for small businesses. This alternative could be combined with either of the first two alternatives to provide various levels of subsidy for various types of bonds used by various sizes of businesses.

5. Student loan bonds

As an alternative, or in conjunction with other requirements, new limitations could be placed on the use of tax-exempt bonds to finance student loans. For example, student loan bonds could be limited to students of families whose income is under a set figure (e.g., $50,000). Further, the volume of student loan bonds that any State could issue could be limited to an amount which varies with its population (e.g., $20 per capita).

6. Small issue bonds

The Administration proposal eliminating the use of small issue bonds by large businesses could be modified. As an alternative, or in conjunction with the Administration proposal, new limitations could be placed on the use of small issue bonds.

a. *Definition of large business.*—The definition of a large business could be modified by either increasing or decreasing the amount of permitted capital expenditures, shortening the measuring period, or adopting a different measurement of size (e.g., number of shareholders, number of employees, amount of paid-in capital, annual gross receipts, whether stock is publicly traded, etc.).

b. *Restriction of small issue bonds to certain uses.*—Small issue bonds could be limited to certain types of uses. For example, small issue bonds could be restricted to industrial use and denied to commercial use or use for the acquisition of land. The definition of commercial could be defined by reference to a uniform classification (such as the SIC code).

Alternatively, the use of small issue bonds could be denied to certain specified uses. For example, small issue financing could be denied to certain sports facilities, professional offices (e.g., doctor or lawyer offices), etc.

c. *Geographical targeting.*—The use of small issue bonds could be limited to certain geographical areas. In the alternative, new restrictions on the use of small issue bonds or private purpose bonds could be relaxed or eliminated in targeted areas. Targeted areas could be (i) areas eligible for urban development action grants (UDAG), (ii) areas eligible under the Administration's proposal as enterprise zones, (iii) areas of chronic economic distress (as defined in the limitations on mortgage subsidy bonds), etc.

d. *Volume limitations.*—The dollar volume of small issue bonds permitted to be issued within any State could be limited. For example, the maximum volume of small issue bonds that any State could issue during any calendar year could be limited to $50 per capita.

e. *Combinations of limitations.*—It is possible to combine some or all of the above limitations. For example, it would be possible to limit small issue bonds to industrial uses except in designated targeted areas. Similarly, it would be possible to limit small issue bonds to small businesses except in designated targeted areas.

7. Recommendations of Oversight Subcommittee on small issue bonds

The Oversight Subcommittee of the Committee on Ways and Means has recommended a series of legislative changes to the rules governing the issuance of small issue IDBs, including the following:

a. *Public hearing requirement.*—Each issuing authority should conduct a public hearing prior to the approval of an issue and prepare a statement with respect to the purpose and expected consequences of such issue.

b. *Reporting requirement.*—Each State should annually report to the Treasury Department certain information regarding issues.

c. *Targeting.*—Commercial projects should be financed with small issue IDBs only if located in an economically distressed areas. Such areas would be designated using the "pocket-of-poverty" concept of the UDAG program. Commercial activities would be defined using the Standard Industrial Classification Manual.

d. *Other limitations.*—Small issue IDBs should not be used to finance the purchase of farmland or to facilitate the relocation of existing activities from one State to another.

e. *Sunset.*—The Treasury should report to the Committee on Ways and Means on the basis of information provided by the States, and no small issue IDBs should be issued after 1983.

Pros and Cons

Arguments for the proposals

1. The proposals would limit the volume of private purpose tax-exempt bonds. These bonds comprised approximately 48 percent of the tax-exempt bond market in 1981, a share that will continue to grow in the absence of additional limits. Meaningful restrictions on private-purpose tax-exempt bonds would help restore the benefit of tax-exempt financing for traditional governmental purposes and would reduce the growing Federal revenue loss attributable to the increasing volume of private purpose tax-exempt obligations.

2. Tax-exempt bonds are an inefficient method of providing a subsidy. Historically, the ratio of interest rates on tax-exempt bonds to the interest rates on taxable bonds has averaged between 65 and 70 percent. At that ratio, the Federal Government loses approximately $3 of tax revenue for every $2 of benefit to the person for whom the bonds were issued. Recently, this interest rate ratio has increased to 80 percent and above, further reducing the efficiency of the method. As more tax-exempt bonds are issued, the ratio will increase further.

3. Tax-exempt IDBs provide a competitive advantage to those companies which remain eligible to use them.

4. Since IDBs generally are issued by all communities, IDBs do not provide an incentive for a business to locate in one community over another.

5. The requirement that private purpose bonds be approved after a public hearing by the highest elected official or an elected legislative body would allow citizens who do not approve of the subsidy to

raise objections to the issuance of the bonds and, thereby, lead to more prudent use of tax-exempt financing. The public should have an opportunity to object to the use of tax-exempt bonds for all private purpose obligations. The higher the volume of private purpose obligations, the higher the interest rates paid by State and local governments on obligations used for traditional purposes and the higher the resulting State and local taxes.

6. The requirement that State and local governments contribute or financially commit themselves to a project would better ensure that the State and local governments make a meaningful determination that the bonds will be used for a valid public purpose. Many State and local governments already contribute toward these projects in the form of property tax abatements, provision of special roads, sewers, etc.

7. The requirement that business users of tax-exempt bonds choose between the benefits of tax-exempt financing and the benefits from ACRS would eliminate double tax benefits which often result in substantial negative effective tax rates. Negative tax rates tend to distort the allocation of capital and to encourage otherwise unprofitable investment. Moreover, this requirement would raise revenue even if the volume of bonds is not decreased, since bond users would have lower cost recovery deductions.

8. The Administration proposal would eliminate use of small issue IDBs by large corporations which do not need tax-exempt financing to raise investment capital. Moreover, the proposal would allow the use of composite or umbrella issues of IDBs and, thus, would extend the benefits of tax-exempt financing to more small businesses by reducing the cost of issuing tax-exempt bonds. Alternatives that would deny small issue bonds for commerical uses would be arbitrary and difficult to enforce; would remove the flexibility that permits governments to determine what is best for their localities; would deny use to commercial businesses which generally are more labor intensive and employ relatively more unskilled workers than industrial businesses; and would deny use of small issue bonds in parts of the country where commercial activity is the major business. Alternatives that would target small issue bonds to certain geographical areas (or provide more generous rules in certain geographical areas) would operate erratically because of the arbitrary nature of the geographical lines which would be drawn and might reduce business activity in other areas. Alternatives that limit the volume of small issue bonds would tend to delay the issuance process and would not account for the different needs of different areas.

9. A requirement that bonds be registered would reduce the possibility for use of tax-exempt bonds to evade income or estate tax liability.

10. A requirement that information concerning bond issues be reported to the Internal Revenue Service would provide information to the Congress and others needed to monitor the tax-exempt bond program and help assure that IDBs are issued only for genuine public purposes.

11. Private purpose tax-exempt bonds should not be allowed to be used to obtain substantial arbitrage profits on reserve funds and funds held during temporary construction periods, since this oppor-

tunity encourages larger issues of bonds than necessary for a project or facility in order to benefit from investment of the larger reserves and encourages the issuance of bonds before the funds are necessary.

Arguments against the proposals

1. No restrictions should be placed on the use of private purpose tax-exempt bonds since these bonds constitute an economic development tool for local communities which can attract private investment capital and create job opportunities. Current high interest rates, high unemployment, and the needs of the communities to have economic development tools necessitate that no new restrictions be placed on the use of IDBs.

2. Tax-exempt bonds provide a subsidy to economic development with a minimum of Federal involvement.

3. The requirement of a public hearing and approval for each bond issue would limit the flexibility in timing bond sales and create delays in securing bond proceeds. In addition, the approval requirement is intended to allow persons disadvantaged by tax-exempt financing an opportunity to express their concerns to elected persons. However, this objective is irrelevant if the bond proceeds are not used in trades or businesses that compete with other trades or businesses (e.g., student loans).

4. A requirement of a financial contribution by the governmental unit issuing the bond is unreasonable, since many local governments could not afford it and some State constitutions prohibit certain types of such contributions.

5. The requirement that would force businesses to make a choice between use of IDB financing or use of ACRS runs counter to the Administration's goal of economic recovery. The use of IDBs or ACRS should not be mutually exclusive, since certain worthwhile investments should benefit from both. Moreover, in the case of certain types of projects, higher levels of subsidy are needed to insure that these projects will be built. For example, some have contended that higher subsidy levels are needed for multi-family rental projects and solid waste disposal facilities for the processing of municipal waste. In the case of certain types of assets, the tax benefits after the Administration proposals would be less than those that existed before ERTA. The depreciable life of the assets financed with tax-exempt bonds should be adjusted so that no group of assets is in a worse position than prior to ERTA.

6. The proposed requirement that would restrict the use of small issue IDBs to small businesses would be inappropriate because it is often necessary to have large, financially strong companies involved in a project in order to make it economically viable. Moreover, larger companies may provide more secure jobs and better benefits to their employees. Similarly, certain distressed areas need both higher levels of subsidy and the ability to encourage large, financially strong companies to invest in them in order to provide a sound business foundation with which to attract other businesses. Appropriate State volume restrictions limit the Federal revenue loss and tend to force States to allocate the limited subsidy to the more meritorious projects, while retaining the flexibility necessary for States to vary their bond programs in accordance with their dif-

ferent needs. On the other hand, the alleged abuses of small issue bonds occur where they have been used for commercial uses and, consequently, only commercial use of the small issue bonds should be limited.

7. Registration and reporting requirements would impose unnecessary burdens and increase the administrative costs to the bond issuers.

8. The restrictions on arbitrage from reserves and temporary construction period investments would reduce the profits from these sources which are typically devoted to financing the project, so that higher amounts of tax-exempt bonds would be issued to finance a project.

9. Competition between communities for business location regularly relies on availability of IDBs, and unless all communities are treated identically in any restrictions on the use of IDBs, unfair competitive relationships would be created.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
a. Administration proposal	([1])	0.4	1.3	2.5	3.8
b. Senate Finance bill	.1	.4	.8	1.4	2.2

[1] Increase of less than $50 million.

C. Taxation of Life Insurance Companies and Annuities

Present Law

Introduction

Generally, a life insurance company receives income from two primary sources: the premiums it receives from policyholders, and investment earnings on the portion of premiums set aside to pay future claims. Although life insurance companies pay income tax at the regular corporate rates, the tax rates are applied to a tax base determined in a special manner.

Taxable income

The regular corporate income tax rates are imposed on "life insurance company taxable income," which is defined as the sum of:

(1) the lesser of (a) taxable investment income or (b) gain from operations;

(2) 50 percent of the amount by which the gain from operations exceeds taxable investment income; and

(3) amounts subtracted from the policyholders' surplus account for the taxable year.

To describe generally a company's applicable tax base, a company is commonly referred to as a "phase I" company if the tax base is taxable investment income; a "phase II negative" company if the tax base is gain from operations which is less than taxable investment income; and a "phase II positive" company if the tax base is the sum of taxable investment income and 50 percent of the excess gain from operations.

The 50-percent portion of gain from operations in excess of taxable investment income that is not taxed currently under (2) above must be added to the policyholders' surplus account and is taxed when distributed from that account.

Taxable investment income

In determining taxable investment income, there first is excluded the portion of the "investment yield" treated as the policyholders' share, i.e., the portion necessary to fund future claims. The "investment yield" means gross investment income (interest, dividends, rents, royalties, short-term capital gains, and trade or business income) reduced by certain deductions (investment expenses, real estate expenses, depreciation, depletion, and trade or business expenses).

The excludable portion treated as the policyholders' share of investment yield is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "policy and other contract liability requirements" by the investment yield. For this purpose, the liabilities reflect the following: (1) the adjusted life insurance reserves (described below) multiplied by the adjusted reserves rate (the lesser of an average rate for a 5-year period or the current earnings rate); (2) the mean of the pension plan reserves at the beginning and end of the taxable year multiplied by the current earnings rate; plus (3) interest paid.

The taxable investment income for a life insurance company is the sum of the remaining portion of the investment yield (i.e., the company's share) and the net capital gain (long-term capital gain in excess of net short-term capital loss) reduced by the company's share of tax-exempt interest income, dividends received deductions, and a small business deduction (10 percent of investment yield up to a maximum deduction of $25,000).

Gain from operations

In determining gain from operations, there first is excluded the share of investment yield set aside for policyholders.

For this purpose, a formula different from that used for purposes of determining the company's taxable investment income is used. The share of investment yield that is excludable from gain from operations is determined by allocating the portion of each item of investment yield which reflects the percentage obtained by dividing the "required interest" by the investment yield.

The required interest is determined by multiplying the required or assumed rates of interest used by the company in calculating reserves for State insurance law purposes by the mean of the applicable reserve at the beginning and end of the taxable year. Generally, there are six categories of items taken into account as reserves related to insurance and annuity contracts.

A company's gain from operations is the sum of its share of investment yield, the amount of a net capital gain, and underwriting income (premiums, decreases in certain reserves, and all other items of gross income), reduced by specified deductions allowed.

Modified coinsurance

A life insurance company sometimes will insure itself against some policyholder risks it has undertaken. This type of insurance between insurance companies is referred to as "reinsurance". Modified coinsurance is a type of reinsurance agreement under which the company transferring some of its risks (the "ceding" company) retains ownership of the assets connected with the risks reinsured and also retains the reserve liabilities connected with the risks reinsured. The company which has agreed to assume the risks under the agreement (the "reinsurer") receives both premium income and investment income attributable to the policies reinsured from the ceding company. Thereafter, periodic settlements are made between the companies for premiums collected, benefits paid, etc.

Code section 820 contains a rule which allows the ceding company and the reinsurer to report a modified coinsurance transaction for tax purposes as if the assets relating to the risks reinsured were transferred to the reinsurer, as if the premium income for the reinsured policies and the investment income on the assets were received directly by the reinsurer, and also as if the reserves to reflect liability for future claims were maintained by the reinsurer. No transfer of assets or reserve liability actually occurs.

Section 820 was originally intended to avoid possible double taxation to both the ceding company and the reinsurer when a modified coinsurance agreement is used. However, some life insurance companies have used modified coinsurance to avoid or substantially reduce income tax paid by both the reinsurer and the ceding company. For example, since a life insurance company cannot deduct policyholder dividends in excess of underwriting income (plus $250,000), it would benefit by converting investment income into underwriting income which then may be offset by excess policyholder dividends which would not otherwise be deductible. Similarly, a company with gain from operations exceeding its investment income, but without sufficient dividends to offset all underwriting income, could benefit by converting investment income into underwriting income because the tax on half of the underwriting income is deferred.

Any increased income to the reinsurer because of the deemed transfer of investment income could be offset by an "experience refund" to the ceding company equal to the investment income minus a minor "service charge." Moreover, a reinsurer may receive an additional benefit of sheltering its other income if it has elected the approximate method for revaluing reserves computed on a preliminary term basis.

Thus, the effect of entering into a modified coinsurance agreement with a section 820 election has often been to convert taxable investment income into underwriting income on which a lesser or no tax is paid by the ceding company and to reduce gain from operations for the reinsurer.

Policyholder dividends

In addition to ordinary business deductions, special deductions are allowed in computing a life insurance company's gain from operations. The combined deductions for policyholder dividends, certain amounts attributable to nonparticipating contracts, and to accident and health and group life insurance contracts, are subject to a special limitation. Under the limitation, these deductions cannot exceed $250,000 plus the amount by which gain from operations (computed without regard to these deductions) exceeds taxable investment income.

Reserves

The concept of reserves is taken into account for several purposes under the life insurance company tax rules. The concept of life insurance reserves is relevant to the definition of a life insurance company which is subject to the special tax provisions; the concept of adjusted life insurance reserves is taken into account for purposes of determining the policyholders' share of investment yield which is excludable from taxable investment income; and increases and decreases in life insurance and other reserves are taken into account in determining gain or loss from operations.

"Menge" formula

A formula, commonly called the "Menge" formula, is used to compute the amount of adjusted life insurance reserves. Simply stated, the "Menge" formula is a mechanical arithmetic adjustment used to compute adjusted life insurance reserves. This computation is then used in determining the policyholders' share of investment yield and accordingly affects the computation of a life insurance company's taxable investment income.

The formula operates to reduce life insurance reserves (other than pension reserves) by 10 percent for each percentage point by which the adjusted reserves rate (the lower of the average earnings rate for a 5-year period or the current earnings rate) exceeds the interest rate assumed in calculating the reserves.

Revaluation of reserves

Present law permits taxpayers to revalue life insurance reserves computed on a preliminary term basis to a net level premium basis. This revaluation may be done under either an exact revaluation method or an approximate revaluation method. (Under the approximate revaluation method, reserves are generally increased by $21 per $1,000 insurance in force other than term insurance less 2.1 percent of reserves under such contracts. Reserves for term insurance are increased by $5 per $1,000 term insurance in force covering a period of more than 15 years, less 0.5 percent of reserves under such contracts.)

Certain reserves for guaranteed interest

Under present law, certain taxpayers have calculated reserves for certain deferred annuities and similar contracts (including certain tax-qualified pension contracts) in a manner that accelerates deductions for interest in excess of the assumed rate that is guaranteed for longer than one year. In general, the reserve is computed by taking the interest guaranteed for future periods into account at the guaranteed rate but is discounted to present value at the end of the company's taxable year at the low rate required to be assumed by State regulatory authorities (typically at a rate of approximately 4 percent). The effect of computing reserves in this manner is to accelerate deductions in computing gain from operations for interest payable in subsequent taxable years. This computation also increases the reserves for purposes of computing the portion of investment yield excludable from taxable investment income.

Consolidated returns

Two or more affiliated domestic life insurance companies may elect to file a consolidated return. Also, beginning in 1981, life insurance companies may be included in consolidated returns with non-life affiliated companies. For reporting purposes, some taxpayers have taken the position that taxable income first is determined for each component member of the affiliated group (e.g., taxable investment income for some companies and gain from operations for others) and then consolidated by adding those separate company taxable income bases. This approach is sometimes referred to as the "bottom line" method of consolidation.

The ruling position of the Internal Revenue Service, as taken in letter rulings, has been that the taxable investment income bases and the gain from operations bases first must be aggregated to arrive at consolidated group amounts and then these aggregate tax bases (taxable investment income and gain from operations) apply for the consolidated group. This approach is sometimes referred to as a "phase-by-phase" method of consolidation.

Under regulations proposed on June 3, 1982, with respect to consolidation of non-life and life companies, a modified phase-by-phase method of consolidation would apply to a life insurance subgroup of companies. Consolidated amounts would be determined by aggregating separate amounts for each member in a life subgroup, and a consolidated limitation would apply whenever a deduction is limited by an amount or percentage of an amount (including the 50-percent deferral for gain from operations in excess of taxable investment income and the limitation on policyholder dividends and special deductions). The proposed regulations would apply to the first taxable year for which the due date (without extensions) for filing a return is after the date final regulations are adopted. The proposed regulations would apply only in the limited context of consolidation of life insurance companies and non-life affiliates, but indicate a preference of the Internal Revenue Service for "phase-by-phase" consolidation over "bottom line" consolidation of life insurance companies.

Taxation of policyholders

Gross income includes any gain received as an annuity under an annuity, endowment, or life insurance contract. Amounts received before the annuity starting date are first considered to be nontaxable returns of premiums and other consideration paid. Except for certain annuities under qualified pension plans, no special rules are provided with respect to the tax treatment of loans against an annuity contract or for withdrawals before either a specified time or attainment of a specified age.

Indeterminate premiums and excess interest

In recent years, many stock companies have begun to offer "indeterminate premium" policies under which the company charges a premium lower than the maximum premium fixed in the policy and "excess interest" policies under which the company credits interest at a rate in excess of the low, permanently guaranteed rate in the contract. Such lower premiums and higher interest rates are guaranteed to the policyholder on a temporary basis because the rate of interest companies can permanently guarantee in setting policy benefits is limited as a practical matter by State law (to as low as 4 to 5 percent in the case of life insurance reserves).

In computing their taxable income, these companies have included only the payments that they actually received under their indeterminate premium policies and have fully deducted, as additions to reserves to provide for guaranteed benefits, the amounts that they credited as excess interest. Recently, however, the Internal Revenue Service has suggested that the excess of the maximum premium chargeable over the premium actually collected may be income to these companies with the difference being deductible only as policyholder dividends. Also, the Internal Revenue Service has suggested that the excess interest may not be fully deductible by these stock companies by treating it as a policyholder dividend subject to the limitations previously described.

In a widely publicized private letter ruling, issued in June 1982, the Internal Revenue Service held that the excess of the maximum premium chargeable over the premium actually collected should be treated as a distribution of policyholder dividends which is paid back as a premium to the company and that excess interest credited to policies was deductible only as a policyholder dividend. Also, the Internal Revenue Service took the position (Rev. Rul. 82–133) that the excess interest credited with respect to certain deferred annuity contracts is a policyholder dividend subject to the statutory deduction limitation.

Administration Proposal

The provision of the Code that treats modified coinsurance arrangements as conventional coinsurance arrangements would be repealed. In addition, the proposal would clarify the treatment of experience refunds by providing for an allocation between investment and underwriting income. Also, the tax treatment of coinsurance arrangements would be revised to prevent disproportionate allocation of investment and underwriting income between the reinsured and the reinsurer.

These provisions generally would apply to all reinsurance arrangements entered into after 1981. The provisions relating to experience refunds and disproportionate allocations would apply after 1981 to all reinsurance arrangements.

Senate Finance Committee Bill

The bill would repeal the modified coinsurance ("Modco") rules in section 820; treat existing Modco agreements as terminated on January 1, 1982, but allow a three-year installment payment of the tax increase from termination treatment of existing agreements for certain reinsurers; provide related party allocation authority for Treasury for future conventional coinsurance agreements; prevent tax avoidance by disallowing an interest deduction with respect to conventional coinsurance funded by a debt obligation; and grandfather prior Modco transactions except in the event of fraud.

The bill would raise the present $250,000 special deductions limit to $1 million, would impose an affiliated group limit, and target the provision to smaller companies. The bill also would allow a 100 percent deduction for policyholder dividends and interest for qualified pension business.

Under the bill, mutual life insurance companies would be allowed to deduct a minimum of 77½ percent of policyholder dividends on nonqualified business. Stock life insurance companies would be allowed a minimum policyholder dividend and interest deduction of 85 percent of amounts paid or credited on nonqualified business.

A geometric "Menge" formula would be provided to compute adjusted life insurance reserves for purposes of allocating investment yield to policyholders.

A "bottom-line" method of consolidation would be allowed for determining consolidated life insurance company taxable income.

The bill would revise the approximate revaluation formula for preliminary term reserves by reducing the revaluation from $21 to $19 per $1,000 of other than term insurance in force, for business written after March 31, 1982.

No reserve deductions would be allowed for interest guaranteed beyond the annual valuation date.

Tax treatment for modified coinsurance transactions with a section 820 election for periods prior to January 1, 1982 would be grandfathered except in cases of fraud. Excess interest credited to policyholders for years prior to 1982 would be fully deductible. Similarly, treatment claimed with respect to consolidation of two or more life insurance companies would be grandfathered for years prior to 1982.

The tax treatment of recipients of annuities would be modified. Withdrawals would be deemed to be taxable to the extent income from investment had been earned. A rule for treating loans as distributions and a 10-percent penalty for withdrawals prior to age 59½ or within 10 years of contribution, whichever period is shorter, would also be added. A 100-percent excess interest deduction would be allowed to insurance companies for amounts credited to deferred annuity business.

The bill would prescribe guidelines for eligibility of the proceeds from "universal life" products for the income tax death benefit exclusion and, except for grandfather protection for prior periods, would not prescribe tax treatment of excess interest (leaving the issue open for litigation during the effective period as to characterization as fully deductible interest paid, alternatively, or as a policyholder dividend deductible to the extent allowed under the percentage limitation safety net).

All of the above provisions would terminate after 1984 (a three-year stopgap period) except for (1) the treatment of modified coinsurance and related transactions, (2) the tax treatment of amounts received under an annuity contract and the deductibility of excess interest credited on deferred annuities, and (3) the "grandfather" rules.

Alternative Stopgap Proposal

Modified coinsurance

The alternative proposal would suspend for two years (a "stopgap" period) the modified coinsurance rules for purposes of determining taxable investment income (generally affecting the ceding or reinsured company); continue modified coinsurance treatment for purposes of determining gain and loss from operations (generally benefiting the reinsurer); and provide grandfathering protection for prior periods for certain modified coinsurance contracts (for taxable years beginning before 1982).

Policyholder dividend limitations

For a two-year stopgap period, companies would be given two alternative means of calculating the limitation for the policyholder dividend deduction and other special deductions.

The first alternative would incorporate the present limitation with only one change—the statutory dollar limit would be increased from $250,000 to $1 million.

The second alternative would provide a limitation determined as follows:

(a) 100 percent of the dividends attributable to insured qualified pension plans;

(b) a statutory amount of $1 million (same as in the first alternative); and

(c) in the case of a mutual company, 80 percent of any remaining dividends or, in the case of a stock company, 87½ percent of any remaining dividends and the special deduction for nonparticipating contracts.

The 7½ percent differential is intended to reflect that a portion of the dividend distribution to mutual company policyholders constitutes a return of corporate earnings to them (deriving from their ownership interest in the company), and, accordingly, should not be deductible.

(In addition to the higher percentage limitations proposed, this proposal differs from the Senate Finance Committee bill by not containing affiliated group and small company targeting limitations.)

"Menge" formula

For a 2-year stopgap period, the 10–for–1 "Menge" formula would be revised to allow the policyholders' share of investment yield to be computed by using a geometric 10-for-1 formula to adjust statutory life reserves, and a 9.5 percent cap would be provided on the adjusted reserves rate that will be used.

(The Senate Finance Committee bill does not contain an adjusted reserves rate cap.)

Consolidated returns

For the 2-year stopgap period, the proposal would provide that consolidated life insurance company taxable income is determined by first computing the separate life insurance company taxable income for each affiliated company and then combining those amounts. Also, grandfathering protection would be provided for companies that have taken this reporting position for taxable years beginning before 1982.

(These proposals are consistent with provisions included in the Senate Finance Committee bill.)

Excess interest deductions

For taxable years beginning before 1982, the alternative stopgap proposal would provide that amounts treated as interest deductions by a taxpayer on insurance or annuity contracts will be protected from reclassification as policyholder dividends on audit by the Internal Revenue Service.

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(The Senate Finance Committee bill contains similar grandfather rules.)

Indeterminate premium policies

For taxable years beginning before 1982, the alternative stopgap proposal would provide that amounts that could have been charged as a premium or mortality charge, but were not, would not be included in income.

(The Senate Finance Committee bill contains similar grandfather rules.)

Proposal for Revaluing Certain Reserves

As recommended by a GAO report, the approximate revaluation method for revaluing life insurance reserves computed on a preliminary term basis could be revised for insurance (other than term insurance) so that reserves are increased by $15 per $1,000 insurance in force rather than by $21 per $1,000, and reduced by 1.5 percent of reserves rather than 2.1 percent. Alternatively, the approximate revaluation method could be repealed, so that the revaluation of reserves computed on a preliminary term basis would have to be computed under the exact revaluation method.

Pros and Cons

Argument for the Administration proposal

Repeal of the modified coinsurance provisions (with other conforming changes) would eliminate permanently the unintended tax benefits derived from the provisions, e.g., the conversion of taxable investment income into underwriting gains on which little, if any, taxes are paid.

Arguments against the Administration proposal

1. The modified coinsurance provision should be considered as part of a package with some other needed changes in the insurance tax laws.

2. Until there is a comprehensive review of the life insurance company tax laws, there should only be a suspension of the modified coinsurance provisions, together with temporary changes of certain other provisions of the 1959 Act which are outdated, for an interim period during which the Congress could conduct the comprehensive review.

3. A simple repeal of the modified coinsurance provisions would increase the tax burden of certain members of the life insurance industry too much. In addition, it would result in decreasing funds accumulated from the sale of life insurance policies that could be used as long-term capital.

Arguments for the alternative stopgap proposal

1. The stopgap proposal would raise a more appropriate amount of revenues from the life insurance industry, i.e., increasing revenues over present law with the present treatment of modified coinsurance, but providing some degree of tax relief from changed ef-

fects of certain provisions of the 1959 Act due to changed interest rates and different insurance products.

2. The alternative proposal would provide interim corrections during the two-year stopgap period (1982 and 1983) to permit a thorough Congressional review of the 1959 Act.

3. At a time of inflation and higher interest rates, the alternative proposals relating to limitations on the policyholder dividend and other special deductions would carry out Congressional intent that investment income attributable to insured pension plans would be tax-free and permit the insurance industry to compete effectively for qualified pension plan business. Also, by allowing a minimum deduction of 80 percent for mutual companies and 87½ percent for stock companies, the proposal would (1) temporarily correct the problem arising when increases in taxable investment income attributable to high interest rates decrease the limitation on deductible policyholder dividends (the portion of the limitation based on operating gains in excess of taxable investment income); (2) generally restore the level at which policyholder dividends were deductible in 1959 (approximately 90 percent of policyholder dividends were deductible in 1959, but the portion has been approximately 60 percent recently); and (3) permit life insurance and annuity policies to remain competitively attractive by allowing companies to reflect better investment performance by higher dividends, lower premiums, or increased benefits. Finally, the proposal would take into account the effects of inflation since 1959 by increasing the minimum dollar limitation from $250,000 to $1 million and thereby restore the assistance to small companies intended in 1959.

4. The proposal would correct inaccuracies attributable to substantial increases in interest rates in recent years with respect to the 10-for-1 "Menge" formula used to revalue statutory reserves.

5. The proposal relating to consolidated returns would permit life insurance companies to file consolidated returns on a basis comparable to other taxpayers.

6. The grandfathering provisions for previous modified coinsurance arrangements, consolidated returns, excess interest, and indeterminate premium products would remove doubt about the tax treatment for such items for prior taxable years.

Arguments against the alternative stopgap proposal

1. Because of the general acknowledgment that modifed coinsurance has been abused, the modified coinsurance provisions should be repealed, rather than merely suspended for a two-year period (including repealing present treatment for reinsurers as well as for reinsured companies). If the present treatment of modified coinsurance were merely suspended, some unintended benefits could continue.

2. The proposal relating to provisions other than modified coinsurance should be considered within the context of a thorough review of the 1959 Act to develop permanent, rather than temporary, solutions.

3. Grandfathering protection for past modified coinsurance transactions sets an inappropriate precedent as a matter of tax policy and would unduly restrict the authority of the Internal Revenue Service to examine the substance of past transactions. If the trans-

actions do not meet long-standing general requirements for favorable tax treatment, they should be challenged by the Internal Revenue Service. Other grandfathering provisions would also set inappropriate precedents.

4. The proposal does not deal with all provisions that are not operating correctly because of changed circumstances since 1959, e.g., the approximate method for revaluing life insurance reserves computed on a preliminary term basis.

5. The minimum policyholder dividend deduction levels under the proposal would not sufficiently reflect the status of a policyholder of a mutual company as an owner-investor, i.e., amounts equivalent to nondeductible regular corporate dividends should not be deductible as policyholder dividends. Further, the proposal does not sufficiently reflect the tax deferral and exemption treatment available to policyholders on dividends credited to their policies.

6. The proposal relating to consolidated returns fails to reflect the general rule applicable to other taxpayers that dollar or percentage limitations should be determined on a consolidated basis.

7. Technical modifications to the alternative stopgap proposal are necessary.

Arguments for proposal as to revaluing certain reserves

1. As indicated by a GAO report, the approximate method for revaluing reserves for life insurance other than term insurance that are computed on a preliminary term basis ($21 per $1,000 insurance in force) should be revised because it produces reserves greater than what is actuarially needed. This is due to changed circumstances since 1959 (mortality, product, and reserve method changes). Likewise, many large established companies have obtained excessive allowances by electing the method which was originally intended to aid new and small companies.

2. The proposal to revise the approximate method for revaluing life insurance reserves on a preliminary term basis would remove an unintended benefit which now results in a substantial revenue loss.

3. The proposal is consistent with a package of changes to deal with circumstances which have changed since the 1959 Act was enacted.

Arguments against proposal as to revaluing certain reserves

1. The proposed revision of the approximate method of revaluing life insurance reserves computed on a preliminary term basis would increase the tax burden of the life insurance industry by too much.

2. Revision of the approximate method of revaluing life insurance reserves would impact heavily upon smaller stock companies.

3. These proposals should be considered only in the context of a thorough review of the tax rules relating to life insurance taxation.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1982	1983	1984	1985	1986	1987
Administration proposal	0.9	2.6	2.5	2.7	2.9	3.2
Senate Finance bill [1]	.5	1.5	1.5	2.2	2.9	3.2
Alternative stopgap proposal [2]	.4	1.2	.6			

[1] The provisions would be effective for a 3-year stopgap period except for repeal of the modified coinsurance provisions, certain deferred annuity provisions, and grandfathering provisions.

[2] The proposal is only for a 2-year stopgap period.

D. Construction Period Interest and Taxes

Present Law

Individuals, personal holding companies, and subchapter S corporations are required to capitalize interest and real property taxes attributable to the construction period of real property, other than low-income housing, that will be used in a trade or business or held for investment (sec. 189). The capitalized interest and taxes are amortized (i.e., deducted in equal portions) over a 10-year period.

The interest that must be capitalized under this rule is interest which is attributable to the construction period for any debt incurred or continued for the purpose of acquiring, constructing, or carrying the real property. The construction period is defined as the period beginning on the date construction of the building or improvement begins and ending on the date the property is ready to be placed in service or is ready to be held for sale.

The amortization of capitalized interest and taxes begins in the year the interest or taxes are paid or accrued. However, the amortization of capitalized interest and taxes is then suspended until the year the building or improvement is ready to be placed in service, at which time the amortization resumes.

Corporations other than personal holding companies and subchapter S corporations are not subject to the capitalization requirement. For these corporations, interest and real property taxes are deductible for the year in which paid or accrued.

Administration Proposal

Corporations (other than personal holding companies and subchapter S corporations, which would continue to be subject to the present-law rules) would have to capitalize and amortize over 10 years interest and taxes attributable to the construction period of nonresidential real property.

Senate Finance Committee Bill

The Finance Committee bill requires that (under section 189) interest and taxes paid or accrued on nonresidential real property the construction of which begins after 1982 must be capitalized and amortized over 10 years. Under the Finance Committee bill, the amount of interest allocable to construction of nonresidential real property would be provided under Treasury regulations which would be similar to the rules used for financial accounting purposes.

Possible Alternative Proposal

1. The proposal could be limited to apply to a narrower group of assets than all nonresidential real property. For example, the pro-

posal could be limited to apply to nonresidential property described in section 1250 or to nonresidential buildings.

2. The proposal could be modified to provide different rules for determining the amount of interest allocable to nonresidential real property. For example, the proposal could be modified to provide that interest on indebtedness allocable to a specific construction project could be allocated to the project, while interest on remaining indebtedness could be allocated to other construction projects based on the ratio that the expenditures on those construction projects bears to total assets.

Pros and Cons

Arguments for the proposal

1. Construction period interest and taxes, like other costs of construction, such as labor, materials, fees, and permits, may be viewed as costs incurred in acquiring property. Therefore, as in the case of these other costs under present law, construction period interest and taxes should be capitalized and deducted only when the property is sold or used to produce income. The lack of restriction on these deductions under present law allows construction of an asset to create accounting losses which shelter other income from tax, since income and expenses are not properly matched.

2. Tax accounting rules requiring the deferral of costs of acquiring or producing property until the time the property is placed in service or sold generally apply equally to corporations and individual taxpayers. Insofar as these rules restrict the deduction of construction period interest and taxes, no policy reasons are apparent which justify limiting their application only to individual taxpayers.

3. By eliminating the disparate treatment of corporations and other taxpayers, the proposal would reduce the tax motives taken into account in determining whether to incorporate a business.

4. Unless this proposal is adopted, corporate taxpayers which construct their own assets would have an advantage over taxpayers which purchase assets from contractors subject to the proposed restrictions on the completed-contract method of accounting. These proposed restrictions would require contractors to cumulate ("capitalize") most construction costs.

Arguments against the proposal

1. The present-law limitation on deducting construction period interest and taxes, applicable to individuals, restricts deductions of costs that can be used to produce accounting losses and shelter income from other sources. Such tax-shelter activities have been of greater concern to Congress when engaged in by individuals, personal holding companies, and subchapter S corporations rather than by larger corporations.

2. In view of the fungibility of money, it may be difficult to distinguish construction period interest from other interest. If the proposal is adopted, the allocation rules should assume that construction expenditures can be financed with equity as well as debt.

3. Some taxpayers argue that ACRS results in a higher effective tax rate for real property than for personal property. The contin-

ued application of the capitalization rules, and the extension of those rules to corporations, would exacerbate any such bias against real estate investments.

4. Some corporations might cancel plans to construct property if the proposal were enacted, creating greater unemployment.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	.5	1.0	1.0	1.0	.9
Senate Finance bill	.6	1.2	1.3	1.2	1.0

E. Minimum Tax

Present Law

Corporate add-on tax

Corporations must pay a minimum tax on certain tax preferences in addition to the regular corporate income tax. The amount of the minimum tax is 15 percent of tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in the minimum tax base for corporations are:

(1) Accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deduction over the amount of that deduction computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property;

(5) 18/46 of the corporation's net capital gain; and

(6) Amortization of child care facilities (the excess of 60-month amortization over depreciation otherwise allowable).

In computing the amount of regular tax deductions from the minimum tax base, the corporation's regular tax liability is reduced by nonrefundable credits other than the ESOP credits. Credits (other than refundable credits) are not allowed against the corporate minimum tax.

The add-on minimum tax for corporations raises about $600 million per year.

Individual add-on tax

In the case of individuals, a similar add-on minimum tax applies, except that the items of tax preference also include (1) accelerated depreciation on personal property subject to a lease, and (2) intangible drilling costs on oil and gas wells in excess of the amount amortizable with respect to these costs, and in excess of net income from oil and gas production. Capital gains are not an item subject to the add-on tax for individuals. In the case of an individual, the add-on minimum tax is imposed on the amount of tax preferences in excess of the greater of one-half the regular income tax paid or $10,000.

In 1979, the add-on minimum tax for individuals raised $309 million.

Individual alternative tax

Individuals are also subject to an alternative minimum tax, which is payable to the extent it exceeds the regular tax paid. The alternative minimum tax is generally based on taxable income increased by (1) the deduction for long-term capital gains and (2) the amount of the taxpayer's adjusted itemized deductions.

Generally, adjusted itemized deductions are the amount of itemized deductions (other than for medical expenses, casualty losses, and State, local, and foreign taxes) in excess of 60 percent of adjusted gross income (reduced by the itemized deductions excluded above).

The tax rate (for both single and joint returns) is 10 percent of the alternative minimum taxable income from $20,000 to $60,000, and 20 percent of the amount in excess of $60,000. Tax credits, other than the foreign tax credit, are generally allowable only if attributable to an active trade or business and only to the extent the tax is not attributable to net capital gains or to adjusted itemized deductions. Any credit disallowed by this rule increases the amount allowed as a credit carryover.

The foreign tax credit is allowed in full. In general, the regular foreign tax credit rules apply, but the foreign tax credit limitation is computed separately. Thus, the amount of foreign tax that may be credited is limited to the same proportion of the gross alternative tax as the taxpayer's alternative minimum taxable income from sources without the U.S. bears to his entire alternative minimum taxable income. The taxpayer is then required to pay an amount equal to the greater of the after-credit regular tax or the after-credit alternative minimum tax. A special rule is also provided for computing the amount of unused foreign taxes that may be carried back or carried forward.

In 1979, the alternative minimum tax for individuals raised $860 million.

Administration Proposal[1]

Overview

The proposal would repeal the present law 15-percent add-on minimum tax for corporations (except for subchapter S corporations and personal holding companies) and establish a 15-percent alternative minimum tax. Under the proposal, a corporation would pay the alternative minimum tax only when it exceeds its regular income tax. The proposal would not amend the present law minimum tax provisions for individuals.

The new alternative minimum tax would apply to domestic corporations and foreign corporations engaged in a trade or business in the U.S. In general, the tax base would be a corporation's regular taxable income, increased by certain tax preference items for the year. Net operating loss deductions would not be allowed in computing the minimum tax base. The tax base then would be reduced by a $50,000 exemption and taxed at a 15-percent rate.

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[1] This description includes changes made by the Administration since the publication of the proposal in February 1982.

The foreign tax credit, but no other credits, would be allowed against the alternative minimum tax. The excess of the alternative minimum tax over the regular tax would be carried over as a credit to be applied against the regular tax in future years.

Preferences

Existing tax preference items

Five preference items that would be added to taxable income in computing the alternative minimum tax base under the Administration proposal would be identical to tax preferences subject to the present law corporate minimum tax. The capital gains preference under the present corporate minimum tax would not have to be added separately to the tax base since the alternative minimum tax base automatically would include it as part of regular taxable income.

New tax preference items

In addition, the following items would be included as tax preferences under the Administration proposal:

(1) Intangible drilling costs.—Deductions for intangible drilling and development costs of oil, gas, and geothermal wells (other than dry holes) in excess of the aggregate amount of deductions that would have been allowable for the year had the IDCs on all such wells drilled after 1982 been capitalized and amortized on a straight line basis over 10 years. There would be no offset for the net income from oil and gas production for the year.

(2) Mining exploration and development costs.—Deductions for mining exploration and development costs in excess of the amortization that would have been allowable on a straight line basis over 10 years.

(3) Lessor safe-harbor leasing benefits.—Benefits attributable to safe-harbor leases under ACRS. The amount of the preference for each lessor (buyer of tax benefits) would be the excess of (1) the current year's ACRS deduction minus the excess of the rental income over the interest deductions with respect to the lease for the taxable year (i.e., the net deductions received by the lessor as a result of the safe-harbor sale-leaseback transaction) over (2) the initial amount of cash investment by the lessor amortized over the lease term. Leases entered into before February 26, 1982 would be exempted.

(4) Deductions for debt to carry tax-exempt securities.—Interest on indebtedness to purchase or carry tax-exempt securities purchased after 1982, to the extent deducted under current law.

(5) Deferred DISC income.—A corporate shareholder's pro rata share of DISC income for the year that is not taxed currently.

(6) Deferred shipping income.—The net increase for the taxable year in the income and capital gains accounts under capital construction funds under the Merchant Marine Act.

(7) Amortization of motor carrier operating rights.—All deductions claimed under the 5-year amortization provisions added by ERTA for motor carrier operating authorities, many of which diminished in value as a result of the deregulation of motor carriers on July 1, 1980.

(8) Excess OID interest.—Interest deductible on original issue discount (OID) bonds in excess of the amount that would be deductible were the OID amortized according to a method which yields the same pattern of deductions that would result from borrowing the same amount of money with par-value bonds having the same yield to maturity. (For OID bonds issued after May 3, 1982, the Treasury Department proposes to require that deductions be computed with this method under the regular tax. See item H below.)

(9) Deductions for costs incurred for long-term contracts.—Current deductions of certain indirect costs incurred for long-term contracts entered into on or before February 26, 1982. The amount of the preference would be the excess of those deductions over the deductions that would have been allowable if those costs were capitalized and deducted under the proposed progress payment method of accounting for long-term contracts. The indirect costs subject to this rule are those costs that would have to be allocated to long-term contracts subject to the proposed progress payment method of accounting were the contract entered into after February 26, 1982.

Net operating losses

Net operating loss (NOL) carryovers and carrybacks would not be allowable as deductions in computing the minimum tax base. The amount of any NOL carryover or carryback allowable in computing the regular tax would be treated as absorbed, even for years in which the corporation pays the alternative minimum tax.

Foreign tax credit

The foreign tax credit allowed against the alternative minimum tax would be computed in a manner similar to the way the foreign tax credit is presently computed when it is allowed against the alternative minimum tax for individuals. In general, the amount of foreign income taxes paid or accrued that could offset the minimum tax could not exceed the portion of the tax attributable to foreign source minimum taxable income. The present limitations for foreign oil income (sec. 907) would apply. Foreign taxes in excess of the current year's limitation could not be carried over to be used against the minimum tax in other years.

Other regular tax credits

No other credits would be allowed. The amount of any unused credit carryover or carryback allowable in computing the regular tax would be treated as absorbed, even for years in which the corporation pays the alternative minimum tax.

Minimum tax credit

The Administration proposal would establish a minimum tax credit equal to the excess of the alternative minimum tax liability over the regular tax liability computed for that year. The credit would be applied as a carryover against the regular tax in subsequent years. The carryover period would be 15 years.

Effective date

The new minimum tax provisions for corporations would apply for taxable years beginning after 1982.

Senate Finance Committee Bill

Overview

In place of a new corporate minimum tax, the Finance Committee bill would substitute a 15-percent across-the-board cutback in a list of business tax preferences. Also, the bill would expand the present alternative tax for individuals and repeal the add-on minimum tax for individuals.

Corporate tax preference reform

The following corporate tax preferences would be reduced by 15 percent: percentage depletion for coal and iron ore, excess bad debt reserves, interest on debt used to carry tax-exempt securities acquired after 1982, deferred DISC income, section 1250 recapture on structures, rapid amortization of pollution control facilities, and mineral exploration and development costs.

Under the bill, integrated oil producers would be allowed to expense up to 85 percent of intangible drilling costs. The remainder would be written off under the ACRS 5-year recovery percentages with an investment credit but without safe-harbor leasing. Fifteen percent of mining exploration and development costs would be recovered under the same method as IDCs.

Rules would be provided to prevent preferences from being cut back excessively through the interaction of this provision and the add-on minimum tax.

The limit on the amount of tax which may be offset by the investment tax credit for both individuals and corporations would be reduced from 90 percent to 85 percent of tax liabilities in excess of $25,000.

These provisions generally would apply to taxable years beginning after 1982.

Individual minimum tax

The add-on minimum tax for individuals would be repealed, and the existing alternative minimum tax would be expanded, effective for taxable years beginning after 1982.

All present-law preferences under the existing add-on and alternative minimum taxes, except adjusted itemized deductions, would be included in the base of the expanded alternative minimum tax. New preferences would be added. They are excluded interest and dividend income (including interest on tax-exempt bonds issued after December 31, 1982) and the excess of expensing over 10-year amortization for mining exploration and development costs, research and development costs, and magazine circulation expenditures.

In order to compute minimum taxable income, preference amounts would be added to adjusted gross income, and deductions would be allowed for charitable contributions, medical expenses, casualty losses, personal housing interest, other interest to the extent of investment income, and real net operating losses. The first $30,000 of minimum taxable income ($40,000 on joint returns) would be exempt from the alternative minimum tax. Minimum taxable income in excess of $30,000 but less than $50,000 ($40,000–$60,000 for couples filing joint returns) would be taxed at a 10-percent rate. Income in excess of such higher amounts would be taxed at a 20-percent rate.

Individuals other than limited partners could elect to depreciate intangible drilling costs under the rules for the 5-year ACRS class with an investment credit but without safe-harbor leasing.

Alternative Proposals

Corporations

1. The across-the-board preference cutback in the Finance Committee bill could be modified by increasing the 15-percent rate and expanding the affected tax preferences. Additional preferences might include (1) all percentage depletion, (2) contributions to capital construction funds, (3) motor carrier operating rights, and (4) capital gain treatment of timber, coal, and iron royalties. Also, intangible drilling costs subject to the cutback could be recovered under the present law straight line recovery of intangibles method or, alternatively, under 5-year amortization with no investment credit, and mining exploration and development costs subject to the cutback could be recovered under 10-year amortization with no investment credit.
2. The existing add-on minimum tax for corporations could be repealed.
3. The Administration's proposed alternative minimum tax could be modified by allowing deductions for real net operating losses and by making a series of adjustments to ensure that the tax base does not exceed economic income.
4. There could be a limit on tax preferences. Corporations could not be allowed to use preference deductions to reduce their taxable income by more than two-thirds, and they could be required to carry over credits (other than the foreign tax credit) to the extent that those credits reduce tax liability below 46 percent or one-third of taxable income plus preference deductions.
5. There could be an alternative minimum tax equal to 5 percent of earnings and profits, with no credits.
6. DISC could be deleted as a tax preference.

Individuals

1. The alternative minimum tax for individuals in the Senate Finance Committee bill could be changed by adjusting the rate schedules and exemptions and by adding or modifying preferences. New preferences could include excluded earnings of Americans working abroad, incentive stock options, the deduction for two-earner couples, net passive investment losses, and the excess of deductions allowed for soil and water conservation, land clearing, and fertilizer expenditures over what would be allowed under 10-year amortization. The intangible drilling costs preference could be modified by eliminating the present law rule that only deductions in excess of oil and gas production are considered a preference. Taxpayers with expenses considered a preference to the extent they exceed 10-year amortization, or with intangible drilling costs, could be given an election to use 10-year amortization for regular income tax purposes.

The itemized deductions could be changed by not allowing a deduction in excess of basis for charitable contributions of appreciated property and by considering interest incurred on debt used to purchase an interest in a limited partnership or a subchapter S corporation as an itemized deduction subject to the net investment income limitation. Itemized deductions could be considered a preference, as under present law, only to the extent that they exceed a percentage of adjusted gross income.

2. There could be an alternative minimum tax equal to 5 percent of gross income, reduced by an exemption, with no credits.

3. Preferences for individuals could be reduced directly, for example, by limiting itemized deductions to 40 percent of adjusted gross income for purposes of the regular income tax.

Pros and Cons

Arguments for the proposals

1. Every corporation and individual whose economic income exceeds a certain amount should be required to pay the government at least a minimum amount of tax on that income.

2. Broadening the base of corporate and individual taxes would reduce the economic distortions caused by various tax preferences and thus be consistent with recent efforts to reduce the economic distortions induced by high marginal rates.

3. Taxing corporations on financial income would conform tax income to income computed in the marketplace, thus substituting a measure of income which more accurately reflects economic income.

4. In periods of budget stringency, tax preferences should be scaled back along with direct spending.

Arguments against the proposals

1. The proposals would reduce the investment incentives which the Congress has enacted.

2. An alternative minimum tax for corporations may lead to an incentive to merge companies with large tax preferences with those with large taxable income.

3. The proposals would add complexity to the law.

4. The tax preferences which would be subject to the minimum tax were generally enacted into law in order to accomplish some social or economic purpose. These goals would be undermined by a minimum tax.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal (corporate alternative minimum tax) [1]	2.3	4.8	4.5	3.7	3.8
Senate Finance bill:					
i. Corporate minimum tax preference reform	.5	.8	.8	.8	.7
ii. Individual minimum tax	([2])	.2	.3	.3	.3

[1] Figures reflect administration estimate and do not take into account changes in the proposal since February 1982.

[2] Increase of less than $50 million.

F. Accelerated Corporate Income Tax Payments

Present Law

Rules applicable to corporations generally

Estimated tax.—A corporation generally must make payments of estimated tax liability during the taxable year if its estimated tax for such taxable year can reasonably be expected to be $40 or more. The estimated tax is payable in up to four installments over the taxable year.

In general, if estimated tax payments are not equal to at least 80 percent of the tax due, a nondeductible penalty equal to the interest that would accrue on the unpaid tax is imposed on the amount by which the payment is less than 80 percent of the tax due. However, the underpayment penalty does not apply if, before the due date of any installment, the corporation pays an installment based on:

(1) the corporation's tax liability for the prior year,

(2) the corporation's tax liability on the prior year's income computed using tax rates for the current year, or

(3) 80 percent of the tax which would be due if the corporation's annual income were equal to the amount which would result if the corporation continued to receive income during the remainder of the year at the same rate experienced up to the date of the installment (i.e., the corporation's income computed on an annualized basis).

Final payment of tax.—As a general rule, a corporation's final tax payment is due with its income tax return 2½ months after the end of the corporation's taxable year. However, the corporation may elect to pay only half of the unpaid tax on this date and the second half three months later.

Refunds of overpaid tax generally are not made until after an income tax return is filed. However, an adjustment of overpaid estimated taxes may be requested immediately after the close of the taxable year if the overpayment exceeds $500 and 10 percent of expected tax liability. Tax returns are due 2½ months after the end of the taxable year, but the Internal Revenue Service may grant an extension of this date; however, interest is charged on any tax not paid when due.

Special rules applicable to large corporations

In general, large corporations (i.e., those with taxable income of $1 million or more during any of the three preceding taxable years) are subject to the same rules on payment of income tax as are smaller corporations. Under present law, however, for 1984 and thereafter, a large corporation will not be able to use the first two exceptions above in order to avoid the underpayment penalties. For

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1982 and 1983, large corporations will be able to use the first two exceptions only if their estimated tax payments equal at least 65 percent (in 1982) or 75 percent (in 1983) of the current year's tax liability.

Administration Proposals

1. The amount of estimated tax payments required for all corporations to avoid underpayment penalties would be increased from 80 percent to 90 percent of current year's tax liability for 1983 and thereafter. A corresponding change would be made in the third exception, above.
2. The full amount of unpaid tax would be due 2½ months after the end of the taxable year.
3. For 1984 and 1985, the first two exceptions to the underpayment penalty (estimated payments based on prior year's tax liability or income) would be available to large corporations only if estimated tax payments were at least 80 and 85 percent of tax due, respectively. These exceptions would not be available to large corporations after 1985. Thus after 1985, to avoid underpayment penalties, large corporations would be required to pay at least 90 percent of their current tax liability through estimated payments unless the third exception is applicable.

Senate Finance Committee Bill

Same as Administration proposal, except the penalty on underpayments of estimated tax would be one-half the full rate for underpayments on the portion of the underpayment between 80 and 90 percent of actual tax due.

Possible Additional Proposals

A rule could be provided to reduce the overpayment of estimated tax by large corporations having seasonal income when they rely on the annualized income exception. For large corporations with a history of fluctuating income, annualized income could be computed by assuming that income in the current year is earned in the same pattern as in preceding years.

The definition of a large corporation could be clarified to provide that the $1 million taxable income test is to apply without regard to any net operating loss carryover or carryback.

The $40 threshold for payment of corporate tax liabilities on an estimated basis could be increased to the levels applicable to individuals: $300 in 1983, $400 in 1984, and $500 in 1985 and thereafter.

Pros and Cons

Arguments for the proposals

1. Corporations may defer paying a significant portion of their income tax liability until after the end of the taxable year. Thus, they may obtain the equivalent of an interest-free loan from the Treasury, which is required to borrow this amount at market interest rates. Although the same requirements for prepayment of tax and exceptions from underpayment penalties generally apply to in-

dividuals, most individuals prepay more than 100 percent of their tax through withholding.

2. Corporations have ready access to professional tax assistance, can estimate their income accurately, and thus can determine their tax liability as installments are due. Once determined, there is no justification for not paying the tax.

3. Increasing the threshold for estimated tax payments would reduce paperwork and compliance burdens.

Arguments against the proposals

1. In computing the tax liability of a large corporation, there are numerous issues of law and fact that can affect tax liability. The 90-percent requirement would demand greater precision than is possible under these circumstances.

2. Overpayments are likely to be increased if larger amounts of tax must be prepaid, since deductions and tax credits accrued or business conditions occurring late in the year could reduce the corporation's tax liability below the prepaid amount. Since refunds or overpayments generally are not made until several weeks after a tax return is filed, the overpayment might not be refunded for almost a year after the close of the corporation's taxable year. (The return would be filed 8½ months after the close of the taxable year if an extension of time to file were granted.)

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Administration proposal	1.0	1.0	1.2	0.9	0.1
Senate Finance bill	0.7	1.0	1.2	0.8	0.1

G. Business Energy Tax Incentives

Present Law

Energy tax credits

Business energy tax credits are available for qualified investments in specified energy property. The amount of the credit depends upon the type of property acquired and the acquisition date.

Generally, the credit for energy property investments is 10 percent and expires after 1982; however, an affirmative commitment rule extends the credits until 1990 for certain long-term projects. In addition, the energy credit is available through 1985 for investments in (1) solar, wind, and geothermal property (a 15-percent rate), (2) ocean thermal property (a 15-percent rate), (3) qualified hydroelectric generating property (an 11-percent rate), (4) qualified intercity buses (a 10-percent rate), and (5) biomass property (a 10-percent rate).

Production tax credit

A production tax credit of up to $3 per barrel of oil equivalent (adjusted for post-1979 inflation) is provided for the production of qualified fuels including oil from shale and sands, gas from unconventional sources, synthetic fuels from coal, certain processed wood fuels, and steam from agricultural by-products. The production credit generally is subject to a phase-out as domestic oil prices approach $29.50 per barrel adjusted for post-1979 inflation ($35.10 per barrel for calendar year 1981) and expires in 2001.

Industrial development bonds (IDBs)

Present law permits tax-exempt IDB financing for certain small-scale hydroelectric facilities owned by municipalities, certain facilities to produce steam or alcohol from solid waste, and certain State energy conservation programs.

Alcohol fuels exemption and tax credit

Gasohol which contains at least 10 percent alcohol is exempt (through 1992) from the 4-cent-per-gallon excise tax on motor fuels. Alternatively, alcohol used in fuels is eligible for a tax credit (through 1992) of up to 40 cents per gallon.

Administration Proposal

All of the above business energy tax incentives would be repealed as of December 31, 1982, and the existing affirmative commitment rule applying to credits which expire in 1982 under present law would be modified. However, transition rules would apply to these changes.

The transition rules would be as follows:

a. The repeals would not apply if a binding contract for the acquisition of eligible property was entered into before February 26, 1982.

b. For self-constructed property and progress expenditure property (projects with construction periods of at least two years), the credits would apply for 1982 expenditures even though the property is placed in service after 1982.

c. Taxpayers signing binding contracts before January 1, 1983, to acquire or construct long-term projects would be eligible for credits until December 31, 1985. In addition, this rule would replace the present affirmative commitment rule which applies to property for which the energy credit presently expires after 1982.

d. Alcohol fuel producers would be eligible for a production credit through 1988 for capacity either in place or for which a binding contract had been signed by February 26, 1982. For production from this capacity, the credit would be at the present-law rate through 1985 and would phase out by 10 cents per year thereafter.

Alternative Proposal

The transition rules in the Administration proposal could be liberalized so that taxpayers who have made binding commitments would continue to receive the full benefit from the energy credits.

Pros and Cons

Arguments for the proposal

1. The need for these special incentives has been substantially eliminated by the decontrol of oil prices, the gradual deregulation of natural gas, and generally higher energy prices.

2. These incentives were enacted prior to adoption of ERTA. The liberalization of depreciation and the regular investment credit in ERTA provides adequate incentives to capital investment without these energy credits.

3. If Federal support is to be given to synfuels and conservation expenditures, that decision should be made directly by the Congress through the authorization and appropriations processes.

4. The availability of these incentives for only a few alternative energy sources diverts capital and technology away from conservation expenditures and other alternative energy sources which may be less expensive ways of reducing oil and gas consumption.

Arguments against the proposal

1. Reducing oil imports would have benefits, including improved national security and lower prices for imported oil, which are not taken into account by consumers in deciding whether to switch to alternative energy sources. Thus, it is necessary for the government to provide extra incentives for the production of these sources.

2. These incentives were designed to encourage development of new forms of energy production by providing incentives for early development of pilot projects. Since the provisions which would be

repealed were enacted in their present form only in 1980, there has not been adequate time to prove the merit of these new technologies.

3. The recent slump in oil prices has jeopardized many energy projects. Repeal of these incentives would further delay development of technologies and construction of facilities that are needed to reduce our dependence on fossil fuels.

4. Some taxpayers have planned their investments for 1983 and later in reliance on these energy incentives. Repeal would force them to delay investments and incur expenses in restructuring their activities.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
Administration proposal	0.1	0.3	0.5	0.5	0.5

H. Amortization of Original Issue Discount on Bonds

Present Law

Tax treatment of corporate original issue discount bonds

Normally, a bond is issued at a price approximately equal to the amount for which the bond will be redeemed at maturity, and the return to the holder of the bond is entirely in the form of periodic interest payments. However, in the case of original issue discount (OID) bonds, the issue price is below the redemption price, and the holder receives some or all of his return in the form of price appreciation. The gap between the issue price and redemption price is the original issue discount. The extreme case of an OID bond is a zero-coupon bond, in which there are no periodic interest payments, and the holder's entire return comes from price appreciation.

Under present tax law, for bonds issued by a corporation the original issue discount is treated as accruing in equal installments over the life of the bond. Thus, an issuer of an OID bond deducts, as interest, both any periodic interest payments and a ratable portion of the original issue discount each year, and the holder of the bond includes this same amount in income. For example, if a corporation issues a $1,000 25-year bond paying a $70 annual coupon for an issue price of $500, it would deduct the $90 each year over the life of the bond ($70 annual coupon plus 1/25th of the $500 original issue discount). The holder of the bond would also report $90 of income each year.

Example comparing corporate OID and ordinary bonds

Assume a 15-percent interest rate. Suppose a business wants to borrow $1 and then borrow at the end of the year to pay all interest charges for the year, and repeat this sequence each year for 30 years. Its interest payments would be 15 cents in the first year, 17.3 cents the second (15 percent interest on the outstanding balance of $1.15), and so on, and would grow exponentially, eventually equaling $8.64 in the 30th year. At the end of 30 years, the overall debt would mount up to $66.21. A total of $65.21 in interest would be paid, and deducted, over the period, but the deductions would start small and grow.

The taxpayer could achieve the same substantive result by issuing a zero-coupon bond at a price of $1 redeemable for $66.21 in 30 years. However, by using the OID bond, the taxpayer can obtain a deduction of $2.17 each year ($65.21 divided by 30). Thus, the OID bond allows larger interest deductions in early years than borrowing the same amount with ordinary loans. Conversely, the purchaser of the OID bond includes more interest in his income in early years than the purchaser of an ordinary bond.

Table 1 shows the different patterns of deductions for the issuer and income inclusion for the holder between a zero-coupon bond and borrowing with ordinary loans under present law.

TABLE 1.—COMPARISON OF INTEREST DEDUCTIONS AND INCOME INCLUSION BETWEEN BORROWING $1 WITH ZERO-COUPON BONDS AND WITH ORDINARY LOANS UNDER PRESENT LAW

[Dollars]

Year	Ordinary loans	Zero-coupon bond	Difference
1982	0.150	2.174	2.024
1983	0.173	2.174	2.001
1984	0.198	2.174	1.976
1985	0.228	2.174	1.946
1986	0.262	2.174	1.912
1987	0.302	2.174	1.872
1988	0.347	2.174	1.827
1989	0.399	2.174	1.775
1990	0.459	2.174	1.715
1991	0.528	2.174	1.646
1992	0.607	2.174	1.567
1993	0.698	2.174	1.476
1994	0.803	2.174	1.371
1995	0.923	2.174	1.251
1996	1.061	2.174	1.113
1997	1.221	2.174	0.953
1998	1.404	2.174	0.770
1999	1.614	2.174	0.560
2000	1.856	2.174	0.318
2001	2.135	2.174	0.039
2002	2.455	2.174	−0.281
2003	2.823	2.174	−0.649
2004	3.247	2.174	−1.073
2005	3.734	2.174	−1.560
2006	4.294	2.174	−2.120
2007	4.938	2.174	−2.764
2008	5.679	2.174	−3.505
2009	6.530	2.174	−4.356
2010	7.510	2.174	−5.336
2011	8.636	2.174	−6.462
Total	65.212	65.212	0
Present value (computed at 8.1 percent after-tax rate)	11.738	24.245	12.505

Assumptions

Ordinary bond: Taxpayer borrows $1 in 1981 and borrows every year to pay the interest on the outstanding indebtedness. Interest rates remain at 15 percent. All debt repaid in 2011.

Zero-coupon bond: Taxpayer issues bond for price of $1 with no coupon, maturing in 30 years at a price of $66.21 (15-percent yield to maturity).

Treatment of noncorporate OID bonds

The statutory rules do not require ratable inclusion of discount income on noncorporate bonds.

Administration Proposal

Amortization of original issue discount for purposes of computing both the interest deduction of the issuer and the income inclusion of the holder would be computed using a formula that parallels the manner in which interest would accrue through borrowing with ordinary bonds. (This is how OID bonds are treated in corporate financial statements.) The difference between the proposed rules and present law can be seen by comparing the two columns of table 1. The proposed rules would apply to bonds issued after May 3, 1982, except where a written binding commitment was made prior to May 4, 1982.

Also, noncorporate OID bonds issued after June 9, 1982, would be treated like corporate OID bonds, with exceptions for U.S. government savings bonds, tax-exempt State and local government bonds, Treasury bills and bonds issued by individuals.

May 3, 1982, and June 9, 1982, were the dates of the Treasury press releases announcing Treasury's intention to seek legislation in these areas.

Senate Finance Committee Bill

Same as Administration proposal.

Alternative Proposals

1. The effective date could be moved to January 1, 1983.
2. More liberal transition rules than those in the Finance Committee bill could be provided.

Pros and Cons

Arguments for the proposal

1. The larger deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of ordinary bonds is a substantial tax advantage to the former, an advantage that increases with the term of the bonds. There is no justification for providing a tax incentive for issuing long-term OID bonds.
2. The larger income inclusion for OID bond purchasers in early years relative to purchasers of ordinary bonds unjustifiably penalizes those who wish to take advantage of the opportunity the OID bond provides to guarantee the reinvestment of the interest payments at the bond's initial yield to maturity. Under present law, only tax-exempt borrowers, such as pension funds, can avoid this penalty.
3. There is no reason to treat holders of corporate OID bonds more harshly than holders of noncorporate OID bonds.

Argument against the proposal

A tax incentive for long-term borrowing is necessary to encourage corporations to reduce their large amounts of risky short-term borrowing.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.2	.4	.5	.7

I. Stripping of Interest Coupons from Bonds

Present Law

A purchaser of a bond or other debt instrument with coupons attached may strip the unmatured interest coupons from the bond and dispose of either the stripped interest coupons or the corpus of the bond (i.e., the right to receive the principal amounts of the bond at maturity), or both the coupons and the corpus in separate transactions. Most such transactions involve U.S. Government or agency obligations, but they may also involve tax-exempt obligations or taxable bonds issued by the private sector.

It is arguable that all of the taxpayer's basis in the debt instrument is allocated to the corpus, in which case a taxpayer who sells the corpus and retains the coupons may claim a loss on the sale of the stripped corpus equal to the difference between the amount for which he bought the debt instrument (with coupons attached) and the amount received for the corpus (without coupons). The loss, if allowable, would generally be an ordinary loss if the taxpayer is a dealer in such obligations or a bank. Otherwise, any loss allowable would be a capital loss.

For the person who buys the stripped bond, gain on any later sale, or on redemption of the stripped bond, is ordinary income to the extent of the difference between what would have been the value of the obligation with coupons attached at the time of its purchase and the actual cost of acquisition. For the purchaser of detached coupons, the coupons are a capital asset. Gain on their sale may be treated as a capital gain. However, if the coupons are redeemed, the purchaser of the coupons has ordinary income equal to the difference between the amount received on redemption of each coupon and the purchase price allocable to that coupon.

For example, assume that a broker-dealer sells a $100,000 U.S. Government 20-year coupon bond with coupons detached for $8,000 immediately after the bond is issued. The $92,000 may constitute an ordinary loss to the seller. Also, the buyer of the stripped bond who holds it until maturity will report no income until maturity, when he or she will report $92,000 of ordinary income. Thus, there is a tax deferral on $92,000 of income.

There is also a tax benefit to a purchaser of detached, unmatured interest coupons. In substance, each coupon is like an original issue discount bond, which should be subject to periodic inclusion rules (see item H above). Under present law, income is deferred until the coupon is sold or redeemed.

Administration Proposal

Under this proposal, the taxpayer who strips coupons from a bond and disposes of either the bond or the unmatured, detached coupons would be required to allocate the basis of the obligation (with coupons attached) between the retained portion and the portion disposed of in accordance with their respective fair market values. This rule would prevent an artificial loss on the sale of a stripped bond.

When either a stripped bond or detached, unmatured coupons are purchased, the purchaser would be treated as having acquired an original issue discount bond with a discount equal to the excess of the redemption price of the bond (or amount payable on the coupon) over the purchase price of the stripped bond (or detached coupon). Thus, discount income would be attributed to the stripped bond or detached coupon and taxed to the purchaser between the purchase date and the date of maturity (or due date of the coupon) under the inclusion rule for original issue discount.

The taxpayer who strips and disposes of either the bond or the coupons would be subject to the periodic OID inclusion rules with respect to the retained portions, just as if he had purchased each of them for the amount of basis allocated to each retained portion.

The proposal would apply to transactions occurring after June 9, 1982, the date of the Treasury press release announcing its intention to propose legislation on coupon stripping.

Senate Finance Committee Bill

Same as Administration proposal.

Pros and Cons

Arguments for the proposal

1. Coupon stripping may permit income tax deferral through an artificial loss from selling the stripped bond, analogous to the deferral formerly accomplished through straddles that was eliminated by ERTA. Deferral through coupon stripping should be subject to the same policy that eliminated deferral through straddles.

2. Allocating the entire cost of an obligation with interest coupons to the corpus when a stripped bond or interest coupons are disposed of is economically unrealistic.

3. Upon disposition of the stripped bond or the detached, unmatured coupons, both the retained portion and the portion disposed of represent the right to a fixed amount payable at a future date that is purchased at a discount. The periodic OID inclusion rules applicable to obligations issued at a discount provide the appropriate tax treatment.

Argument against the proposal

The proposed rules would be somewhat more complicated than current law for persons desiring to purchase stripped bonds and unmatured interest coupons.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.1	.1	.1	.2

J. Medicare Tax on Federal Employees

Present Law

The Federal Insurance Contributions Act (FICA) imposes two employment taxes on employers and employees—a "social security" tax and a "hospital insurance" tax. The two FICA taxes are imposed on wages paid for employment, and both taxes are imposed at rates which are the same for both employer and employee. The amount of wages taxable for a calendar year is subject to a limit ($32,400 for 1982) which is adjusted each year to reflect the increase in average wage levels.

Revenues from the hospital insurance FICA tax are deposited into the Hospital Insurance Trust Fund and finance the costs of hospital and related post-hospital services (Part A of Medicare) incurred by beneficiaries as provided for in the Social Security Act. This tax is imposed at the rate of 1.3 percent of wages received from employment during the calendar years 1982–1984, 1.35 percent of wages received during 1985, and 1.45 percent of wages received after December 31, 1985.

Entitlement to Part A Medicare benefits for the vast majority of workers currently reaching age 65 is based on eligibility for monthly retirement or survivor benefits under social security or the railroad retirement system. Entitlement also applies to certain disabled workers under age 65 and certain workers with end-stage renal disease.

In general, wages from all kinds of employment are subject to FICA taxes. However, certain types of employment or trades or businesses are exempt from social security coverage. Wages paid to individuals employed by the United States or any instrumentality of the United States, other than members of the uniformed services, are generally exempt from FICA taxes if (1) the employment comes under a retirement system established by a law of the United States, (2) the service is performed for certain U.S. instrumentalities that were exempt from tax in 1950 and that have established a retirement system, or (3) the service is performed by certain individuals or groups.

Administration Proposal

Beginning in 1983, Federal employees would begin paying the Hospital Insurance (HI) portion of FICA taxes. Federal employees who reach age 65, suffer from end-stage renal disease, or become disabled would earn coverage for, and become entitled to, Medicare after paying taxes for the same number of years (usually 10) as is required of other employees. Federal employees would not earn coverage for social security cash benefits through payment of this

HI tax, but could, as at present, earn such coverage through another source of employment.

The Administration proposal includes a transitional provision for Federal employees who are age 56 or above on January 1, 1983, and who otherwise may not earn coverage sufficient to qualify for Medicare at age 65. This provision would require these employees to work and pay the HI tax each year beginning in 1983 but only up to age 65. Federal employees who become disabled would be required to meet the same disability criteria imposed on applicants for social security disability cash benefits. Spouses of Federal employees would be covered for the hospital insurance part of Medicare under the normal criteria contained in title II of the Social Security Act: a spouse who is over age 65 would be entitled to HI based on the Federal employee's coverage status.

Senate Finance Committee Bill

Same as Administration proposal.

Pros and Cons

Arguments for the proposal

1. Approximately 80 percent of retired Federal workers aged 65 or older are already covered by Medicare because of other employment during their working lives covered by social security, or because of their status as a spouse of a covered worker. Yet, these workers pay much less into the Medicare trust fund than other Medicare beneficiaries, who typically contribute to the trust fund during their entire working lives.
2. The proposal would increase the income of the HI Trust Fund.

Argument against the proposal

1. Take-home pay of Federal workers has been adversely affected by limitations on pay raises and dramatic increases in health plan premiums. Under these circumstances, it would be unfair to adopt another policy reducing their take-home pay. The reduction in take-home pay would also interfere with the Federal Government's ability to attract qualified workers.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.6	.8	.9	1.1	1.2

Note.—Medicare trust fund receipts would be increased by double these amounts because the Federal Government would make a matching employer contribution which would not affect unified budget receipts.

Outlays would be decreased by approximately $0.1 billion in fiscal year 1983, and $0.2 billion in each of fiscal years 1984 through 1987; these are offsetting receipts attributable to the employer contributions of the Postal Service.

K. Airport and Airway Trust Fund Taxes

Present and Prior Law

Present law

Since October 1, 1980, when aviation excise taxes either expired or were reduced and the transfer of aviation excise tax revenues to the Airport and Airway Trust Fund ceased, a tax on air passenger tickets has been imposed at the pre-trust fund rate of 5 percent, and the revenues have been going into the general fund. In addition, the revenues from a 4-cents-per-gallon tax on noncommercial (general) aviation gasoline and taxes on aircraft tires and tubes currently go into the Highway Trust Fund.

Currently, there are no aviation excise taxes on air freight, international departures, nongasoline aviation fuels, or aircraft use.

Prior law

During the period from July 1, 1970 through September 30, 1980, the Airport and Airway Trust Fund was financed by the receipts from several aviation excise taxes. The tax on domestic air passenger tickets was 8 percent; the tax on air freight was 5 percent; the international departure tax was $3 per person; and the fuels tax for noncommercial aviation was 7 cents per gallon (for gasoline and nongasoline). Also, there was an annual aircraft use tax, and there were taxes on aircraft tires and tubes.

Administration Proposal

Under the Administration proposal, the Airport and Airway Trust Fund excise taxes would be reinstated generally at the prior law levels, except that fuels tax rates for noncommercial aviation would be higher then prior law levels.

The Administration proposal would make the following permanent changes: increase the air passenger ticket tax from 5 percent to 8 percent; reinstate the 5-percent air freight waybill and $3 international departure taxes; and increase the fuels taxes for noncommercial aviation to 12 cents per gallon for gasoline and 14 cents per gallon for nongasoline (e.g., jet) fuels. Further, the fuels tax rates would each increase by 2 cents per gallon on October 1, in 1983 and each of the following three years, until reaching 20 cents per gallon for gasoline and 22 cents per gallon for nongasoline fuels in fiscal year 1987 and thereafter. The prior law aircraft use tax would not be reinstated.

Revenues from these aviation excise taxes and the existing taxes on aircraft tires and tubes would be transferred to the Airport and Airway Trust Fund on a permanent basis.

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Senate Finance Committee Bill

The following aviation excise taxes would be designated for the Airport and Airway Trust Fund on a permanent basis, beginning September 1, 1982: (1) an 8-percent air passenger ticket tax; (2) a 12-cents-per-gallon tax on noncommercial aviation gasoline; (3) a 14-cents-per-gallon tax on nongasoline fuels for noncommercial aviation; (4) a 5-percent air freight waybill tax; (5) a $3 per person international departure ticket tax; and (6) amounts equal to revenues from the present taxes on aircraft tires and tubes. The prior law aircraft use tax would not be reinstated. (Certain helicopters engaged in natural resources and timber operations would be exempt from the fuel taxes, where there is no use of Federal-aid airports or Federal airway facilities or services.) The tax changes would apply to tickets and to fuels purchased after August 31, 1982.

In addition, the Finance Committee bill contains a separate provision (title IV) regarding the Airport and Airway System Development Act which would: (1) authorize expenditures for certain capital improvements to airports; (2) authorize certain expenditures for Federal Aviation Administration programs; (3) establish a State block grant program; (4) require the Secretary of Transportation to study an airport defederalization program; and (5) permit airports to voluntarily withdraw from the Federal airport improvement program. The Airport and Airway Trust Fund programs would be authorized for fiscal years 1982–1987.

Ways and Means Committee Bill (H.R. 4800)

As reported by the Committee on Ways and Means, H.R. 4800 would extend and reinstate the aviation excise taxes and would transfer revenues from those taxes to the Airport and Airway Trust Fund, during the period from July 1, 1982 through December 31, 1983. Trust Fund revenues would be available for the purposes specified in H.R. 2643, as reported by the House Committee on Public Works and Transportation.[1]

Under H.R. 4800, the air passenger ticket tax would continue at its present 5-percent rate and the air freight waybill tax would be reinstated at its prior rate of 5 percent. The international departure tax would be reinstated at a rate of $5 per person. The fuels tax for noncommercial (general) aviation would be imposed at 12 cents per gallon for both gasoline and jet fuel and the airport tire and tube taxes would continue as under present law. The prior law aircraft use tax would not be reinstated.

(Table 2 following gives a comparison of aviation excise taxes and rates under present and prior law, H.R. 4800, the Administration proposal, and the Finance Committee bill.)

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[1] H.R. 2643 would provide Airport and Airway Trust Fund authorizations through fiscal year 1983.

TABLE 2.—COMPARISON OF AVIATION EXCISE TAXES UNDER PRESENT AND PRIOR LAW, H.R. 4800, ADMINISTRATION PROPOSAL, AND SENATE FINANCE COMMITTEE BILL

Tax	Present law rates	Prior trust fund rates (July 1970–Sept. 1980)	H.R. 4800—Ways and Means Bill [1]	Administration proposal [2]	Finance Committee bill (H.R. 4961)
Air passenger ticket tax	5 percent	8 percent	5 percent	8 percent	8 percent.
Air freight waybill tax	None	5 percent	5 percent	5 percent	5 percent.
International departure tax.	None	\$3/person	\$5/person	\$3/person	\$3/person.
Fuels tax for noncommercial (general) aviation:					
Gasoline	4 cents/gal.	7 cents/gal.	12 cents/gal.	12 to 20 cents/gal. [3]	12 cents/gal. [6]
Nongasoline (jet fuel, etc.).	None	7 cents/gal.	12 cents/gal.	14 to 22 cents/gal. [3]	14 cents/gal. [6]
Aircraft use tax	None	(4)	None	None	None.
Aircraft tires and tubes taxes.	(5)	(5)	(5)	(5)	(5).

[1] Except for the 5-percent ticket tax (which is a continuation of present law), the tax rates under H.R. 4800 would apply from July 1, 1982 through December 31, 1983. Transfers of aviation tax revenues to the Trust Fund would apply to revenues received from July 1, 1982–December 31, 1983.

[2] The new tax rates and transfers to the Airport and Airway Trust Fund would be effective on July 1, 1982 (with no expiration date).

[3] The gasoline tax rate would be 12 cents/gallon for fiscal years 1982 and 1983, increasing by 2 cents/gallon annually to 20 cents in fiscal year 1987 and thereafter. For non-gasoline, the tax rate would be 14 cents/gallon in 1982 and 1983, increasing 2 cents/gallon annually to 22 cents in fiscal year 1987 and thereafter.

[4] An annual use tax of two parts: (1) a \$25 per plane tax, plus (2) a weight tax of 3½ cents/pound for turbine-powered (jet) aircraft or 2 cents/pound for nonturbine-powered aircraft for each pound in excess of 2,500 pounds of maximum certificated takeoff weight.

[5] Taxed at the general rates for nonhighway tires (5 cents/pound before Jan. 1, 1981, and 4.875 cents/pound thereafter) and inner tubes (10 cents/pound).

[6] Helicopters used in timber and natural resource operations would be exempt from the fuels taxes where the helicopter does not make use of airports eligible for Federal aid or of other Federal airway facilities or services.

Pros and Cons

Arguments for the proposals

1. The airport and airway system costs should be financed primarily by, and the costs distributed fairly among, the direct beneficiaries of the system, rather than by the general taxpayer. Thus, the aviation user taxes should be sufficient to finance airport and airway system costs.

2. The aviation excise taxes should be dedicated to the Airport and Airway Trust Fund in order to make sure the revenues are used for airport and airway purposes rather than general purposes.

3. General aviation users should pay a share of the system costs more commensurate with their use of the system. The prior law tax level (4 cents per gallon) is an insufficient share and should therefore be increased.

Arguments against the proposals

1. An air passenger ticket tax above 5 percent is too high at the present time because the existing trust fund uncommitted balance would be sufficient to finance trust fund expenditures in the near term.

2. An increase in the air passenger ticket tax at this time would harm the airline industry and would be unfair because commercial airline passengers already pay more than their share of the system's expense.

3. The 12-cent per gallon (or higher) tax rate for noncommercial aviation fuels would be too high and would unduly burden general aviation operations.

Revenue Effect

[Fiscal years, billions of dollars] [1]

Item	1983	1984	1985	1986	1987
Administration proposal[2]	.8	1.0	1.1	1.3	1.4
Senate Finance bill[3]	.8	1.0	1.1	1.2	1.4
Ways and Means Committee bill (H.R. 4800)[4]	.3	.1			

[1] Net increase in budget receipts over present law taxes.

[2] Under the Administration proposal, the tax increases would have been effective on July 1, 1982, and would be permanent.

[3] The increases and reimposition of aviation excise taxes would be effective on September 1, 1982, and would be permanent.

[4] The additional aviation taxes over present law would be effective for July 1, 1982 through Dec. 31, 1983.

L. Withholding on Interest and Dividends

Present Law

Present law requires information reporting for payments of most types of interest and dividends but does not require withholding on such payments, except in the case of payments to certain foreign persons. Among the types of payments for which there are no information reporting requirements are payments of interest on bearer obligations, unless received and paid over by nominees.

Administration Proposal

Overview

The Administration proposes withholding on dividend and interest payments at a flat 5-percent rate, beginning on January 1, 1983. Generally, the proposal would require withholding on payments by commercial and financial institutions and similar organizations to individuals, partnerships, and certain trusts, in generally the same manner that tax is withheld on wages, except that the withholding on dividends and interest would at a flat rate. Payments to corporations, including regulated investment companies (e.g., mutual funds), would not be subject to withholding; thus, intercorporate dividends and most commercial or financial transactions would be unaffected. Interest payments made by individuals, generally, would not be subject to withholding.

In addition, the Administration proposal would extend the information reporting requirements to any payments to noncorporate recipients of taxable interest or accruals of original issue discount on all debt obligations of the sort generally offered to the public.

Recipients of taxable interest, original issue discount, or dividends would be required to attach to their income tax returns statements received from payors, showing the amount of the taxable item and the amount of tax withheld, just as is currently required for wage statements (W-2s) received by employees. Individuals making estimated tax payments could reduce their estimated tax payments by an amount equal to the withholding credit to which they would be entitled as of the payment date. Because of liberalizations on the wage withholding rules enacted in ERTA, individual wage earners would be able to adjust their withholding allowances to reflect some or all of the amount of taxes which would be withheld from their dividend and interest income.

Time of withholding

In general, withholding would occur when the taxable interest or dividend would be includible in the gross income of the taxpayer.

In the case of cash payments, withholding would occur when the payment is made. In the case of constructive payments, withholding would occur at the time of constructive receipt.

Special rules would be provided under the Administrtion proposal for payments of interest on accounts with depository institutions. Ordinarily, withholding would occur when an amount is posted to the account; however, an option would be provided for depository institutions to withhold from passbook accounts, interest bearing checking accounts and similar accounts on an annual basis. The withholding would be accelerated if an account were to be closed, and the account could not be reduced beyond its accrued withholding obligation.

Exemptions from withholding

Under the Administration proposal, payments made to two classes of recipients would be exempt from withholding. First, taxable dividend and interest payments made to corporate recipients would not be subject to withholding. These corporate recipients would, however, withhold from any further distributions of dividends or interest to non-exempt persons.

Second, exemptions from withholding would be provided for payments made to certain persons who file exemption certificates with the payor. Persons eligible to file exemption certificates would include (1) individuals who had no income tax liability in the preceding taxable year and who reasonably expect to have no income tax liability for the current taxable year; (2) individuals 65 years of age or older who had tax liabilities of not more than $500 ($1,000 for married couples filing jointly) for both their prior and current taxable years (the Administration estimates that over 70 percent of all elderly persons would be exempt from withholding); (3) organizations, including State and local governments, exempt from income taxation (such as those described in sec. 501(a)); (4) noncorporate dealers in securities required to register as broker-dealers; and (5) noncorporate nominees. Individuals would not be allowed partial exemptions from withholding to reflect the $100 or $200 dividend exclusion or 15 percent net interest exclusion (effective after 1984) provisions. No withholding would be required on interest paid on All-Savers certificates or tax-exempt bonds.

Senate Finance Committee Bill

Generally, the bill would provide a limited system of withholding on payments of dividends, patronage dividends, or interest to individuals (other than certain low income and elderly individuals) at a rate of 10 percent. Withholding also would be required on payments to unincorporated entities, such as partnerships or estates, which are not themselves required to withhold on payments to individuals.

Interest subject to withholding requirement would include most interest paid by persons other than individuals, including payments by the United States and payments on bearer obligations. Dividends subject to the withholding obligation would include most of the distributions of property by a corporation to its shareholders out of its earnings and profits that are subject to information reporting under present law. Withholding also would be required on most payments of patronage dividends by cooperatives.

Exemptions would be specifically provided for (1) payments to individuals who had no tax liability in the preceding year, (2) payments to elderly persons whose tax liability was $1,500 or less ($2,500 on a joint return) in the preceding year, (3) payments on the redemption of United States savings bonds the interest on which aggregates $10 or less in any transaction, (4) payments by consumer cooperatives, (5) payments to corporations, governments, security dealers, money market funds, exempt organizations, and nominees or custodians, and (6) if the payor elects to not withhold, payments which on an annual basis would aggregate $10 or less during the calendar year.

The bill would provide that, in implementing the withholding requirements, the Treasury is to take into account the costs incurred by payors in instituting withholding and the special problems faced by small banks. Specifically, the Treasury is to structure rules for paying withheld taxes over to the Treasury taking into account start-up costs of withholding agents. Further, small banks would be exempted from the withholding requirements (except to the extent they elect, under regulations, to have all such provisions apply) until they are able to comply.

Pros and Cons

Arguments for the proposal

1. Individuals who fail to report income from interest and dividends pay less than their fair share of tax; a significantly smaller proportion of interest and dividend income is reported on tax returns than of wage and salary income. Recovering such lost tax revenues through withholding on interest and dividends would be both an efficient and equitable step to take.

2. Recipients of interest and dividends should pay their taxes with no less certainty than persons who receive wages that are subject to withholding, and those taxes should be paid just as promptly.

3. The failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system and reduces the extent of voluntary compliance. Experience has shown that withholding is the most effective method to improve compliance in the reporting of income.

4. The proposed withholding system would be integrated with the payor's existing accounting and information reporting system. This would minimize inconvenience and expense to payors.

5. Withholding would be less intrusive in the affairs of payors and payees than the vigorous program of enforcement in connection with the information returns program that would be necessary to obtain comparable compliance levels without withholding.

Arguments against the proposal

1. Withholding a portion of dividend and interest income could drive funds away from corporate equities, bonds, and other savings mechanisms.

2. Witholding would lower the real rate of return on some investments by denying investors the use of withheld funds. This could make investments less attractive.

3. Withholding would increase operating cost and paperwork burdens on savings institutions.

4. Compliance on interest and dividends would be enhanced by improving the information reporting system.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
a. Administration proposal	2.3	2.0	2.4	2.9	3.4
b. Senate Finance bill	4.3	3.6	4.1	4.7	5.3

II. AREAS ADDRESSED BY ADMINISTRATION-ENDORSED PROPOSALS

A. Compliance

Present Law and Background

The internal revenue laws impose income taxes on individuals, estates, trusts, corporations, and other organizations. These taxes are levied and collected under a system of self-assessment which requires taxpayers to file returns reporting income, losses, deductions, credits, and other information necessary to compute their tax liability. This system covers foreign as well as domestic transactions.

To assure compliance with the self-assessment system, the tax law imposes a variety of requirements both on taxpayers and on other persons. These include minimum filing requirements, recordkeeping requirements, withholding tax requirements, estimated tax payment requirements, and information reporting requirements. Taxpayers who fail to pay or who underpay their tax are subject to interest charges and may incur penalties. Similarly, failure to file required information returns and statements may result in imposition of penalties. The tax law also provides administrative and judicial rules relating to the examination, assessment, and collection of taxes.

Currently, the Internal Revenue Service estimates that, under present law, the revenue loss resulting from noncompliance may be approximately $95 billion in 1981. The Internal Revenue Service projects a compliance gap of approximately $133 billion in 1985 absent any change in the tax laws or the current level of enforcement funding. The preliminary data shows underpayments of $91 billion by individuals (including $8 billion attributable to criminal activities) and $4 billion by corporations.

Of the $83 billion estimated underpayment by individuals engaged in legal activities, $66 billion results from underreporting of income, $12 billion from overstatement of deductions, credits, and exemptions, and $5 billion from failures to file tax returns. At the present time, the Internal Revenue Service has no estimate of the extent of the tax gap attributable to taxpayers owning overseas businesses or investments. One of the principal reasons for this has been its inability to examine adequately the books and records of many offshore enterprises. This is particularly true for businesses operating in tax haven countries.

Compliance rates by selected income sources according to Internal Revenue Service preliminary estimates are shown in table 3 below.

TABLE 3.—IRS ESTIMATES OF TAX COMPLIANCE RATES, SELECTED INCOME SOURCES, 1981 (PRELIMINARY)

[In percent]

Source		Source	
Wages	99	Pensions	80
Farm business	92	Nonfarm business	80
Interest	89	Capital gains	56
Dividends	85	Tip income	16
State tax refunds	81	Illegal income	5

TABLE 4.—PRELIMINARY IRS ESTIMATES OF GROSS TAX GAP FROM INDIVIDUAL INCOME TAX RETURNS FILED, NONFILERS, CORPORATE TAX AND ILLEGAL SECTOR, TAX YEARS 1976 AND 1981

[In billions of dollars]

Item	Amount of tax gap	
	1981	1976
Legal sector, total	87.2	42.6
Individual income tax returns, total	83.3	39.0
Filed returns, total	78.4	36.8
Income underreported:		
Wages	2.5	.7
Tips	2.3	1.4
Dividends	3.6	1.5
Interest	4.1	1.3
Capital gains	9.1	5.1
Nonfarm business	26.2	11.6
Farm business	1.4	1.7
Pensions	2.8	1.1
Rents	1.5	.6
Royalties	1.3	.4
Partnerships	5.5	2.5
Estates and trusts	.5	.3
Small business corporations	1.7	1.2
State income tax refunds	.4	.1
Alimony	.1	*
Other	3.1	1.0
Total underreported income items	66.1	30.6
Overstated expenses, deductions, and credits	12.3	6.2
Nonfilers	4.9	2.2
Corporate tax	3.9	3.6
Illegal sector, total [1]	6.1–9.8	2.5–4.0
Drugs	4.5–8.1	1.4–2.7
Gambling	0.6–1.2	0.4–0.7
Prostitution	0.4–1.2	0.3–1.0

Note: Details may not add to totals because of rounding.
* Less than one hundred million.
[1] Total of three items below and does not include any other illegal activities.

Senate Finance Committee Bill

Under the bill, compliance with the income tax laws would be improved by adopting a number of new provisions to address specific tax compliance challenges.

a. Amendments to the Internal Revenue Code

(1) Information reporting

The current information reporting system would be improved by providing the Internal Revenue Service and taxpayers with additional and more accurate information.

Reporting with respect to interest would be improved by requiring registration of most long-term debt obligations and by requiring reporting of payments of interest (including original issue discount) on bearer bonds, Federal debt obligations and certain other obligations. Information reporting would also be required on securities and commodities transactions effected through brokers (including barter exchanges), transactions involving independent contractors and direct sellers, and State and local tax refunds.

Large food and beverage establishments whose employees customarily receive tip income would be required to allocate an amount equal to 7 percent of their gross food or beverage receipts among their employees for reporting purposes. Employees would be permitted to report lower amounts on the basis of adequate records. The Internal Revenue Service would be allowed to prove that an employee had received higher amounts of tip income. Employers would also be required to report their gross receipts, gross charge receipts, and the aggregate of all charged tips to the Internal Revenue Service.

The quality of information received would be improved by increasing the penalties upon persons who fail to comply with information reporting requirements and by imposing withholding on persons who fail to supply their taxpayer identification numbers or who supply incorrect numbers.

(2) Voluntary withholding on pension and annuity payments

Compliance with respect to pension and annuity payments would be strengthened through improved recordkeeping and reporting. The voluntary withholding system on annuities under pension plans and commercial annuity arrangements would be modified to require withholding on annuities, under the wage withholding rules, unless the taxpayer elected out on an annual basis. No withholding would be required on any annuity of less than $5,400 a year. In addition, mandatory withholding on lump sum distributions would be instituted except when the distribution is rolled over into another plan. Withholding would be required at a 10-percent rate on other benefit payments under pension plans and annuity arrangements unless the payee elects out.

(3) Penalties

Penalties for filing frivolous tax returns and for extended failures to file returns would be imposed. Persons who aid or abet others in the violation of tax laws or who cause others to file false returns would be subject to a new penalty. Certain taxpayers who have substantially underreported their tax liability would be penalized. A penalty would be imposed and injunctive relief allowed against advisers and promoters who commit fraud or provide a substantial overvaluation overstatement with respect to a deduction or credit.

(4) Interest

The rules relating to computation of interest under the tax laws would be amended to require compound (rather than simple) interest, to limit interest on certain loss and credit carrybacks and on delinquent returns, and to adjust the rate of interest semi-annually based upon an average prime interest rate.

(5) Foreign transactions and taxpayers

Compliance with respect to tax liability arising from foreign activities would be improved through provisions designed to permit simplification of returns and information statements on such activities, and to strengthen the penalties for failure to supply information and to file required returns and statements. Withholding would be imposed under the Foreign Investment in Real Property Tax Act.

(6) Administrative summonses

Taxpayers seeking to challenge an Internal Revenue Service summons to a third-party recordkeeper would be required to petition a court to quash the summons. A "bright-line" rule would be provided with respect to the use of administrative summonses in civil tax cases with criminal aspects.

(7) Independent contractors

The bill would include provisions for information reporting with respect to payments of remuneration for services and certain direct sellers.[1]

b. Internal Revenue Service funding

A sense of the Congress resolution would express the view that additional funds should be appropriated for Internal Revenue Service enforcement personnel.

Additional Provisions in H.R. 6300

(1) Jeopardy assessments

The collection of tax could be explicitly presumed to be in jeopardy when the taxpayer is engaged in an illegal activity or when large amounts of cash or its equivalent have no readily ascertainable owner.

[1] The Finance Committee bill also would establish a safe-harbor test for classification as an independent contractor for Federal employment tax purposes, would provide for reduction of certain employment tax liabilities when workers are reclassified as employees, and would extend jurisdiction of the U.S. Tax Court to include reclassification employment tax issues.

(2) Cash transaction reporting

Criminal penalties could be imposed on attempts to transport monetary instruments in or out of the United States in violation of the Bank Secrecy Act.

(3) Fraud penalty

The penalty on fraudulent underpayment of tax could be increased by adding a time-sensitive element.

(4) Casualty insurance reimbursement

Information reporting could be imposed on casualty insurance reimbursements in excess of $600.

(5) Voluntary pension withholding

Proposals similar to the Finance Committee bill could be adopted, with modifications so that (1) an election not to have withholding on annuities once made would remain in effect until revoked; (2) an election-out on lump-sum distributions would be permitted for any reason; (3) no exception would be provided for small pensions; and (4) withholding on annuities would not begin until April 1983.

(6) Penalty on early distributions from IRAs

The 10-percent excise tax on certain early distributions from individual retirement accounts from accumulated deductible employee contributions or from H.R. 10 plans could be increased to 15 percent.

(7) Foreign books and records

Rules could be provided governing the admissibility in civil litigation concerning tax liabilities of foreign books and records which the taxpayer has refused to provide during the administrative process. Additional rules could be provided to assure access to records related to foreign transactions.

(8) Partnership audits

The resolution of income tax issues arising with respect to partnerships and subchapter S corporations could be simplified by providing for a single administrative and a single judicial proceeding.

Additional Possible Proposals

(1) Mandatory pension withholding

Mandatory withholding could be imposed on all pension and other annuity distributions, under a system similar to withholding on wages. Thus, as in the case of withholding, no tax would be withheld on payments of $7,400 a year or less made to a couple 65 years of age or older. Similarly, pensioners who owed no tax in the prior year and who expect to owe no tax for the current year could claim exemption from withholding. If a person failed to file an exemption certificate, he could be presumed to have claimed one withholding exemption.

(2) Estimated tax penalty reform

The exceptions to the estimated tax penalty based on prior year's liability could be made available to taxpayers who had no liability in the prior year.

(3) Reporting on capital gains

The provisions requiring reporting by brokers could be expanded specifically to require reporting of large transactions with respect to nonproductive capital assets.

(4) Reporting of prior year losses, etc.

Reporting of profits or losses for the prior three years could be required on each return for an individual's trade or business. Similarly, information on payments to family members could be required. Finally, if a direct seller showed a loss for two years in a row, it could be presumed that his or her activity is not engaged in for profit.

(5) Withholding on payments to independent contractors

Tax could be withheld, at a flat rate of 10 percent, from payments made in the course of a payor's trade or business to certain independent contractors. For administrative convenience, there could be an exception for payments to individuals who provide services for multiple (more than five) payors.

(6) Partnership audit of windfall profit tax items

The resolution of windfall profit tax issues arising with respect to oil produced by partnerships could be simplified by providing for a single administrative and a single judicial proceeding.

Pros and Cons

Arguments for the proposals

1. The taxes of complying taxpayers should not be raised to make up for the revenue shortfall which would result in the absence of every reasonable effort to assure collection of the taxes already imposed and owing under the law.

2. The rate of voluntary compliance with the income tax laws has declined steadily in recent years. Failure to adopt limited solutions currently may require extension mandatory withholding to non-wage payments.

3. Wage earners have a high rate of compliance because they are subject to withholding. Compliance by other taxpayers must be improved to assure that the tax burden is equitably shared by all.

4. The information reporting system has not been significantly revised since 1962. The advances in information processing technology since that time justify strengthening the information reporting system.

5. The voluntary self-assessment system depends on taxpayer perceptions that the system is fair and effective. Widespread noncompliance undermines this perception. However, an increase in Internal Revenue Service funds for enforcement would help assure

taxpayers that the system has the resources to be fairly and effectively administered.

6. The penalties on tax shelters and the improvement in compliance generally resulting from the proposals would encourage taxpayers to invest in more productive activities rather than in activities that primarily provide an opportunity for tax avoidance or evasion.

7. The information reporting provisions would assure that taxpayers are informed of items includible in income, thereby increasing compliance.

Arguments against the proposals

1. The compliance proposals, taken as a whole, could create an atmosphere of suspicion and distrust between the Internal Revenue Service and taxpayers.

2. A more effective approach to improving voluntary compliance would be to simplify the tax laws and to make them more equitable.

3. Several of the proposed provisions (such as the penalty for frivolous returns, the presumptions of jeopardy, and the use of administrative summonses in cases with criminal aspects) may raise questions of fairness and due process which deserve careful scrutiny.

4. The increased paperwork and compliance costs associated with information reporting would adversely affect third parties not responsible for noncompliance by shifting to them the costs of compliance.

Revenue Effect

The revenue effect would depend on the details of the proposal. The following table shows the estimated revenue effect of H.R. 6300 (the Tax Compliance Act of 1982) and the Senate Finance bill.

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
a. H.R. 6300 [1]	2.0	3.5	4.7	5.8	6.5
b. Senate Finance bill [1]	2.4	3.6	4.8	5.7	6.1
c. 10% withholding on independent contractors [2]	.6	.7	1.0	1.2	1.3

[1] Estimate shown does not include effect of proposals to increase funding of Internal Revenue Service.

[2] Estimates do not take into account interaction with information reporting requirements of above proposals.

B. Income Tax Proposals Primarily Affecting Individuals

1. Tax-Qualified Pension Plans

a. Limits on contributions and benefits under qualified plans

Present Law

Overall limits

Present law provides special tax treatment for employers who maintain tax-qualified pension, profit-sharing, and stock bonus plans, and for employees who are covered by these plans. Generally, (1) employer contributions are deductible (within limits) when made; (2) employees are not taxed on plan benefits until those benefits are distributed; (3) a trust which meets the qualification rules is tax-exempt; (4) 10-year forward income averaging and capital gains treatment are provided for lump sum distributions of benefits; and (5) estate and gift tax exclusions are provided.

Under the qualification rules for defined contribution plans (e.g., profit-sharing plans), the annual addition with respect to each plan participant (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) is limited to the lesser of 25 percent of compensation for the year, or $25,000 adjusted for inflation according to increases in the consumer price index (CPI) since 1974 ($45,475 for 1982).

Under a defined benefit pension plan, the annual benefit derived from employer contributions is generally subject to an overall limit of the lesser of (1) 100 percent of average compensation for the highest-paid three consecutive years or (2) $75,000, adjusted for inflation (CPI) since 1974 ($136,425 for 1982). The annual benefit is the equivalent of a retirement benefit for the life of the employee, without regard to certain survivor benefits. If the retirement benefit begins before age 55, the annual limit of $136,425 (for 1982) is reduced to the actuarial equivalent of an annual benefit of $136,425 (for 1982) beginning at age 55.

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit of 1.4 under the qualification rules (computed on a cumulative basis to give credit for prior years in which the limit was not reached). For example, if the annual additions under a defined contribution plan are 5/10ths of the maximum amount of permitted annual additions (giving credit for prior years in which the limit was not reached), then the annual benefit earned under the defined benefit plan cannot exceed 9/10ths of the defined benefit limit for the year.

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Special limits for plans of self-employed individuals

Annual deductible contributions to a profit-sharing or other defined contribution plan which benefits a self-employed individual (an H.R. 10 plan) are limited to the lesser of $15,000 or 15 percent of net self-employment earnings. The 15-percent rate corresponds to 17.6 percent of net earnings after the contribution is taken into account. For a defined benefit H.R. 10 pension plan, a special schedule limits benefit accruals to correspond to the defined contribution limit. The same or equivalent contribution and benefit limits apply to plans of subchapter S corporations and employer contributions to simplified employee pensions (SEPs).

Retirement plans of incorporated professionals are subject to the same limits that apply to other corporate plans (e.g., for a profit-sharing plan, 1982 annual additions are limited to the lesser of 25 percent of compensation or $45,475).

Senate Finance Committee Bill

Overall limits

The bill would (1) reduce the overall limits to $30,000 (defined contribution plans) and $90,000 (defined benefit plans); (2) adjust the limits for post-1984 inflation (beginning in 1986) based upon the social security benefit cost-of-living index then in effect; (3) preclude an employer from anticipating cost-of-living increases to the $90,000 limit for deduction purposes; (4) require that the $90,000 limit be actuarially reduced if benefits begin before age 62 (rather than age 55); (5) reduce the aggregate limit for an employee participating in both a defined contribution and a defined benefit plan from 1.4 to the lesser of 1.25 (as applied only to the dollar limits) or 1.4 (as under present law); and (6) require that an interest rate assumption of at least 5 percent be used to determine whether benefits paid in a form other than a life annuity or before age 62 satisfy the $90,000 limit. The revisions generally would be effective for years beginning after December 31, 1982.

Special limits for plans of self-employed individuals

The bill would increase the contribution limit for H.R. 10 plans from $15,000 to $20,000 in 1983, $25,000 in 1984, and $30,000 in 1985. In addition, beginning in 1986, the H.R. 10 plan limits would be adjusted for cost-of-living increases on the same basis as the overall limits.

Possible Alternative Proposals

1. The aggregate 1.4 limit for an employee who participates in both a defined benefit plan and a defined contribution plan could generally be reduced to the lesser of 1.0 (as applied only to the dollar limits) or 1.4 (as under present law). However, an employee could be permitted aggregate benefits (based only on the dollar limits) in excess of the 1.0 limit (but not in excess of 1.25) if the plans meet certain additional requirements with respect to the rank-and-file employees.

2. Employer deductions for post-retirement medical benefits could be limited.

Pros and Cons

Arguments for the proposals

1. The present-law limits on tax-favored retirement savings are too generous. High income individuals affected by the proposed reductions in the limits can afford to provide for a portion of their retirement needs without a tax benefit (e.g., additional benefits can be provided under unfunded plans which receive no tax subsidy). A tax incentive of the magnitude of the present-law limits is unnecessary.
2. Although it may be desirable to provide a cost-of-living adjustment to the limits, it is not necessary to provide the present level of adjustment which has caused the dollar limits to grow to more than 180 percent of the original limits set in 1974.
3. The proposal would raise significant revenues without decreasing the tax incentive of most employers to provide pension benefits. Reductions would be required for only a small percentage of plan participants.
4. The proposal would reduce the difference between the limits for plans of corporate employers and those for self-employed individuals. This would reduce the incentive for partnerships and sole proprietors to incorporate solely to take advantage of the higher limits.
5. Requiring that the $90,000 benefit limit be reduced if benefits commence before age 62 would be consistent with current retirement policy to encourage later retirement and with most private and public retirement systems that require actuarial reduction upon early retirement.
6. Requiring actuarial reductions in the $90,000 benefit limit would preclude setting of an artificially early retirement age merely to accelerate deductions for pension plan contributions.

Arguments against the proposals

1. Any reduction in the present-law limits is not justified because these limits represent no more than inflation-adjusted limits which were acceptable in 1974 when ERISA was enacted.
2. The reduction of the present-law limits would reduce the incentive for employers to maintain a pension plan and thus could lead to plan terminations and benefit cuts for rank-and-file employees.
3. The proposals would require employers to undertake the expense of amending their plans.
4. If overall limits on contributions and benefits are reduced, it is inappropriate to limit cost-of-living adjustments designed to prevent further reductions caused by inflation. Periodic Congressional action designed to permit increases would not permit adequate advance funding because some plans would require time to fund for the higher benefit levels.
5. Reduction of the present-law limit would encourage more employers to provide benefits through nonqualified, unfunded plans which are not subject to ERISA provisions requiring vesting and nondiscriminatory coverage and benefits.

6. If the proposal for increasing the limits for H.R. 10 plans is adopted, highly paid individuals who participate in such plans would be given a tax cut by the bill.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Senate Finance bill [1]	0.2	0.6	0.7	0.8	0.8

[1] Includes effect of restrictions on loans described in next section.

b. Loans to plan participants

Present Law

A qualified plan, including a plan with a cash or deferred arrangement, generally is permitted to lend to a participant if certain requirements are met. 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. However, an H.R. 10 plan is not permitted to lend to a self-employed individual whose ownership interest exceeds 10 percent, and a subchapter S corporation's plan is not permitted to lend to a shareholder-employee owning more than 5 percent of the corporation's stock. Also, if a self-employed individual participating in an H.R. 10 plan borrows from the plan or pledges an interest in the plan as security for a loan, the transaction is treated as a plan distribution, and the usual tax rules for distributions apply. Loans are also permitted under tax-sheltered annuity programs.

Senate Finance Committee Bill

Under the bill, amounts borrowed by a participant under tax-qualified pension, etc., plans and tax-sheltered annuities are treated as distributed to the participant to the extent that the sum of the participant's outstanding loan balances exceeds $10,000. The bill would apply to loans made after July 1, 1982. A loan outstanding on July 1, 1982 which is renegotiated, extended, renewed, or revised after that date would be treated as made on the date of the renegotiation, etc. Reporting requirements are also provided.

Possible Alternative Proposals

1. Plan loans or pledges used for specified purposes (e.g., mortgages, education, etc.) could be treated as distributions only to the extent that the participant's outstanding balance attributable to these special purpose loans, when added to other plan loans, exceeds $20,000. Alternatively, loans used for specified purposes could be exempt from any limitations.

2. All loans made to key employees (i.e., officers, directors, and those owning an interest in the employer) and loans in excess of a specified amount made to non-key employees could be treated as distributions.

Pros and Cons

Arguments for the proposals

1. Under present law, many individuals make deductible contributions of their income to a plan and then borrow back the contribution, thus receiving their income tax-free and further benefiting from interest deductions associated with the repayment of the loan and from possible estate tax deductions and exclusions. In this situation, pension plans are simply a device for improperly avoiding tax liability.
2. Restricting loans and pledges under qualified plans would improve the likelihood that amounts contributed to retirement plans will be used for retirement.
3. Restricting loans to key employees would curb the use of pension plans as tax shelters that are not intended to be used for retirement.

Arguments against the proposals

1. The proposals could disrupt financial plans of people who made plan contributions and expected to borrow back the funds.
2. Any proposal which limits individuals' access to plan assets will make them more reluctant to make plan contributions, and thus could decrease retirement security and aggregate savings.

c. Integration with social security

Present Law

Overview

A retirement plan does not qualify for special tax treatment unless it satisfies rules designed to assure coverage of either a significant part of the employer's work force or a classification of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. In addition, with respect to the group of employees actually covered by a plan, the plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated by providing them with contributions or benefits which are a higher percentage of their pay than the contributions or benefits provided for other employees.

Integration of defined benefit pension plans

Under present law, in determining whether pension plan benefits, as a percentage of pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits considered paid for by the employer may be taken into account. If these social security benefits and the employer-provided benefits under the plan, when added together, do not provide an aggregate pension which is a higher percentage of pay for highly compensated employees than for other employees, the benefits under the plan are considered not to discriminate in favor of highly compensated employees.

Under present law, the Internal Revenue Service has determined that the employer-provided social security benefits are equal to (1) 83⅓ percent of the employee's basic social security benefit (the annual primary insurance amount, or PIA), or (2) 37½ percent of the employee's covered compensation (the maximum pay on which the employee's social security benefits are based).

Thus, a defined benefit plan can integrate with social security either by (1) reducing the employee's plan benefits by up to 83⅓ percent of the employee's PIA (an offset plan), or (2) providing benefits at a rate of up to 37½ percent on pay in excess of the employee's covered compensation and no benefits on such covered compensation (an excess plan). Thus, under the excess approach, a plan could provide a benefit of 37½ percent of pay in excess of $11,004 for an employee who is age 65 in 1982 while providing a benefit of 37½ percent of pay in excess of $32,400 for an employee who is age 25 in 1982).

The integration formulas allow an employer's plan to reduce an employee's plan benefits on account of social security benefits provided by the present employer and by all prior employers. Thus, the formulas allow multiple and cumulative reductions of plan benefits. Thus, when an employee works for a series of employers during a career, the total benefit reductions under all plans of the employers will often exceed the reduction which would be allowed if the employee had worked for only one employer.

Integration of defined contribution plans

A defined contribution plan is also integrated by taking into account employer-provided benefits under the social security system. Specifically, social security benefits are taken into account by reducing contributions to the plan by the assumed cost of providing social security benefits with respect to the portion of an employee's pay subject to the social security tax. The Internal Revenue Service has determined that the employer's cost of providing social security benefits is 7 percent of pay subject to the tax ($32,400 for 1982). The actual tax rate with respect to Old Age, Survivors, and Disability Insurance (OASDI) benefits is 5.4 percent of the taxable wage base for 1982 through 1984.

Possible Proposals

Defined benefit plans

The integration rules could be revised to prevent an employer from reducing an employee's pension benefit on account of social security benefits earned with another employer.

Defined contribution plans

The credit for integration could be limited to the OASDI tax rate actually in effect at the end of the plan year.

Pros and Cons

Arguments for the proposals

1. The proposal relating to multiple and cumulative benefit reductions would protect employee pension benefits against inappropriate reductions under the integration rules because of job changes.
2. The proposal relating to defined contribution plans would insure that an employer does not reduce plan contributions for an employee by more than the OASDI tax actually paid for the employee.
3. By reducing social security integration, the proposals would increase plan benefits for lower-paid workers.

Arguments against the proposals

1. Because the proposals would limit social security integration, they would increase plan costs. Employers could be forced to reduce wages or benefits for lower-paid workers in order to compete with other employers with no plans.
2. The proposal could require employers to undertake the expense of amending their plans.
3. The disparity between the present-law 7-percent rate used to integrate defined contribution plans and the actual OASDI rate (5.4 percent for 1982) will decrease in future years due to scheduled increases in the OASDI tax rate. Therefore, it is inappropriate to

suddenly eliminate this disparity by requiring plan amendments which would increase plan costs.

4. Because the National Commission on Social Security Reform is currently studying social security and is not scheduled to issue its report until December, 1982, it is inappropriate to amend the integration rules at this time.

d. Special rules for retirement plans of self-employed individuals and professional corporations

Present Law

Self-employed individuals

A qualified plan which benefits a self-employed individual (an H.R. 10 plan) is subject to special rules in addition to the qualification rules generally applicable to all plans. Similar special rules also apply to qualified plans of subchapter S corporations and to simplified employee pensions (SEPs). These rules include the following:

1. *Benefit and contribution limits.*—Annual deductible contributions are limited to the lesser of $15,000 or 15 percent of net self-employment earnings for a defined contribution plan; defined benefit plan accruals are limited by a special schedule to correspond to the defined contribution limit.

2. *Limit on includible compensation.*—Only the first $200,000 of an employee's annual compensation may be taken into account under the plan. If more than $100,000 is taken into account for any employee, annual contributions on behalf of a common-law employee must be at least 7.5 percent of compensation. A corresponding rule applies for defined benefit plans which take into account compensation of more than $100,000.

3. *Loans.*—If a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the transaction is treated as a plan distribution and the usual tax rules for distributions apply.

Self-employed owner-employees

If a tax-qualified retirement plan of a self-employed individual (an H.R. 10 plan) benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), the plan is required to meet additional special qualification standards which limit the extent to which the plan can focus benefits upon the sole proprietor or partners while eliminating or minimizing benefits for rank-and-file employees. These special standards include rules under which—

1. The plan must benefit all employees who have completed at least three years of service with the employer.

2. An employee's rights to plan benefits must be nonforfeitable at the time the contributions are made (i.e., the plan must provide full and immediate vesting).

3. A defined benefit pension plan cannot integrate with social security, and integration of defined contribution plans is limited or, in many cases, prohibited.

4. The payment of plan benefits to an owner-employee must begin no earlier than at age 59½ and no later than at age 70½.

Professional corporations

Retirement plans of incorporated professionals are subject to the qualification rules generally applicable to plans of corporate employers. These qualification rules are less restrictive than the rules for H.R. 10 plans and also provide higher limits on contributions and benefits.

Possible Proposals

1. The owner-employee H.R. 10 plan rules regarding participation, vesting, restrictions on contributions, and required distributions could be made applicable to all H.R. 10 plans.
2. The special H.R. 10 plan rules, including those applicable to owner-employees, could be applied to plans of professional corporations providing services in fields of health, law, engineering, architecture, accounting, actuarial science, athletics, performing arts, or consulting.
3. The special H.R. 10 plan rules, including those applicable to owner-employees, could be reevaluated to determine which rules prevent abuse. Under this proposal (1) those rules which promote retirement savings and hinder abuse of the qualification provisions could be extended to plans of all employers; (2) those rules which specially restrict plan benefits for key employees but do not secure plan benefits for rank-and-file employees could be eliminated; and (3) those rules which limit the extent to which plan benefits can be focused on such key employees could be extended to all plans which primarily benefit officers, owners, and highly compensated employees (top-heavy plans). Also, the proposal would provide safeguards to preclude tax avoidance through the use of shell corporations and arrangements with no economic substance (e.g., the *Keller* case).

Pros and Cons

Arguments for the proposals

1. The generous tax treatment for retirement plans of corporate employers is being abused by highly paid individuals, many of whom incorporate to avoid the present-law restrictions applicable to H.R. 10 plans. The rules applicable to plans of corporate employers allow highly paid people to focus plan benefits on themselves. For example, slow vesting reduces or eliminates benefits for many rank-and-file employees, because turnover rates for the rank-and-file are generally much higher than those for key employees.
2. Requiring that plan benefits be distributed when an individual attains age 70½ discourages the accumulation of tax-favored retirement savings as an estate planning device.
3. By establishing generally uniform tax treatment for all plans the proposal would remove a major tax incentive for professionals to incorporate.
4. If the special H.R. 10 plan rules were originally designed to prevent a plan from focusing benefits on certain key employees

without providing significant benefits for rank-and-file employees, it is more appropriate to apply these rules to all top-heavy plans, whether maintained by a partnership or corporation.

Arguments against the proposals

1. If any of the enumerated rules for H.R. 10 plans are to be applied to plans of corporate employers, they should be applied to all plans of all corporate employers. Applying the H.R. 10 plan rules only to plans of professional corporations unfairly discriminates against them.
2. Although the proposal relating solely to professional corporations would substantially reduce the tax advantages of incorporation for professionals, the advantages would remain for any other self-employed individual who incorporates a trade or business.
3. The proposals would require the amendment of affected plans.
4. Applying additional requirements to plans of self-employed individuals and professional corporations or to top-heavy plans would increase plan costs. Employers could be forced to reduce wages or benefits, or possibly terminate plans, in order to compete with other employers with no plans.

e. Nondiscrimination rules for employer-provided statutory fringe benefits

Present Law

Present law generally excludes from an employee's income—

1. the cost of the first $50,000 of employer-provided group term life insurance for employees (the full cost for former employees) and all death benefits under the policy;
2. amounts received under an employer's accident or health plan and the employer contribution to the plan;
3. benefits received under an employer's qualified group legal services plan;
4. the value of transportation provided under an employer's van pooling plan;
5. employer contributions under a cafeteria plan to the extent the employee elects nontaxable benefits;
6. benefits under an employer's education assistance program; and
7. benefits under an employer's dependent care assistance program.

The applicable income exclusion does not apply if, with respect to eligibility to participate, there is discrimination in favor of employees who are officers, shareholders, or highly compensated under (1) a prepaid legal services plan, (2) an educational assistance program, or (3) a dependent care assistance program. For prepaid legal services plans, present law also prohibits such discrimination as to contributions or benefits. In the case of a cafeteria plan or a van pooling plan, present law prohibits such discrimination with respect to employee eligibility and to the availability of contributions or benefits under the plan.

In the case of a self-insured medical reimbursement plan, present law prohibits discrimination in eligibility to participate or in benefits in favor of certain highly compensated employees or shareholders.

Possible Proposal

Uniform nondiscrimination rules would be applied to all the statutory fringe benefit plans described above. Under these rules—

1. Benefits provided key employees would be included in their income if the plan discriminates in their favor. Key employees could be officers, owners of at least 5 percent of the employer, and the highest paid employees.
2. A plan's eligibility standards would not be considered discriminatory if (1) the plan benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the Secretary of the Treasury finds the standards

to be nondiscriminatory. Part-time, seasonal, and short-service (less than 3 years) employees could be excluded from consideration, as could nonresident aliens with no U.S. source income from the employer. In addition, employees covered by a collective bargaining agreement, could be excluded if plan benefits were the subject of good faith bargaining between the employer and employee representatives.

3. The plan's benefits would be discriminatory unless all benefits available to participating key employees are also available to other participants. The amount of group-term life insurance could vary according to pay. Disability benefits provided by an employer would not be affected by the proposal.

Pros and Cons

Arguments for the proposal

1. Prohibiting discrimination with respect to employer-provided group term life insurance and accident and health plans would encourage employers to provide such coverage for rank-and-file employees. It would insure that the benefits of the present-law income exclusions are not provided to cover the needs of key employees unless the needs of rank-and-file employees are also covered.

2. A single set of nondiscrimination rules (and definitions) would simplify the administration of statutory fringe benefit programs. This is especially true for small businesses where the same employees are likely to be covered under each plan.

Arguments against the proposal

1. Uniform nondiscrimination rules would complicate the administration of fringe benefit programs, because even uniform rules would have to be applied separately to each fringe benefit program taking into account the nature of the fringe benefit offered. For example, the rules applied to medical benefits, where benefit utilization is involuntary, may not be appropriate for educational benefits, where benefit utilization is voluntary.

2. Vast numbers of the nation's workers are covered under employer-provided accident and health plans. Cost savings resulting from including a large number of individuals in an insured plan already tend to discourage discrimination. In addition, imposing nondiscrimination rules could increase plan costs and could force employers to reduce wages or benefits under the plans in order to compete with other employers who have no plans.

3. Imposing nondiscrimination rules with respect to employer-provided group term life insurance could disrupt long-standing insurance plans upon which people have been relying for coverage which they cannot obtain individually.

4. Uniform nondiscrimination standards could introduce unjustified rigidity and prevent employers from offering employees a choice among statutory fringe benefits.

f. Estate tax exclusion for retirement savings

Present Law

The value of certain amounts payable to a beneficiary (other than the executor) of a deceased employee under a qualified retirement plan, a tax-sheltered annuity, an IRA, and certain military pensions, generally may be excluded from the decedent's gross estate. The exclusion is limited to amounts attributable to employer contributions or to deductible employee contributions under the plan. However, if benefits are payable to a beneficiary as a lump sum distribution under a qualified plan, no amount payable to the beneficiary under the plan is eligible for the estate tax exclusion unless the beneficiary irrevocably elects to forego the capital gain and 10-year income averaging treatment otherwise applicable to the lump sum distribution.

Possible Proposals

The estate tax exclusion for retirement savings could be limited to a specified dollar amount or repealed.

Pros and Cons

Arguments for the proposals

1. The proposals would limit or eliminate the use of the estate tax exclusion for tax-favored retirement savings as an estate planning device to maximize benefits passing to a decedent's beneficiaries.
2. Limiting or eliminating the estate tax exclusion would encourage retirees to actually use tax-favored retirement savings for retirement income. The present-law unlimited exclusion encourages retirees to preserve these savings as an asset that can be transferred tax-free to heirs and beneficiaries.
3. Because estate taxes are paid with respect to fewer than one percent of all decedents, either proposal would affect only the wealthiest taxpayers. With respect to such estates, the proposals would affect only those decedents with respect to whom tax-favored retirement savings are payable to a beneficiary other than the surviving spouse, or in whole or in part to the surviving spouse in a form which does not qualify for the unlimited marital deduction.
4. The exclusion should be repealed because particular classes of property should not be singled out for preferential treatment. Estates of equal value should be treated equally under the tax law. Tax liability should not depend upon the nature of the property making up the estate.

Argument against the proposals

The proposals would disrupt the estate plans of individuals who are relying on present law.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
$500,000 limit on exclusion		.1	.1	.1	.1

2. Medical Expense and Casualty Loss Deductions

Present Law

Medical expense deduction

Individuals who itemize deductions may deduct two categories of medical expenses. First, a deduction of up to $150 is allowed for one-half of health insurance premiums. Second, a deduction is allowed for all other unreimbursed medical expenditures, including health insurance premiums not allowed in the first category, to the extent that these expenses exceed 3 percent of adjusted gross income. Drug expenditures may be included in the second category only to the extent the total of drug expenditures exceeds 1 percent of adjusted gross income.

Casualty loss deduction

Individuals who itemize deductions may deduct unreimbursed losses of nonbusiness property resulting from fire, storm, shipwreck, or other casualty, or from theft. The amount of the loss is the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis. For any one casualty, the deduction is allowed only to the extent that the amount of the loss exceeds $100.

Senate Finance Committee Bill

The floor for deductible medical expenses would be increased from 3 percent to 10 percent of adjusted gross income. The bill would not modify either the separate deduction for a portion of health insurance premiums or the separate 1-percent floor for drug expenditures.

The deduction for casualty and theft losses would be allowed only to the extent that they exceed 10 percent of adjusted gross income. As under present law, a casualty or theft loss would be taken into account only to the extent that the loss exceeded $100 for any one occurrence.

Alternative Proposals

1. The medical and casualty loss deductions could be combined, so that medical expenses and casualty losses could be allowed only to the extent that, in the aggregate, they exceed (for example) 5 or 10 percent of adjusted gross income.

2. The separate deduction for a portion of health insurance premiums (up to $150) could be repealed.

3. Medicine other than prescription drugs and insulin could be excluded from the deduction and the separate 1-percent floor could be eliminated.

4. The $100 per-casualty floor could be increased to $200.

Pros and Cons

Arguments for the proposals

1. The deductions create significant problems of complexity, recordkeeping, and audit for both individuals and the Internal Revenue Service, since arbitrary lines must be drawn between deductible expenditures for medical treatment, or sudden casualty losses, and nondeductible expenditures for ordinary consumption, or losses from gradual deterioration. Taxpayers must keep detailed records for the medical expense deduction and must be prepared to document and defend estimates of fair market value of lost and damaged property for the casualty loss deduction. As a result of this complexity a high percentage (35 percent for the casualty loss deduction, according to the Internal Revenue Service estimates) of amounts claimed as deductions are not properly deductible. These difficulties are justifiable only when the amounts involved are significant in relation to the taxpayer's income.

2. Increasing the floors under these deductions would reduce substantially the number of taxpayers using these complicated deductions. Increasing the floor under the medical expenses deduction to 10 percent would reduce the number of users by almost 80 percent; a 10-percent-of-income floor under the casualty loss deduction would reduce the number of users of that deduction by 90 percent. A large part of truly catastrophic losses would continue to be deductible.

3. Combining the medical expense and casualty loss deductions, subject to a percentage of income floor, is appropriate because the deductions would then be available only to taxpayers who had suffered extraordinary losses regardless of how the losses were divided between medical and casualty, and taxpayers experiencing a similar impact on ability to pay would be treated the same.

4. The casualty loss floor has not been raised from $100 since it was established in 1964. This unrealistic floor should be raised, and changed to a percentage of income, in fairness to lower income taxpayers and in order to allow this deduction only when losses have a significant impact on ability to pay taxes.

5. The casualty loss deduction offsets a higher percentage of losses for high-bracket than for low-bracket taxpayers, even though the latter are less able to purchase insurance to avoid losses and also are more likely to need assistance in coping with expenses.

6. Because these deductions provide, in effect, partial reimbursement of uninsured expenses, they largely constitute "free" government insurance for expenses some of which could be avoided had proper insurance been purchased. Thus, these deductions should be available only when expenses are very large relative to income.

7. The medical expense deduction, with its very broad coverage of such expenses as certain capital expenditures and transportation expenses, creates a subsidy for unnecessary health care spending.

8. The separate deduction for health insurance premiums is allowed even to individuals who also benefit from high levels of tax-free employer health plan contributions.

9. Allowing the medical deduction only for prescription drugs and insulin would permit the elimination of the complicated separate 1-percent floor and would conform the deduction more closely to the coverage of private health insurance policies.

Arguments against the proposals

1. Taxpayers who suffer unpredictable and unavoidable medical expenses or casualty losses not covered by insurance have a diminished ability to pay Federal income taxes, and this diminished ability should be reflected in tax liability as fully as possible.

2. Some types of health care expenses, even though burdensome in individual cases, are not covered by health insurance policies, such as nursing home care and various forms of custodial care.

3. Income which is used for medical expenses or to compensate for a taxpayer's casualty losses does not increase an individual's net wealth and thus should not be taxed.

4. If an employer pays for health insurance premiums, the payments are excluded from tax, so that repealing the $150 premium deduction would be unfair to those who pay their premiums themselves. At the same time, if this deduction were retained only for individuals not covered by an employer health plan (rather than for all individuals), there would be administrative complexity. Accordingly, the deduction should be retained for all.

5. Even losses which are smaller than 5 percent of adjusted gross income may have an impact on ability to pay taxes.

6. Whether or not a drug is available by prescription is an arbitrary distinction to make for the purposes of the medical deduction. Many nonprescription drugs are legitimate treatments for illnesses and should remain deductible.

7. Medical expenses and casualty losses have different effects on taxpayers' ability to pay taxes and should not be combined into one deduction. For example, the medical expense deduction is claimed for actual cash outlays, while the casualty loss deduction is allowed merely for a reduction in value of property, whether or not the loss results in additional outlays for the taxpayer. Further, under a combined deduction, the deductibility of one type of loss could depend on whether an individual had a large amount of the other type of loss; thus, individuals who have casualty losses could claim a deduction for small amounts of medical expenses, complicating their recordkeeping burden. In addition, for the purpose of determining the net operating loss deduction, which is allowed for nonbusiness casualty losses but not for medical expenses, the deduction would still have to be allocated between the two types of expenses.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Increase floor under medical expense deduction to 10 percent; impose 10 percent floor under casualty loss deduction; retain separate deduction for health insurance (Senate Finance bill)	.3	3.0	3.2	3.5	3.8
2. Increase floor under medical expense deduction to 5 percent; impose 5 percent floor under casualty loss deduction; repeal separate deduction for health insurance	.3	2.3	2.6	2.7	3.0
3. Repeal separate deduction for health insurance and impose floor under sum of medical expenses and casualty losses:					
5 percent	.3	2.2	2.4	2.6	2.8
10 percent	.4	3.6	3.9	4.2	4.6

[1] Assumes Jan. 1, 1983, effective date.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Medical and Casualty Losses

[1981 income levels, 1984 rate schedules]

Income class	Separate 10% floors under medical and casualty deductions; retain separate health insurance deduction (Senate Finance)				Combined medical and casualty deductions with 5% floor; repeal separate health insurance deduction			
	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increase		Percentage increase in tax liability for all taxpayers
		Amount [1]	Percentage increase			Amount [1]	Percentage increase	
Below $10	643	$30	11.94	0.29	1,238	$12	4.78	0.24
$10 to $20	2,292	115	11.47	.75	3,982	34	3.17	.46
$20 to $30	3,136	179	8.04	1.08	5,314	57	2.66	.69
$30 to $50	3,416	267	5.69	1.21	6,938	89	2.05	.97
$50 to $100	953	509	4.62	1.07	2,290	151	1.43	.89
$100 to $200	110	1,259	4.28	.65	386	230	.79	.48
Above $200	27	2,522	2.69	.39	97	434	.45	.26
Total	10,578	231	5.86	.97	20,245	76	1.71	.71

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Medical and Casualty Losses—Continued

[1981 income levels, 1984 rate schedules]

Income class	Combined medical and casualty deductions with 10% floor; repeal separate health insurance deduction			
	No. of taxpayers with tax increases (thousand)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers
		Amount [1]	Percentage increase	
Below $10	1,260	$21	8.65	0.44
$10 to $20	4,053	68	6.41	.92
$20 to $30	5,340	107	5.00	1.30
$30 to $50	6,948	139	3.21	1.51
$50 to $100	2,292	222	2.11	1.32
$100 to $200	386	378	1.30	.78
Above $200	97	718	.75	.42
Total	20,376	126	2.83	1.18

[1] Under 1983 rate schedules, amount would be approximately 5 percent larger.

3. Public Utility Dividend Reinvestment Plans

Present Law

ERTA added a provision which allows public utility corporations to set up dividend reinvestment plans under which shareholders electing to receive distributions in the form of common stock, rather than money or other property, may exclude from income up to $750 per year ($1,500 in the case of a joint return) of the stock distribution. These amounts are taxed as capital gains when the stock is sold.

The provision applies to distributions made after 1981 and before 1986.

Senate Finance Committee Bill

The provision of ERTA providing a tax exclusion for dividends reinvested in public utility stock would be terminated, effective for dividends paid after 1982.

Pros and Cons

Arguments for the proposal

1. By giving favorable tax treatment to reinvested public utility dividends, the present-law provision may divert capital away from other industries which might make more productive investments if they could obtain the funds.
2. Some consider the provision to be inequitable because it provides lower tax liability to an individual whose portfolio contains stocks with qualified programs than to another individual with the same income but with different types of stocks.
3. The provision provides a windfall to those who already owned public utility stock before it was enacted.

Arguments against the proposal

1. The proposal would remove an incentive enacted to help the public utility corporations overcome the difficulties which they have in raising needed capital from external sources. In the past decade, public utilities have not been able to earn adequate rates of return on their investments, and the dividend reinvestment provision is necessary for them to make up for lost ground.
2. The proposal was recently enacted and should not be terminated until its effectiveness can be properly evaluated.
3. The proposal would be unfair to investors who have purchased public utility stocks in reliance on the ERTA provision.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.1	.4	.4	.3	....

C. Income Tax Proposals Primarily Affecting Corporations

1. Capital Cost Recovery—Investment Tax Credit

a. Basis adjustment for investment credits

Present Law

In general, a taxpayer is allowed cost recovery deductions for 100 percent of the cost (or basis) of a depreciable asset, including property for which a regular or energy investment tax credit is allowed, or for which the 25-percent investment credit for rehabilitation expenditures for certified historic structures is allowed.

However, if the 15- or 20-percent investment credit is claimed for qualified rehabilitation expenditures on a nonresidential building, the basis of the property must be reduced by the amount of credit. This lower basis is used to compute cost recovery deductions and capital gain or loss.

Senate Finance Committee Bill

Taxpayers would be required to reduce the basis of an asset by one-half the amount of regular, historic rehabilitation, and energy investment tax credits for the asset.

Alternative Proposals

1. Taxpayers could be required to reduce the basis of an asset by the full amount, rather than by one-half, of the investment credits.
2. Reduction of basis could be required for the investment credits other than the energy investment credits for renewable energy and cogeneration property.
3. The amount of the investment credit could be included in taxable income and added to the basis of the property; the cost of the property plus the investment credit would be depreciated.
4. Instead of reducing the depreciable basis by the amount of the investment credit, the taxpayer could be allowed to depreciate the full basis of the property, but the amount of depreciation claimed in the first year could be reduced by the amount of the credit.

Pros and Cons

Arguments for the proposals

1. A taxpayer should not be allowed cost recovery deductions for that portion of asset cost which has, in effect, been paid for by tax credits.
2. For most personal property, under current economic conditions the cost recovery deductions currently allowed under ACRS, in combination with investment credits, generate tax benefits the present value of which is more generous than the tax benefits of

expensing—that is, a full deduction of cost in the year of investment. This results in negative effective tax rates and makes profitable investment that would not be undertaken if there were no income tax. The proposal would mitigate these effects.

3. The rapid cost recovery under the ACRS system will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefits. This creates an incentive, based solely on tax considerations, for these corporations to merge with taxpaying corporations which can benefit from the otherwise unused deductions and credits.

4. A basis adjustment for one-half the amount of credits allowed would make the combination of ACRS cost recovery deductions and the regular investment credit approximately equivalent to expensing at a 10-percent after-tax discount rate. These benefits would provide investment incentives comparable to incentives that would exist in the absence of an income tax, and thus encourage the private sector to undertake only those investments which would be profitable in the absence of tax.

Arguments against the proposals

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.

2. Some businesses may have planned or undertaken investment programs for 1983 that would be profitable after taxes only if investment incentives are not reduced.

3. A basis adjustment for the full amount of investment credits would mean that some taxpayers would have higher effective tax rates than they had before the enactment of ACRS.

4. The discount rate used to conclude that the present system is more generous than expensing would be inappropriately low if inflation and interest rates increase significantly, in which case a basis adjustment for one-half of the regular credit would make ACRS less generous than expensing.

5. The proposals may involve technical complexities if, for example, the investment credit is recaptured because of a change of use which does not also trigger depreciation recapture or if the credit is not fully used in the year earned.

Revenue Effect [1]

[Fiscal years, billions of dollars]

Item	1983 [2]	1984	1985	1986	1987
Basis adjustment for:					
100% of credits	.7	2.5	4.9	8.1	11.2
50% of credits (Finance Committee bill)	.3	1.2	2.5	4.0	5.6

[1] These estimates do not take into account interaction with safe-harbor leasing.
[2] Assumes an effective date of Jan. 1, 1983.

b. Reduction in regular investment tax credit

Present Law

Overview

A taxpayer may claim a regular investment tax credit, in addition to depreciation deductions, for tangible personal property and certain other tangible property (generally not including buildings or structural components) used in connection with manufacturing or production. The amount of this credit is 6 percent of the cost of property which is in the 3-year recovery class, and 10 percent of the cost of eligible property which is not in the 3-year class.

In general, the regular investment credit may be claimed for the taxable year in which the property is placed in service. This credit may be used to offset the first $25,000 of tax liability plus 90 percent of tax liability in excess of $25,000.

Imports

The President has authority to issue an Executive Order under which the investment credit would be denied to certain property that was completed outside of the United States, or for which less than 50 percent of the property's basis is attributable to value added within the United States. The President may take this action when he determines that denial of the investment credit is in the public interest. The criteria the President is to take into consideration include the maintenance by a foreign country of nontariff trade restrictions or other discriminatory activity that substantially burdens U.S. commerce. This restriction was applied under Proclamation 4074 from August 15, 1971, through December 19, 1971.

Possible Proposals

1. The regular investment credit could be reduced to 4, 4½, or 5 percent for property in the 3-year recovery class, and to 7, 7½, or 8 percent for other eligible property.

2. The investment credit could be repealed and the present cost recovery rules could be replaced by an expensing system—that is, allowing the deduction of full cost of an asset when placed in service. This system could be phased in by reducing the credit and accelerating depreciation in stages, so that cost recovery benefits are gradually brought to expensing.

3. The investment credit could be disallowed for imported automobiles, trucks, and machine tools.

Pros and Cons

Arguments for the proposals

1. For most personal property, the regular investment credit and cost recovery deductions currently allowed under ACRS generate tax benefits that are more generous than the tax benefits of expensing—that is, a full deduction of cost in the year of investment. This results in negative effective tax rates and makes profitable uneconomic investment (i.e., investment that would not be undertaken if there were no income tax). The proposal to reduce the regular investment credit would mitigate these effects by making the combined benefits of ACRS and the regular investment credit slightly less generous than the tax benefits of expensing.
2. The benefits of the investment credit and ACRS deductions will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefit. This creates an incentive for these corporations to merge with taxpaying corporations which can benefit from the otherwise unused deductions and credits.
3. An expensing system would insure, by definition, that the value of cost recovery deductions was equivalent to expensing, regardless of future changes in interest rates and inflation.
4. The investment credit should not be allowed for imported goods which compete with products of depressed domestic industries, since the cost of imports is often reduced because of export assistance programs in other countries.

Arguments against the proposals

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.
2. Some businesses may have undertaken or planned investment programs for 1983 that would be profitable after taxes only if investment incentives are not reduced.
3. Reduction in the regular investment credit could mean that some taxpayers would have higher effective tax rates than they had before the enactment of ACRS.
4. During the period during which the expensing system is being phased in, the constant changes in the combination of investment credit and cost recovery deductions could be confusing and could affect the timing of investments.
5. Denying the investment credit for imported goods could violate international agreements and could lead to retaliation by foreign countries, adversely affecting U.S. exports.

Revenue Effect [1]

[Fiscal years, billions of dollars]

Item	1983 [2]	1984	1985	1986	1987
Reduction to 4 and 7 percent	2.3	5.6	7.1	8.2	9.3
Reduction to 5 and 8 percent	1.5	3.5	4.4	5.1	5.8

[1] These estimates do not take into account interaction with safe-harbor leasing.
[2] Assumes effective date of Jan. 1, 1983.

c. Tax liability limitation

Present Law

Investment tax credits are allowed against the first $25,000 of tax liability plus 90 percent of tax liability in excess of that amount. Credits disallowed under this rule may be carried back 3 years and carried forward for 15 years.

Senate Finance Committee Bill

The 90-percent limit would be reduced to 85 percent, effective for taxable years beginning after 1982.

Pros and Cons

Argument for the proposal

Under the 90-percent limit of present law, businesses can use the investment credit to reduce their tax liability to 4.6 percent of their taxable income, and to even lower fractions of "book" income reported to shareholders on financial statements. This causes some taxpayers to believe that the tax system is inequitable.

Arguments against the proposal

1. An 85-percent limit would increase the amount of earned, but unused, investment credits. This would encourage tax-motivated mergers and acquisitions and greater use of leasing.

2. This proposal would increase the number of companies which cannot make full use of additional investment credits and, thus, which are not allowed the same investment incentives allowed to most companies. This would cause an unjustifiable distortion in the effects of the tax system on investment.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Finance Committee bill..	.2	.3	.2	.2	.2

2. Capital Cost Recovery—Depreciation

a. 1985 and 1986 accelerations of depreciation under ACRS

Present Law

Under ACRS, the cost of personal property (generally, machinery and equipment) is recovered over a period of 15, 10, 5, or 3 years, depending on the type of property. For property placed in service before 1985, these cost recovery deductions are determined according to statutory tables which approximate the result of using the 150-percent declining balance method in early years and the straight-line method in subsequent years.

Cost recovery deductions are scheduled to accelerate further in 1985 and again in 1986. For property placed in service in 1985, these deductions approximate the result of using the 175-percent declining balance method in early recovery years and the sum-of-the-years-digits (SYD) method in subsequent years. For property placed in service after 1985, the deductions approximate the result of using the 200-percent declining balance method in early recovery years and the SYD method in subsequent years.

Senate Finance Committee Bill

The 1985 and 1986 accelerations of depreciation scheduled for property placed in service after 1984 would be repealed.

Pros and Cons

Arguments for the proposal

1. For most personal property (other than long-lived utility property), the cost recovery deductions currently allowed under ACRS, in combination with the investment tax credit, generate tax benefits that are more generous than the tax benefits of expensing—that is, full deduction of cost in the year of investment. This results in negative tax rates, which make profitable investments which would not be profitable if there were no income tax. The further acceleration of depreciation would increase the generosity of ACRS deductions compared to expensing, thus further increasing the subsidy for uneconomic and unproductive investment.

2. Investment and economic growth may be retarded in 1983 and 1984 if these provisions are not repealed, since businesses may postpone investments to qualify for more generous deductions.

3. The rapid cost recovery under the ACRS system, especially after 1984, will eliminate the tax liability of many corporations, leaving them with excess deductions and credits from which they do not receive full benefit. This creates an incentive for these corporations to merge with taxpaying corporations, which can benefit from the otherwise unused deductions and credits.

Arguments against the proposal

1. Tax benefits more generous than expensing are necessary to offset disincentives to investment, such as the double taxation of dividends, and to make up for the shortfall in capital formation that has built up over the past decade.

2. In 1981, the Congress decided that cost recovery deductions should be liberalized further. Adopting the proposal would result in less investment in modern plant and equipment.

Revenue Effect [1]

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
....	....	1.5	9.6	17.4

[1] This estimate does not take into account interaction with safe-harbor leasing.

b. Depreciation allowances for structures

Present Law

Under ACRS, the cost of depreciable real property (generally buildings and structures) is recovered over 15 years. The cost recovery deductions are determined according to tables which approximate the result of using the 175-percent declining balance method (200-percent for low-income housing) in early years and the straight-line method in subsequent years.

Possible Proposals

1. The recovery period could be lengthened to 20 years either for all structures or only for used structures.
2. Cost recovery deductions could be determined according to tables which approximate the result of using the 125-percent declining balance method (150-percent for low-income housing) in early years and the straight-line method in subsequent years.
3. Cost recovery deductions could be determined by using the straight-line method over a recovery period of 18 years (15 years for low-income housing).

Pros and Cons

Arguments for the proposals

1. A 15-year period for buildings and structures, when combined with highly accelerated depreciation methods, generates excessive tax benefits.
2. Highly accelerated depreciation allowances for residential structures encourage tax-motivated sales of used property. This occurs because the buyer is entitled to use the current market value of the sale for purposes of computing depreciation (which is deductible in full against ordinary income). The seller, however, includes in ordinary income only a portion of the difference between the depreciated basis of the asset and the selling price, since the part of this amount not attributable to depreciation in excess of straight-line is treated as a capital gain.

Arguments against the proposals

1. Some taxpayers already may have planned or undertaken investment programs that would be profitable on an after-tax basis only if tax benefits are not reduced.
2. Any reduction in tax incentives for investment would discourage capital formation which is necessary to make up for the shortfall that has built up over the past decade.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. 20-year life with 175% rate (200% for low-income housing).....	.2	1.1	2.5	4.0	5.5
2. 15-year life with 125% rate (150% for low-income housing).....	.2	.7	1.4	2.2	3.0
3. Straight-line over 18 years (15 years for low-income housing)......	.3	1.2	2.4	4.0	5.6

[1] Assumes effective date of Jan. 1, 1983.

c. Open accounts depreciation system

Present Law

Under ACRS, the cost of personal property (generally, machinery and equipment) is recovered over one of four fixed recovery periods. The recovery allowances are computed using the accelerated percentages set forth in ERTA or percentages derived from the straight-line method. The recovery percentages are applied each year to the original cost of the property.

The ACRS recovery allowances (using both the straight-line and accelerated percentages) for a $100 asset in the 5-year class are shown in the table below. The first-year allowance using the straight-line method is 10 percent of asset cost rather than 20 percent, using a half-year convention to account for the average amount of time that an asset is presumed to be in service in the first year. Recovery allowances using the accelerated recovery percentages are shown in the second column of the table. These accelerated recovery percentages are intended to approximate the result of using the 150-percent declining balance method (described below) in the early years of the recovery period and the straight-line method in the later years. A half-year convention is also used in these percentages.

Using the 150-percent declining balance method for a 5-year asset, the recovery allowance for the year is determined by applying a constant 30 percent (150 divided by 5) to the cost of the asset as reduced by prior recovery allowances. Because this rate is applied to an amount that declines each year as recovery allowances are taken, the recovery allowance also declines each year. However, the fact that the recovery allowance is always 30 percent of the remaining balance means that the balance is never fully recovered. This is shown in the third column of the table. This result could be averted by switching to the straight-line method at an appropriate time into the recovery period to ensure full recovery of cost by the end of the recovery period, as shown in the last column of the table. A half-year convention is used in both of these illustrations of the declining balance method.

ANNUAL RECOVERY ALLOWANCES

Year	Present ACRS		ACRS open account (30-percent rate) (3)	150-percent D.B.; switch to straight-line (4)
	Straight-line (1)	Accelerated (2)		
1	$10	$15	$15.00	$15.00
2	20	22	25.50	25.50

Annual Recovery Allowances—Continued

Year	Present ACRS		ACRS open account (30-percent rate) (3)	150-percent D.B.; switch to straight-line (4)
	Straight-line (1)	Accelerated (2)		
3	20	21	17.85	17.85
4	20	21	12.50	16.66
5	20	21	8.75	16.66
6	10	...	6.12	8.33
Total	100	100	85.72	100.00

Under ACRS, the recovery allowances are computed separately for each asset. The taxpayer must keep track of the adjusted basis of each asset for purposes of determining gain on disposition of the property. Thus, a different account may be required for each asset (asset-by-asset accounting).

Possible Proposal

An open account system could be established under ACRS for personal property to replace the present asset-by-asset accounting system for personal property. The basic ACRS concepts and recovery periods would be unchanged.

Under an open account system, depreciable personal property would be grouped into four classes based on the four ACRS recovery periods (15-, 10-, 5-, and 3-year recovery periods). The cost of all property within the class would be placed in the same account regardless of the year of acquisition. For example, a business which acquires an automobile in each of three consecutive years would place these costs into one open account rather than three separate accounts.

In any taxable year, the cost recovery allowance for a class of assets in an open account would be computed under a declining balance method by applying the same percentage each year to the account balance rather than to each asset. If structured under a 150-percent declining balance system, the constant percentage applied to the account for each class would be 50 percent for 3-year recovery property, 30 percent for 5-year recovery property, 15 percent for 10-year recovery property, and 10 percent for 15-year public utility property. The account balance would be increased by additions to the account and decreased by recovery allowances. Because the recovery allowances would be computed by using a declining balance method, the cost of any particular asset in the account would not be completely recovered by the end of that asset's regular recovery period (as shown in the third column of the table above for a 5-year asset).

Instead of immediately recognizing gain or loss on disposition of an asset, the entire proceeds would reduce the account balance which, in turn, would reduce the amount of cost recovery allowances in the year of disposition and subsequent years. Thus, the taxpayer would not have to keep track of the adjusted basis of any asset in the account.

Pro and Cons

Arguments for the proposal

1. The proposal would simplify accounting by greatly reducing the number of accounts and by making them easier to manage as assets are acquired, depreciated, and disposed of.

2. The open account depreciation system has been recommended by the American Institute of Certified Public Accountants.

Arguments against the proposal

1. Adoption of the proposal would mean that a taxpayer for several years may need to keep at least 3 different kinds of accounts for determining cost recovery allowances: accounts for prior law, asset-by-asset accounts for ACRS, and open accounts.

2. Because the cost recovery allowance is computed as a constant percentage of the account balance, rather than of the asset cost, the open account system does not allow the entire cost of the asset to be recovered.

Revenue Effect

The revenue effect would depend on the details of the proposal—for example, the declining balance percentages to be applied to the accounts.

3. Safe-Harbor Leasing

Prior Law

Prior to the enactment of ERTA the law contained rules to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery (depreciation) deductions and investment tax credits.

The prior rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales, financing or other arrangements, in which the user of the property owned the property for tax purposes. These rules were not set forth in the Internal Revenue Code. Instead, they evolved over the years through a series of court cases, and revenue rulings and revenue procedures issued by the Internal Revenue Service.

Essentially, pre-ERTA law provided that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have a nontax business purpose which, in general, meant that the lessor had to derive a profit independent of tax benefits. Also, the lessor had to retain significant burdens and benefits of ownership.

Revenue Procedure 75–21 (and a series of related revenue procedures) provided requirements that, if met, could allow a letter ruling to be issued by the Internal Revenue Service stating that a transaction was a lease. These guidelines were not a definitive statement of legal principles. If all requirements were not met, a court might still determine that, based upon all the facts and circumstances, the transaction was a lease under general principles set forth in cases and rulings. Rev. Proc. 75–21 applied only to leveraged equipment leases. Other leases were governed by these general principles.

The specific requirements for obtaining a ruling under Rev. Proc. 75–21 (and related revenue procedures) are as follows:

1. *Minimum investment.*—The lessor must have a 20-percent minimum at-risk investment in the property throughout the lease term.

2. *Lease term.*—The lease term must not be more than 80 percent of the useful life of the property; at least 20 percent of the value of the property must remain at the end of the lease.

3. *Pre-tax profits.*—The lessor must have a positive cash flow and a reasonable expectation of profit from the lease independent of tax benefits.

4. *Fair market value options.*—The lessee must not have a right to purchase the property at less than fair market value (e.g., no fixed price purchase option). The lessor must not have a contractual right to require the lessee to purchase the property at the end of the lease (i.e., a put), even at fair market value.

5. *Lessee financing precluded.*—The lessee must not have an investment in the lease and must not lend any of the purchase cost to the owner.

6. *Limited use restriction.*—The use of the property at the end of the term of the lease by a person other than the lessee must be commercially feasible.

Present Law

ERTA provides a new set of rules which represent a major departure from prior law. The purpose of these rules is to permit a transfer of tax benefits, rather than to determine who is the owner of property. Under the new rules, certain transactions involving tangible personal property are treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction meets these safe-harbor requirements, the lessor in the agreement is treated as the property owner for Federal income tax purposes and is entitled to cost recovery deductions and the investment credit.

Under the new rules, for example, a person who has acquired and will use the property may, in effect, by entering into a nominal sale and safe-harbor lease-back, sell some of the tax benefits associated with the property to a corporation, while retaining all economic benefits and burdens of ownership. This type of transaction has been referred to as a tax benefit transfer. Other transactions not qualifying as leases under Rev. Proc. 75-21 (and related revenue procedures) may also qualify as leases under the safe harbor. The prior law rules remain in effect for transactions not qualifying for the safe harbor or when the safe harbor is not elected.

The requirements for safe-harbor lease treatment are as follows:

1. *Election.*—All parties to the agreement must elect.

2. *Corporate lessors.*—The lessor must be a corporation (other than a subchapter S corporation or a personal holding company), a partnership all of the partners of which are qualified corporations, or a grantor trust with respect to which the grantor and all beneficiaries of the trust are corporations or a partnership comprised of corporations.

3. *Minimum investment.*—The lessor must have a minimum at-risk investment in the property, at all times during the lease term, of at least 10 percent of the adjusted basis of the property. (Under ACRS, property has a zero basis at the end of the recovery period.)

4. *Lease term.*—The lease term must not exceed the greater of 90 percent of the property's useful life or 150 percent of the ADR midpoint life of the property.

5. *Eligible property.*—The property must be "qualified leased property." To be qualified leased property, the property must either be new property eligible for the investment credit, or mass commuting vehicles financed in whole or in part by proceeds of tax-exempt bonds.

Temporary regulations under ERTA impose additional requirements, including a minimum lease term, a maximum rate of interest, and a fixed repayment schedule on debt.

Senate Finance Committee Bill

The safe-harbor leasing rules would be modified as follows:

A 50-percent limitation would be imposed on the percentage of tax liability that a lessor may avoid through the use of safe-harbor leasing, and lessors would not be permitted to carry back leased tax benefits to prior tax years.

The maximum interest rate on obligations of the lessor to the lessee in a safe-harbor sale-leaseback would be reduced to 5 percentage points less than the interest rate on overpayments and underpayments of tax, but not below 8 percent.

The maximum lease term would be reduced to 100 percent of the ADR midpoint.

The maximum percentage of eligible property that may be leased by any lessee would be 45 percent in 1982 and 1983 and 40 percent in 1984 and 1985.

Property leased under the safe-harbor rules would be depreciated under the cost recovery methods and periods provided for the minimum tax.

Investment tax credits earned on leased property would be allowable over 3 years—50 percent the first year and 25 percent in each of the next 2 years.

The use of leasing to increase foreign tax credits and depletion and leases between related parties would be prohibited.

Certain tax-exempt entities would not be permitted to structure transactions to benefit from leasing.

Starting January 1, 1985, all leases (including leases other than safe-harbor leases) would be permitted to include a fixed price purchase option at the end of the lease term of at least 10 percent of the original cost.

Mass transit leasing would continue to be permitted for property placed in service on or before December 31, 1987, for property purchased under certain binding contracts or commitments entered into on or before March 31, 1983.

So-called investment tax credit strips entered into before October 20, 1981 would be permitted.

The Internal Revenue Service would be precluded from retroactively denying lease treatment under pre-ERTA rules for motor vehicle nonleveraged leases involving business users by reason of the fact the lease contained a terminal rental adjustment clause. However, the Treasury would not be precluded from issuing regulations on a prospective basis that would preclude lease treatment for such leases. The provision would apply on a retroactive basis to any open taxable year.

Safe-harbor leasing would be repealed after September 30, 1985.

These rules would be generally effective after July 1, 1982, except for the rules relating to depletion and leases between related parties, which would be generally effective after February 19, 1982. Transition rules would be provided.

Alternative Proposals

Repeal

The safe-harbor rules could be repealed. There could also be some attempt to codify and clarify prior law rules.

Modification of prior law rules

There could be a restoration of some (but not all) of the prior law rules relating to lease transactions: (1) leases would have to pass a profitability and cash-flow test; (2) lessee financing of the property would be prohibited; (3) the lessor would have to own the property under State law; (4) the lessor's minimum investment would have to be 10 percent of the original cost of the property (or, alternatively, 20 percent); (5) options to purchase the property would be limited to fair market value or at least 10 percent (or, alternatively, 20 percent) of the cost and put options would not be allowed; and (6) the maximum lease term would be 90 percent (or, alternatively, 80 percent) of the useful life of the property. The limited use restriction would not apply.

Alternative proposal

1. Safe-harbor lessors would not be able to reduce their tax liability by more than 50 percent by virtue of tax benefits purchased through safe-harbor leasing. Tax benefits denied under this rule could be carried forward and used in subsequent years. This would preclude use of purchased tax benefits to obtain tax refunds by carrying back losses or credits to prior years.
2. The amount of property eligible for safe-harbor leasing could be reduced to the extent the lessee's foreign source income exceeds the cost of eligible property.
3. The maximum interest rates on loans made in connection with safe-harbor leases would be limited to the interest rate on tax deficiencies, the prime rate of a local bank, or a reasonable rate established by regulations, whichever is greater.
4. The at-risk rules relating to tax shelters could be eliminated for closely held corporations with respect to their activities as safe-harbor lessors.

Other proposals

1. Lease terms could be limited to the ACRS recovery period.
2. The investment credit could be reduced for property subject to safe-harbor leases.
3. Safe-harbor leasing could be denied for property used predominantly outside the United States by a person not subject to U.S. tax.
4. Safe-harbor leasing could be denied to companies where more than a certain percent of revenues comes from Federal subsidies.
5. Safe-harbor leasing could be replaced by a refundable investment tax credit.

Pros and Cons

Arguments for the proposals

1. The public perceives safe-harbor leasing to be inequitable for a variety of reasons, including the following:

   a. The safe-harbor rules permit transactions that are entered into only for tax reduction purposes.

   b. Profitable companies that pay no tax because of large tax benefits are allowed to sell excess tax benefits.

   c. Large profitable companies can purchase sufficient tax benefits to eliminate current tax liability and, by carrying back excess benefits against tax liability from prior years, obtain a substantial tax refund.

   d. Nonbusiness tax benefits, such as personal exemptions, cannot be transferred by individuals and, therefore, safe-harbor leasing creates the perception that tax avoidance or tax reduction is allowed only for businesses.

   e. A side effect of safe-harbor leasing is that users of equipment, by selling tax deductions which reduce taxable income, can increase tax benefits other than ACRS.

   f. Safe-harbor leasing puts some companies in a better position than if the corporate income tax were repealed.

2. The safe-harbor lease rules are an inefficient means of giving users of equipment the benefits of tax deductions and credits they cannot use currently, as indicated by the fact that some of the lost revenue has gone to lessors and third parties. Refundability of tax benefits or direct subsidies would be a more efficient mechanism.

3. Safe-harbor leasing gives companies that do not expect to be taxable for long periods of time incentives to purchase equipment that would be unprofitable on a pre-tax basis.

4. Requiring that the transfer of tax benefits be cast in the form of a lease is unnecessarily complex.

Arguments against the proposals

1. ACRS was intended to encourage modernization of plant and equipment by all companies regardless of their marginal tax rate. Without some form of transferability, companies with large net operating losses and investment tax credits would be denied the tax benefits—and associated competitive advantages—of those tax attributes. Denying such benefits would make the tax system nonneutral with respect to risk.

2. Safe-harbor leasing reduces the number of tax-motivated mergers that might otherwise result if ACRS benefits could not be used by all companies.

3. Safe-harbor leasing is less complicated than prior law leasing.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1982	1983	1984	1985	1986	1987
Senate Finance bill [1]	0.2	1.1	2.9	4.2	5.7	7.2

[1] These estimates take account of interactions with other provisions of the bill modifying the investment credit and cost recovery deductions.

4. Tax Treatment of Mergers and Acquisitions

Present Law

a. Recognition of gain on certain distributions

Partial liquidations

Under present law, no gain or loss generally is recognized to a corporation on the distribution of property in partial liquidation. The basis of the property, e.g., for purposes of computing such deductions as depreciation and depletion, to the distributee is generally stepped up (or down) to the fair market value of the property at the time of the distribution.

When one corporation acquires control (at least 80 percent of the stock) of another corporation, the acquiring corporation may select assets of the acquired corporation to be distributed in partial liquidation of the acquired corporation's business. The acquired corporation pays no tax on gain attributable to appreciation in the distributed assets except to the extent of past depreciation and other items subject to recapture. The basis of the distributed assets is stepped up to current fair market value in the hands of the acquiring corporation. The acquiring and acquired corporations are eligible to file a consolidated return and, under the consolidated return regulations, any tax on recapture income attributable to a partial liquidation may be deferred. The result is a step-up in basis for selected assets of the acquired corporation without current tax and a continuation of the tax attributes of the acquired corporation which may be combined with the acquiring corporation on a consolidated return. While it is also true that gain or loss is not recognized to a corporation distributing its assets in a complete liquidation, its tax attributes are terminated in that case and the selectivity inherent under the partial liquidation rules is not present.

Stock redemptions

A corporation selling stock or other property in a subsidiary corporation to a corporate purchaser may seek to avoid the taxable gain that would result from a direct sale by structuring the transaction as a redemption of the selling corporation's stock. If the purchase of stock and its subsequent redemption for appreciated property are pursuant to the same plan, the transaction may be treated as a direct sale of the property, resulting in recognition of gain to the selling corporation. If the transaction is treated as a stock redemption, special rules apply. Under present law, a corporation must generally recognize gain attributable to appreciated property used to redeem stock issued by the corporation. However, this recognition rule is subject to several exceptions. The principal exceptions are for certain redemptions in complete termination of the interest of a shareholder owning for 12 months or longer 10 percent or more of the distributing company and certain redemptions involving distributions of stock or obligations of a corporation in which the distributing corporation had at least a 50-percent interest.

b. Stock purchase treated as asset purchase

Under present law, no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of an 80-percent owned subsidiary corporation. Generally, the basis of the property distributed in complete liquidation of a subsidiary carries over to the distributee corporation. Certain other tax attributes of the liquidated subsidiary also are carried over to the distributee corporation.

An exception to the general rules for carryover treatment for basis in assets and other attributes is provided for cases which are in substance a purchase of assets from another corporation, i.e., a purchase of a controlling stock interest followed by a timely liquidation of the acquired corporation into the acquiring corporation. If this exception applies, the acquiring corporation's basis in the "purchased" assets is the cost of the stock purchased, adjusted for items such as liabilities assumed, certain cash or dividend distributions to the acquiring corporation, and post-acquisition earnings and profits of the subsidiary. There is substantial uncertainty under present law as to the mechanics of such adjustments. Inappropriate results are obtained in some cases.

c. Use of holding companies to bail out earnings

Shareholders who have their stock redeemed in a corporate distribution are entitled to sale or exchange treatment rather than a dividend generally only if the transaction results in a substantial reduction in their proportionate interests in the distributing corporation.

This distinction between sale or exchange treatment and dividend treatment is important because a sale or exchange may result in capital gains, whereas a dividend results in ordinary income to the extent of earnings and profits. Where the same shareholder or a group commonly controls two or more corporations, they may attempt to avoid the dividend consequences that would result from a pro rata redemption of stock by selling the stock in one controlled corporation to another. Present law deals with this effort to avoid dividend treatment by testing the transaction as if the shareholders had their stock redeemed by the corporation whose stock is sold.

Shareholders may avoid the present-law rules by borrowing funds secured by the stock of a corporation with earnings and profits and contributing the stock to a newly formed holding company in exchange for the holding company's stock plus its assumption of the liability for the borrowed funds. The transaction literally complies with present-law rules governing tax-free incorporation of property. These rules overlap with those requiring stock sales to a commonly controlled corporation to be tested as stock redemptions. The courts are divided as to which provision controls. Even if the redemption rule aplies and dividend treatment results, dividend consequences would be determined by reference to the earnings of the purchasing corporation. If it is a newly formed holding company, it would have no earnings (a pre-existing corporation without earnings could also be used).

Another device to bail out earnings is to cause a corporation to issue preferred stock as a nontaxable stock dividend to its shareholders. A sale of the preferred stock at capital gain rates would not dilute the interests of the selling shareholders in future corporate growth while they would receive an amount representing corporate earnings. Preferred stock issued under these circumstances (described as section 306 stock) is tainted under present law so that its subsequent sale or redemption results in ordinary income to the shareholder. This provision does not taint stock of a newly formed corporation issued in a tax-free transaction in exchange for stock in a corporation with earnings and profits. Thus, creation of a holding company issuing both common and preferred stock offers the same bail-out opportunity but does not result in tainted section 306 stock.

d. Application of attribution rules

In determining whether a shareholder is entitled to sale or exchange treatment on a stock redemption, stock held by related parties is attributed to the shareholder in determining whether the shareholder's interest in the corporation was terminated or significantly reduced.

The attribution rules do not apply to some transactions that are economically equivalent to straight stock redemptions and that offer an equivalent opportunity to bail our earnings. For example, a shareholer may exchange all of his common stock in a corporation for preferred stock. Such an exchange results in "tainted" section 306 stock only if, had cash been distributed in lieu of preferred stock, there would have been a dividend. Unless stock held by another family member or controlled entity is attributed to the shareholder, cash in lieu of preferred stock would have terminated the shareholder's interest and not result in a dividend. Also, a shareholder exchanging stock in a reorganization for property other than stock or securities may have dividend consequences if the transaction has the effect of the distribution of a dividend. For this purpose, attribution rules do not apply.

e. Waiver of family attribution

In determining whether a shareholder has completely terminated his interest in a corporation on a stock redemption so as to achieve sale or exchange treatment, present law allows the shareholder to waive attribution of ownership from other family members. The waiving shareholder in general may hold no interest in the corporation (except as a creditor), may not acquire any interest for a 10-year period, and must agree to notify the Internal Revenue Service of any such acquisition. The statute of limitations for the year of redemption remains open in the event of such an acquisition.

Stock may be attributed by family attribution and reattributed to an entity such as an estate or trust in which the constructive owner has a beneficial interest. The Internal Revenue Service takes the position that only an individual may waive family attribution. Several decided cases have held that an entity terminating its interest can waive family attribution from a family member to the beneficiary. These cases do not preclude the beneficiary from acquiring an interest in the corporation, do not require an agreement from the beneficiary, and do not reopen the statute of limitations in the event of an acquisition by the beneficiary. One case has also held that an entity may waive attribution from a beneficiary to the entity.

f. Controlled group of corporations

In determining whether a controlled group of corporations is confined to one surtax exemption and for other purposes, a brother-sister controlled group exists where 5 or fewer persons own (1) 80 percent or more of the stock in each corporation and (2) more than 50 percent of the stock in each corporation, counting stock only to the extent of identical ownership in each corporation.

Under the regulations, the 80-percent test is satisfied if the same 5 or fewer shareholders singly or in combination own 80 percent of each corporation. For example, if A owns 100 percent of X corporation and 60 percent of Y corporation, and B owns the other 40 percent of Y corporation, a controlled group exists. Identical ownership is 60 percent, and the 80-percent test is satisfied because total ownership in both corporations is confined to 5 or fewer shareholders.

The Supreme Court in *U.S.* v. *Vogel Fertilizer Co.* (January 1, 1982) held the regulation invalid. The Court held that a controlled group did not exist although one shareholder owned 77 percent of one corporation and 87 percent of another. A single shareholder owning the other 23 percent in the first corporation owned none of the second. If the 80-percent test imposes a common ownership requirement, it is not clear that the 50-percent identical ownership requirement has any significant, independent function.

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Liquidations, redemptions

The partial liquidation provisions of present law would be repealed. Capital gain treatment would be retained for noncorporate shareholders who receive property from a trade or business conducted for at least 5 years by the distributing corporation (currently defined as a partial liquidation).

Certain exceptions from the general rule that gain is recognized when appreciated property is used to redeem the stock of a distributing corporation would also be repealed.

Stock acquisitions treated as asset acquisitions

The present law rules for treating the acquisition of a controlled corporation as an asset acquisition would be replaced with a new elective provision. Within 75 days after a purchase of 80 percent or more of the stock of an acquired corporation, a corporate purchaser could elect to treat the acquired corporation as if it had sold all of its assets in a complete liquidation on the date of the stock purchase. The acquired corporation's tax attributes would be terminated and the basis of its assets would be adjusted as of the stock acquisition date to reflect the price paid for its stock.

Consistent treatment would be required where an acquiring corporation or affiliated group of corporations acquires stock in two or more corporations that were members of the same affiliated group. If a purchase of assets (other than in the ordinary course of business) is made from a corporation, the proposal would treat an acquisition of stock of the same corporation or of a member of the same affiliated group as a purchase of assets. Regulations would be authorized to prevent the circumvention of this requirement of consistent treatment through the use of other provisions of law or regulations.

Effective date

Generally, the changes relating to mergers and acquisitions would apply to property distributions after August 31, 1982, and to acquisitions of target corporations after August 31, 1982. The repeal of the partial liquidation provisions would not apply to any distribution in which a tender offer for the target corporation was outstanding on July 1, 1982, or an acquisition pursuant to a binding contract entered into on or before July 1, 1982.

Possible Other Proposals

Anti-bailout provisions

Anti-avoidance provisions (Code secs. 304 and 306) could be extended to the use of a holding company distributing assets or preferred stock or assuming shareholder liabilities as a device to bail out earnings of an operating company without dividend consequences to the shareholders. An exception would be provided for the assumption of debt incurred to acquire the operating company.

The constructive ownership rules could be applied to distributions of preferred stock or to property distributed to a shareholder in a reorganization, in determining whether such distributions are substantially equivalent to dividend distributions.

Waiver of family attribution

The statute could explicitly permit an entity to waive family attribution to an individual with a beneficial interest in the entity in determining whether a redemption completely terminates the entity's interest in a corporation, provided the individual joins in the waiver.

For example, if a father's stock ownership is attributed to his son and through the son to a trust of which the son is a beneficiary, the son and the trust could waive attribution from the father to the son in determining whether the trust terminates its interest in a corporation when its stock is redeemed. Restrictions of present law on reacquiring an interest in the corporation would apply to the son as well as the trust. The proposal would make clear that only family attribution can be waived, e.g., the trust could not waive attribution to it of stock directly owned by the son.

Multiple surtax exemptions

The statute could be amended to provide that, in determining whether multiple surtax exemptions are allowable and for other purposes, a brother-sister control group exists if 80 percent or more of each of two or more corporations are owned by not more than five shareholders without regard to common ownership. For example, if shareholder A owns 60 percent of corporation Y and 100 percent of corporation Z, and shareholder B owns the other 40 percent of corporation Y, a control group exists even though there is not 80 percent common ownership. The rule requiring identical ownership to the extent of 50 percent in each corporation would be retained.

Pros and Cons

Senate Finance Committee bill

Partial liquidations, redemptions

Arguments for the proposal

1. Under the present corporate tax system, it is appropriate for ongoing corporations making distributions of appreciated property, where the shareholders are not taxed as a dividend, to be treated as if the corporation had sold its assets.
2. The present law rules encourage mergers by giving the buyer a step-up on selected assets without recognition of gain.

Arguments against the proposal

1. The present rules are appropriate in that no corporate gain should be taxed in a transaction where the shareholders recognize gain.
2. Changes to corporate tax rules should be made only as part of an overall study of subchapter C of the Code.

Stock acquisitions treated as asset acquisitions

Arguments for the proposal

1. A corporate purchaser of stock should be able to step up the basis of the target corporation's assets without the need to liquidate.
2. Present law results in undue advantage by allowing the tax benefits of the target corporation to continue during the period prior to liquidation.
3. A taxpayer should treat the purchase of more than one subsidiary from one seller consistently.

Arguments against the proposal

1. Present law has worked in practice since it was adopted in 1954 and should not be changed.
2. Any "loophole" in present law can be cured by simply requiring a liquidation sooner than allowed under present law.
3. Consistency of treatment of subsidiaries is not necessarily desirable and involves undue complexity.

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Other proposals

Anti-bailout provisions

Argument for the proposal

The amendments are needed to prevent the "bailout" of earnings through the use of sophisticated transactions to avoid rules presently in the Code.

Argument against the proposal

The proposal should be part of a larger study of the "bailout" problems.

Waiver of family attribution

Argument for the proposal

Trusts and estates should be entitled to the same capital gains treatment available to individuals, when the beneficiaries of the estate or trust comply with the rules which would be applicable if they owned the stock directly.

Argument against the proposal

Present law, as interpreted by certain court decisions, has resulted in reasonable results, and this issue can be resolved by the courts.

Multiple surtax exemptions

Argument for the proposal

Present law, as interpreted by the courts, allows unwarranted multiple surtax exemptions in situations where there is a close ownership of two or more corporations.

Argument against the proposal

The judicial intepretation of present law is proper and should not be changed.

Revenue Effect

[Fiscal years, billions of dollars]

1983	1984	1985	1986	1987
.7	.8	.7	.7	.6

D. Excise Taxes

1. Windfall Profit Tax—Repeal of TAPS Adjustment

Present Law

The windfall profit tax equals a percentage of the excess of the wellhead price of the oil over an adjusted base price. For old oil produced at Prudhoe Bay, the tax rate is 70 percent.

The tax includes a special adjustment for most Prudhoe Bay oil under which reductions in the Trans-Alaska Pipeline System (TAPS) tariff lead to an increase in the adjusted base price. The effect of the TAPS adjustment is to make the windfall profit on this oil invariant to changes in the TAPS tariff.

Senate Finance Committee Bill

Oil produced at Prudhoe Bay in Alaska would be treated like other oil under the windfall profit tax by repealing the special Trans-Alaska Pipeline (TAPS) adjustment presently applicable to that oil. This change would take effect after December 31, 1982.

Pros and Cons

Arguments for the proposal

1. The proposal removes what is in effect a bonus for the owners of Alaskan oil, which was given to them solely because they are vertically integrated in the business of producing and transporting crude oil.

2. Other oil producers are not protected from increases in their windfall profit tax which arise from declines in transportation costs.

Argument against the proposal

When the TAPS tariff declines, the wellhead price of oil at Prudhoe Bay rises, and but for the TAPS adjustment, this would increase the taxable windfall profit. No additional windfall profit tax should accrue, however, because the oil producers are worse off on account of the shift of profit from their transportation subsidiaries to their production subsidiaries, owing to the fact that the higher well-head price leads to additional State severance tax and State royalties. The proposal thus would tax producers on the mere transfer of receipts from their transportation subsidiaries to their production subsidiaries.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Repeal of TAPS adjustment	.1	.1	.2	.1	.1

2. Tobacco Taxes

Present Law

For many years, manufacturers excise taxes have been imposed on cigars, cigarettes, and cigarette papers and tubes manufactured in or imported into the United States. Before their repeal in 1965, excise taxes were also imposed on smoking tobacco, chewing tobacco, and snuff. A majority of the revenue from these taxes is raised by the tax on small cigarettes; the present rate for that tax has been in effect since 1951.

The following is a summary of the Federal excise taxes imposed on tobacco products under present law:

Item	Tax Imposed
Cigars:	
Small cigars	$0.75 per thousand.
Large cigars	8½ percent of wholesale price, up to $20 per thousand.
Cigarettes:	
Small cigarettes	$4.00 per thousand (8 cents per pack).
Large cigarettes	$8.40 per thousand.
Cigarette papers	$.005 per 50 papers.
Cigarette tubes	$.01 per 50 tubes.

Senate Finance Committee Bill

The present Federal excise taxes on cigarettes (both large and small cigarettes) would be doubled, effective on January 1, 1983.

Possible Alternative Proposals

1. The present excise taxes on tobacco products could be doubled and the products subject to tax expanded, as follows:

Item	Tax Imposed
Cigars:	
Small cigars	$1.50 per thousand.
Large cigars	17 percent of wholesale price up to $40 per thousand.

Item	Tax Imposed
Cigarettes:	
Small cigarettes	$8.00 per thousand (16 cents per pack).
Large cigarettes	$16.80 per thousand.
Cigarettes papers	$.01 per 50 papers.
Cigarette tubes	$.02 per 50 tubes.
Pipes	10 percent of manufacturers price.
Smoking tobacco, chewing tobacco, and snuff.	10 percent of manufacturers price.

2. The flat tax rates in proposal 1 above could be indexed for inflation, using either the CPI or the GNP deflator, effective on January 1, 1984.

3. All of the tobacco excise taxes could be imposed as ad valorem taxes equal to a percentage of manufacturer's price. A percentage which would result in the same effective rates for 1983 as would result under proposal 1 could be selected.

4. The increases in tobacco excise taxes could be limited to the taxes on large and small cigarettes as was done in the Finance Committee bill, but the rates could be increased to $9.00 per thousand (18 cents per pack) and $18.00 per thousand (36 cents per pack). A portion of the increased taxes could be dedicated to the Medicare trust fund.

5. The increases in the excise taxes on small and large cigarettes could be limited to one-third, i.e., to $5.33 per thousand on small cigarettes and to $11.20 per thousand on large cigarettes, and the alcohol beverage taxes (discussed in another section) increased by a like percentage to produce an equivalent amount of revenue to that resulting from doubling of only the cigarette taxes (as in the Finance Committee bill).

Pros and Cons

Arguments for the proposals

1. The present Federal excise tax rates on small cigarettes have not been increased since 1951. Inflation since 1951 has resulted in a substantial decrease in the effective rate of these taxes. If the rate had been indexed to the CPI in 1951, the present rate would be almost 30 cents per pack. A higher tax is therefore appropriate. Further, these taxes should remain relatively constant as a percentage of price; therefore, indexing or changing the taxes to ad valorem taxes is appropriate.

2. While excise taxes are generally viewed as affecting the poor more than the wealthy, i.e., as regressive, the tobacco excise taxes are imposed on discretionary purchases. Arguments against such regressive taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes applied to necessities.

3. Increasing taxes on cigarettes is consistent with Federal Government policies concerning health hazards of smoking. Recent

studies indicate that teenage smoking may be quite sensitive to cigarette prices.

4. Excise taxes should not be imposed or increased only on selected tobacco products—all tobacco products should be treated alike.

Agruments against the proposals

1. Excise taxes imposed at a flat rate are regressive, i.e., they cost the poor a larger percentage of available income than they cost wealthier individuals making the same purchases. According to the 1971–72 Consumer Expenditure Survey, tobacco expenditures are 4.0 percent of income for the tenth of the population with the lowest income and are only 0.5 percent of income for the tenth of the population with the highest income.

2. Indexing the tax rate would mean more frequent changes, which are likely to make tax administration and compliance more costly and complex.

3. State and local governments impose excise taxes on cigarettes. Increasing the Federal tax rate could preempt possible increases in State and local tax rates.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Double cigarette tax (Senate Finance bill)	1.3	1.8	1.9	1.9	1.9
Double tax on tobacco products, including pipes	1.3	1.9	1.9	1.9	2.0
Index tobacco products tax at doubled rates		.2	.5	.8	1.1
Impose ad valorem tax on tobacco products	1.3	2.1	2.4	2.7	3.1
Increase tobacco excise taxes by 125 percent	1.6	2.4	2.4	2.4	2.5
Increase cigarette tax by 33⅓ percent	.4	.6	.6	.6	.6

3. Telephone Tax

Present Law

A one-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service. The tax is paid by the user of the service to the person rendering the service, who in turn remits the tax to the government.

An excise tax on telephone service has been in effect in every year since 1941. In 1973, the rate of tax declined from 10 percent to 9 percent, as the first step in a schedule according to which the rate of tax was to decline by one percentage point per year and thus to expire as of January 1, 1982. However, the Omnibus Reconciliation Act of 1980 delayed the final steps of this schedule by one year until January 1, 1983. ERTA further delayed repeal for two additional years, or until January 1, 1985.

Senate Finance Committee Bill

The telephone excise tax would be raised to 2 percent in 1983, 3 percent in 1984, 3 percent in 1985, and 2 percent for years after 1985.

Pros and Cons

Arguments for the proposals

1. The telephone excise tax has been in effect since 1941. Accordingly, making the tax permanent is more appropriate than continuing the past trend of the Congress to extend the tax each time its scheduled expiration approaches. Also, making the tax permanent would permit planning on a long-term basis by eliminating uncertainty as to whether the tax would be allowed to expire.
2. The telephone excise tax is easily administered and collected.

Arguments against the proposals

1. The Congress has committed itself on numerous occasions to permitting the telephone excise tax to expire.
2. The cost of telephone service is a necessary expenditure in today's society. As such, it could be inappropriate to impose a special tax on that expenditure.
3. State and local governments make use of excise taxes on telephone services. Thus, increasing the Federal tax rate could preempt possible State or local use of the tax.
4. According to the 1971–72 Consumer Expenditure Survey, telephone expenditures are 5.4 percent of income for the tenth of the population with the lowest income and are only 0.8 percent of income for the tenth of the population with the highest income. It would be inappropriate to increase or extend such regressive taxes.

5. The telephone excise tax is not designed to reduce incentives to purchase certain goods (e.g., the alcohol and tobacco taxes), or to assign costs borne by the public as a result of the production of certain products (e.g., the black lung tax).

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
2% tax on telephone services	.3	.5	1.0	1.4	1.5
Senate Finance bill	.3	.9	1.6	1.6	1.5

4. Expansion of Dingell-Johnson Fund Excise Taxes on Fishing and Boating Equipment

Present Law

Excise tax on fishing equipment

Under present law, an excise tax equal to 10 percent of price is imposed on the sale of fishing rods, creels, and reels, and on artificial lures, baits, and flies (including parts and accessories of such articles) by a manufacturer, producer, or importer (sec. 4161(a)).

Time for payment of excise tax

Treasury Department regulations require returns of manufacturers excise taxes, including the tax on the sale of fishing equipment, to be filed quarterly, unless the Internal Revenue Service requires more frequent filing by an individual taxpayer (Reg. § 48.6011(a)–1). Quarterly returns are due on the last day of the first month after the quarter ends (Reg. § 48.6071(a)–1).

Although returns generally are filed on a quarterly basis, the regulations require monthly, or semimonthly, payment of the tax in certain cases (Reg. § 48.6302(c)–1). If a taxpayer is liable in any month for more than $100 of manufacturers excise tax and is not required to make semimonthly deposits, the taxpayer must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the taxpayer is located.

If a taxpayer had more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, such taxes must be deposited for the following quarter (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are deposited.

Dingell-Johnson Fund expenditure purposes

Revenues from the 10-percent excise tax on fishing equipment are appropriated for the Dingell-Johnson program. Except for a limited amount of the revenues used to defray Federal Government administrative costs, the revenues are distributed to the States in partial reimbursement of the costs they incur in various fish restoration and management projects. (16 U.S.C. § 777b).

These amounts are appropriated to reimburse States for up to 75 percent of the cost of approved projects, which include research into problems of fish management and culture, surveys and inventories of fish populations, restocking waters with food and game fish according to natural areas, and acquisition and improvement of fish habitats that provide access for public use. The amount of assistance for these programs is determined by statutory formula and is distributed to the 50 States and the District of Columbia, Puerto Rico, Guam, the Virgin Islands, American Samoa, and the Northern Marianas.

Senate Finance Committee Bill

Excise tax on fishing equipment

The Finance Committee bill would expand the types of fishing equipment subject to the 10-percent excise tax to include fishing tackle items not presently covered. Under that bill, the articles of fishing equipment subject to the tax would include, for example, fabricated rods and poles; organic, synthetic, and metallic lines; underwater riggers; underwater spreaders; bags and baskets designed to hold fish; portable bait containers; landing nets; hoops; gaff hooks; rodholders; preserved packaged bait; ice augers; ice spuds, manufactured ice houses; and other similar items.

Excise tax on recreational boats and boating equipment

The Finance Committee bill also would impose a 3-percent excise tax on recreational boats less than 20 feet in length which are designed for fishing or have a capacity label that limits the outboard motor rating to 50 horsepower or less, including component parts, and to certain types of boating equipment designed for recreational fishing. The tax also would be imposed on specified boating equipment, such as portable fish finders, outriggers, fishing chairs, etc. Sailboats, kayaks, hydroplanes, double-ended canoes, and boats designed for commercial purposes would be exempt from the tax, as would outboard motors.

Payment of excise tax

The Finance Committee bill would amend present law to require payment of the fishing and boating excise taxes on a quarterly basis as follows:

(1) March 31, in the case of articles sold during the quarter ending the previous December 31;

(2) June 30, in the case of articles sold during the quarter ending the previous March 31;

(3) September 24, in the case of articles sold during the quarter ending the previous June 30;

(4) On a date prescribed in Treasury Department regulations, in the case of articles sold during the quarter ending September 30.

The bill would not amend the time prescribed under present law for filing of returns of manufacturers excise taxes or the time for payment of such taxes on articles other than fishing equipment.

Transfers to Dingell-Johnson Fund

Revenues from the expanded excise taxes on fishing and boating equipment and from certain tariffs on imported fishing and boating equipment would be transferred to the Dingell-Johnson Fund to be expended for the established purposes of that fund.

Pros and Cons

Arguments for the proposal

1. The Dingell-Johnson program has resulted in construction of numerous new lakes and boating access areas. The beneficiaries of this program should bear an appropriate portion of its rising costs.
2. Many sales of sport fishing equipment are made on credit. Manufacturers and importers should not be required to pay this tax before they receive payment for their merchandise.

Arguments against the proposal

1. The funds expended in the Dingell-Johnson program are all spent by the States, rather than the Federal Government. The States, rather than the Federal Government, should impose the taxes necessary to fund State activities.
2. Manufacturers excise taxes should not be treated differently from other business expenses. Payment of this business expense should not be deferred based solely on industry practices. Further, a special rule for the fishing industry that excludes other industries subject to excise taxes would be inappropriate.
3. The excise tax on fishing equipment should not be increased, and no new tax should be imposed on boats and boating equipment, until legislative action is taken to determine whether additional spending is needed for Dingell-Johnson Fund programs and subsequently the necessary level of increased taxes is determined.
4. Since amounts appropriated to the Dingell-Johnson Fund are automatically expended by the Federal Government, increases or expansions of these taxes would not help to reduce the Federal deficit.

Revenue Effect

This proposal would increase receipts by less than $50 million annually.

E. Employment Taxes

1. Federal Unemployment Tax (FUTA)

Present Law

Under the Federal Unemployment Tax Act (FUTA), employees are subject to a payroll tax of 3.4 percent of the first $6,000 of wages per employee per year. If a State unemployment insurance law meets requirements of Federal law, employers in that State generally receive a 2.7 percent credit against the Federal tax, for a net Federal tax of 0.7 percent. The net effective Federal tax rate will automatically drop by 0.2 percentage points (to 0.5 percent) when the general fund of the Treasury is repaid the outstanding loans to the extended benefit account.

States also levy unemployment compensation taxes in order to finance benefit payments. Almost all jurisdictions determine an employer's tax rate under a system of experience rating in which the tax rate depends on total unemployment benefits recently paid to an employer's former employees. Federal law requires that no reduced rate (usually a rate below 2.7 percent) may be assigned to an employer except on the basis of the employer's experience rating.

Both the State and Federal taxes are part of the Federal budget and are deposited in the Federal Unemployment Trust Fund. State tax revenues are used to pay regular State benefits and one-half of the cost of extended benefits. Federal tax revenues are used to pay State and Federal administrative costs and the remaining half of the cost of extended benefits, and to maintain a loan fund from which a State may borrow if it lacks funds to pay State benefits.

Senate Finance Committee Bill

Effective January 1, 1983, the FUTA wage base would be increased to $7,000 and the tax rate would be increased to 3.5 percent. This would increase the net Federal tax to 0.8 percent. Since many States use the same wage base as FUTA, this would increase State taxes in States with a base currently less than $7,000, as well as Federal taxes. Effective January 1, 1985, the Federal tax rate would be increased to 6.2 percent (a permanent tax of 6.0 percent and an extended benefit tax of 0.2 percent) and the credit to 5.4 percent. This would require that States could not assign to an employer a tax rate below 5.4 percent except on the basis of experience rating.

Pros and Cons

Arguments for the proposal

1. The unemployment insurance program is seriously underfinanced. Recessions of the 1970s and inadequate State and Federal

funding have led to substantial deficits currently being financed through Trust Fund borrowing from the Federal Treasury. Outstanding borrowing from the Treasury was equal to $13.1 billion at the end of fiscal year 1982. Total State debt to the Trust Fund is expected to increase in 1982 because of additional State borrowing.

2. The wage base has not been increased since 1978, so that Federal revenues have not kept up with the increase since that year in benefits and administrative costs.

Arguments against the proposal

1. The FUTA tax is a disincentive to hiring, and raising the tax would have a substantial effect on the employment prospects of low-wage workers.

2. Employment disincentives should not be created during a time of high unemployment.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
Senate Finance bill	1.4	2.4	2.9	2.8	2.6

[1] Assumes effective date of Jan. 1, 1983.

III. OTHER PROPOSALS

A. Income Tax Provisions Primarily Affecting Individuals

1. July 1983 Tax Rate Reduction and Indexing

Present Law

ERTA provides across-the-board reductions of income tax withholding of 5 percent on October 1, 1981, 10 percent on July 1, 1982, and 10 percent on July 1, 1983. The corresponding cumulative reductions in calendar year tax rates relative to prior law are 1¼ percent in 1981, 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984 and subsequent years. (The income distributional effect of the 1983 tax rate reduction is shown in table 4 following.) Beginning in 1985, the income tax brackets, zero bracket amount, and $1,000 personal exemption will be adjusted for increases in the Consumer Price Index.

Present law also provides a deduction for two-earner married couples equal to 10 percent (5 percent in 1982) of the first $30,000 of earnings of the lower-earning spouse.

Possible Proposals

1. All, or a portion, of the July 1983 withholding reduction could be repealed or delayed.
2. The July 1983 rate reduction could be preserved for taxpayers whose incomes are below a certain level and phased out or eliminated for taxpayers above that level.
3. The tax rate schedules for 1982 and 1983 could be changed so that any taxpayer's tax reduction, relative to pre-ERTA law, is limited to $700 for 1982 and $1,400 for 1983.
4. The present rate schedule for married couples filing a joint return could be modified by reducing the number of non-zero brackets from 14 to 4; corresponding changes could be made in other rate schedules. The tax rate in the first bracket would be 20 percent, and, for married couples, this bracket would apply to up to $27,000 of taxable income; the top rate would continue to be 50 percent. The personal exemption for each taxpayer would be increased from $1,000 to $2,400, and the zero bracket amount for married couples would be increased from $3,400 to $4,600. Because the rate schedule and zero bracket amount changes themselves reduce the marriage penalty, the deduction for two-earner married couples could be repealed.
5. Indexing could be repealed, delayed, allowed only for inflation in excess of, say, 3 percent, or, alternatively, could be made effective at an earlier date.

Pros and Cons

Arguments for the proposals

1. It might be very difficult to avoid unacceptably high budget deficits or to maintain essential Federal Government functions if individual tax rates are cut in July 1983, as scheduled. The tax cut should be delayed until the economy is sufficiently strong and revenues sufficiently high so that the cut will not result in too large a deficit.
2. The inflation rate is considerably lower than what was expected when ERTA was passed. Thus, the rate cuts necessary to compensate for bracket creep are smaller than expected.
3. Substituting earlier indexing for the July 1983 tax cut would insure that bracket creep is eliminated sooner for all taxpayers, including lower income groups which benefit relatively little from across-the-board rate cuts.
4. Because of economic uncertainties, indexing should not be a permanent part of the law until it is clear that budget deficits have been brought under control. At the very least, indexing should be allowed only for inflation in excess of 3 percent to avoid overcompensating for small price changes.
5. Targeting the tax cut to lower- and middle-income taxpayers would be more equitable.
6. Flattening the rate schedule and reducing the number of rate brackets would reduce the effects of bracket creep for many middle-income taxpayers and would reduce the marriage penalty without having to distinguish between one- and two-earner couples.

Arguments against the proposals

1. Repeal or delay of the July 1983 rate reductions would decrease the equity of the ERTA rate reductions as a whole, since the highest income taxpayers have already benefited from the reduction of the top income tax rate from 70 percent to 50 percent (see tables below).
2. The long-run benefits of increased work and savings incentives which result from lower marginal tax rates are too important to be sacrificed for temporary revenue increases.
3. Since last summer, individuals have been making investment decisions in reliance on the full 23-percent rate reduction now in the law. It would be unfair and disruptive to the economy to tamper with such an important provision which has been passed so recently.
4. Repealing or modifying indexing could signal to financial markets that the Congress intends to rely on higher inflation, rather than legislative action, to reduce the deficit or to provide additional revenues for spending programs.
5. An across-the-board tax cut is the most equitable approach.
6. The proposal to limit 1982 and 1983 tax reductions would result in increasing the maximum tax rate from 50 to 70 percent creating a serious disincentive for investment.
7. The proposal to flatten the rate brackets would reshuffle the relative tax liabilities of single and married taxpayers and should not be acted upon without thorough study.

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Distributional Effect of Third-Year (1983) Tax Cut

[Millions of dollars—1981 income levels]

Expanded income (thousands)	Tax reduction from first two years of rate reductions		Tax reduction from third-year rate reduction		Tax reduction from a total 3-year rate reduction		Third-year reduction as percentage of total 3-year rate reduction
	Amount	Percent	Amount	Percent	Amount	Percent	
Below 10	1,198	(2.8)	634	(2.7)	1,832	(2.8)	34.6
10 to 20	5,859	(13.8)	3,360	(14.2)	9,219	(14.0)	36.4
20 to 30	8,469	(20.0)	5,275	(22.4)	13,744	(20.8)	38.3
30 to 50	12,312	(29.1)	7,383	(31.3)	19,695	(29.9)	37.5
50 to 100	7,475	(17.6)	4,558	(19.3)	12,033	(18.2)	37.9
100 to 200	3,311	(7.8)	1,805	(7.7)	5,116	(7.8)	35.3
200 and above	3,750	(8.8)	578	(2.4)	4,328	(6.6)	13.4
Total	42,374	(100.0)	23,592	(100.0)	65,966	(100.0)	35.8

Revenue Effect[1]

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
1. Repeal July 1, 1983, rate reduction	7.2	32.4	34.9	36.9	40.0
2. Delay July 1, 1983, rate reduction to Oct. 1, 1983	6.7	.3			
3. Delay July 1, 1983, rate reduction to Jan. 1, 1984	7.2	7.1			
4. Repeal July 1, 1983, rate reduction and replace with two 5% rate reductions on July 1, 1983, and July 1, 1984, with indexing delayed to Jan. 1, 1986	3.5	12.1	8.8	14.4	15.5
5. Repeal July 1, 1983, rate reduction and advance indexing to July 1, 1983	4.3	13.5	11.9	12.8	14.1
6. Repeal July 1, 1983, rate reduction and advance indexing to Jan. 1, 1984	7.2	23.7	20.6	21.9	23.9
7. Cap tax cuts at $700 in 1982, $1,400 in 1983	5.9	12.6	9.2		
8. Repeal indexing			8.9	23.4	39.6
9. Allow indexing only for inflation in excess of 3%			3.7	10.0	17.5
10. Substitute proposal No. 4 for July 1, 1983 rate reduction and repeal indexing	1.2	15.0	35.1	60.6	95.1

[1] Revenue effects without regard to implied amended rate schedules. Final revenue effects may differ slightly depending on the specification of these new rate schedules.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to July 1983 Rate Reduction and Indexing

[1981 income levels, 1984 rate schedules]

Income class	Delay half of July 1983 rate reduction for one year				Repeal July 1, 1983, rate reduction and make indexing effective on that date			
	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers (thousands)	No. of taxpayers with tax increases	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers
		Amount [1]	Percentage increase			Amount [1]	Percentage increase	
Below $10	12,998	$9	2.21	2.09	18,554	−$25	−7.78	−7.78
$10 to $20	23,442	40	3.15	3.15	23,839	16	1.28	1.28
$20 to $30	16,783	95	3.62	3.62	16,810	83	3.18	3.18
$30 to $50	13,516	131	2.76	2.76	13,559	148	3.15	3.15
$50 to $100	3,534	305	2.80	2.79	3,574	446	4.12	4.12
$100 to $200	589	898	2.90	2.83	628	1,562	5.27	5.26
Above $200	142	1,474	1.37	1.28	162	2,211	2.19	2.18
Total	71,004	88	2.90	2.87	77,125	81	2.88	2.88

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

2. Dividend and Interest Exclusions

Present Law

Under present law, individuals may exclude from gross income up to $100 ($200 on a joint return) of dividend income from domestic sources. In addition, a taxpayer may exclude up to $1,000 ($2,000 on a joint return) of interest income earned on qualified savings certificates (generally referred to as "All-Savers" certificates) issued before January 1, 1983, by commercial banks, thrift institutions, or credit unions.

Beginning in 1985, individuals will be able to exclude 15 percent of up to $3,000 of net interest ($6,000 on a joint return). Thus, the maximum exclusion will be $450 ($900 on a joint return). Net interest generally is defined as interest income received by the taxpayer, reduced by any forfeitures due to early withdrawals and any interest expenses paid or incurred during the year other than interest incurred (1) in acquiring, constructing, reconstructing, or rehabilitating a dwelling unit or (2) in carrying on a trade or business.

Possible Proposals

1. The $100/$200 exclusion for dividends could be repealed.
2. The 15-percent net interest exclusion could be repealed.

Pros and Cons

Arguments for the proposals

1. The exclusions provided by present law do not significantly increase the amount of savings. Economic studies indicate that there is only a slight positive correlation between the return on savings, which is increased by the exclusions, and aggregate savings. Thus, the exclusions have little effect on aggregate savings.

2. The dividend exclusion provides a windfall to, and no savings incentive for, those with dividend income over $100 per taxpayer.

3. The present-law exclusions discriminate in favor of income from interest and dividends and against other types of income from property such as royalties and rent, and thus may prevent capital from flowing to the investments which yield the highest return to the economy. In addition, the net interest exclusion applies only to certain types of interest and may encourage individuals to hold bonds instead of stocks.

4. The net interest exclusion provides that interest on residential mortgages does not have to be subtracted from interest income eligible for the exclusion. Thus, the exclusion allows homeowners to increase their mortgage borrowing and use the proceeds to purchase interest-bearing assets; this produces no net saving but increases the revenue loss from the provision.

5. The net interest exclusion reduces the advantage of tax exemption granted to State and local obligations and, thus, increases the interest which State and local governments must pay.

6. Repeal of these exclusions would simplify the computation of the income tax.

Arguments against the proposals

1. These exclusions provide an incentive to save and, thus, contribute toward the goal of increasing the savings rate.

2. In the case of the dividend exclusion, the effect of the exclusion is to partially offset the double taxation of dividend income under both the individual and corporate income taxes.

3. The present dividend and interest exclusions may not work perfectly, but they should be expanded and improved rather than repealed.

4. In the case of the net interest exclusion, the exclusion is designed to apply only to individuals who are net savers and provides incentives to increase savings in a wide variety of interest-bearing assets, and, thus, is the best designed savings incentive in the tax law.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Repeal dividend exclusion	0.2	0.6	0.6	0.6	0.6
2. Repeal net interest exclusion			1.1	3.1	3.4

[1] Assumes effective date of Jan. 1, 1983.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Dividend and Interest Exclusions

[1981 income levels]

Income class	Repeal dividend exclusion (1984 rate schedules) [1]				Repeal net interest exclusion (1985 rate schedules)			
	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers
		Amount	Percentage increase			Amount	Percentage increase	
Below $10	1,591	$13	4.65	0.35	5,986	$20	7.45	2.32
$10 to $20	2,563	18	1.46	.16	10,293	28	3.34	1.06
$20 to $30	2,839	25	.92	.16	8,120	38	1.40	.74
$30 to $50	3,780	37	.74	.22	6,478	71	1.43	.76
$50 to $100	2,004	56	.48	.29	2,042	157	1.41	.87
$100 to $200	456	72	.24	.18	413	266	.88	.61
Above $200	136	77	.08	.16	116	326	.31	.23
Total	13,369	33	.53	.20	33,448	49	1.43	.80

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

3. Exclusion for Employer Health Plan Payments

Present Law

All employer contributions to employee health plans are excluded from an employee's income and wages for purposes of income and payroll taxes. This tax treatment applies regardless of the benefits or coverage of the plan.

Possible Proposal

A limit could be placed on the amount of employer contributions to a health plan which could be excluded from an employee's income and wages for purposes of the income tax, withholding, FICA, and FUTA; amounts over the limit would be subject to tax.

The limit could be a specified dollar amount per month of coverage. The dollar amount could depend on the type of coverage selected by the employee, e.g., $80 per month for individual coverage and $200 per month for family coverage. The limits could be adjusted annually according to increases in the consumer price index.

Special rules could be provided for computing the income and payroll tax liability resulting from contributions to multiemployer plans. These rules could provide that the fraction of these contributions not includible in income would be determined by the ratio of the applicable cap to the plan cost per employee.

For self-insured plans, the amount subject to income and payroll taxes could be based on reasonable estimates of per-employee cost using actuarial factors. A safe-harbor rule could provide that an estimate made for any estimation period (e.g., a calendar year) will be deemed reasonable if it (1) is not less than the actual per-employee cost for claims paid during a preceding base period (adjusted for projected increases in plan costs), and (2) turns out to be not less than 80 percent of the actual per-employee cost for the estimation period. Under this rule, the base period could be defined as the 12-month period ending 3 months before the estimation period (e.g., if the estimation period is the calendar year, the base period is the 12-month period ending on the preceding September 30). For projecting increases in plan costs, the projection factor could be the percentage increase in the CPI medical care component for the 15-month period ending with the end of the base period, plus 4 percentage points.

Pros and Cons

Arguments for the proposal

1. The present law exclusion creates an inequity in the tax system, since an individual all of whose compensation is in cash and who provides for his or her own health care must pay for health care out of after-tax dollars, while the employee covered by

an employer-paid medical plan pays for health care with before-tax dollars. Therefore, the noncovered employee pays more tax than the covered employee who has the same amount of compensation, but receives part of it in the form of tax-free health insurance.

2. The exclusion provides a greater benefit to the high-bracket taxpayer than to the low-bracket taxpayer, even though the latter may need a greater incentive to obtain adequate health insurance.

3. Limiting the exclusion would not prevent either an employer or an employee from providing for the same or a higher level of health care than is provided today. It would merely mean that compensation used to provide health care that costs more than the applicable cap would be taxable just like compensation used to purchase most goods and services.

4. The rapid growth of nontaxable employer health plan payments is eroding the base of the social security tax. Approximately 25 percent of the increased revenues from the proposals would go into the Social Security Trust Funds.

5. The present-law exclusion provides an incentive for the purchase of an unlimited amount of health insurance. As a result, many individuals have health plans which cover virtually every possible expense. These individuals (and their doctors) treat health services as if they were free, which may cause the use of many services that have marginal value or are unnecessarily expensive. The proposed limit, which affects only the most expensive health plans, would eliminate the tax incentive to participate in plans which include coverage which is of little value in treating disease or maintaining good health.

6. Because the exclusion is unlimited, individuals and employers who choose inefficient health plans receive a greater subsidy then those who choose efficient plans (such as HMOs) providing the same level of benefits. Thus, the exclusion reduces the pressure on, and interferes with the incentives for, health care providers to minimize costs.

7. An exclusion limit which is uniform across the United States is consistent with the overall tax system, which, for reasons of equity and simplicity, does not recognize cost-of living differences among different regions or individuals of different pre-retirement ages.

8. The proposed limit is so high that it will affect only those who already have very extensive health coverage. The reduction in coverage which the proposal may induce thus would have only a small effect on out-of-pocket medical expenses.

Arguments against the proposal

1. The cost of a given amount of health insurance is greater in some areas than others and for some groups (e.g., employee groups consisting mostly of older workers) than others. A dollar cap which is the same for everyone would discriminate against high-cost groups, since employees who are in these groups and whose employer contribution is greater than the cap would pay higher taxes than employees in low-cost groups with the same benefit coverage.

2. If the limit on the exclusion leads to a reduction in insurance coverage, then individuals who suffer from illnesses will have higher out-of-pocket medical expenses.

3. Coverage for lower income workers, who can least afford increased medical expenses could be reduced.

4. Reduced insurance coverage, i.e., higher patient deductibles and copayments, could lead to less use of outpatient services and preventive care, which are cost-beneficial expenditures.

5. There will be administrative difficulties in assessing tax liability on contributions to self-insured and multiemployer plans.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1984 [1]	1985	1986	1987
Cap on health plan exclusion:				
1. $250/month for family coverage: [2]				
a. Indexed for CPI	1.4	2.5	3.2	4.5
b. Not indexed	1.4	2.6	3.7	5.2
2. $200/month for family coverage: [3]				
a. Indexed for CPI	2.5	4.3	5.7	7.9
b. Not indexed	2.5	4.5	6.3	8.9
3. $150/month for family coverage: [4]				
a. Indexed for CPI	4.3	7.2	8.5	10.3
b. Not indexed	4.3	7.6	9.7	12.3

[1] Assumes effective date of Jan. 1, 1984.
[2] $100 per month for single coverage.
[3] $80 per month for single coverage.
[4] $60 per month for single coverage.

Note.—Approximately 25 percent of these amounts are increased social security payroll tax receipts.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposal Related to Exclusion for Employer Health Plan Payments

[1981 income levels, 1984 rate schedules]

Income class	$250 per month cap			
	Number of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers
		Amount [1]	Percentage increase	
Below $10	320	$100	27.82	.52
$10 to $20	1,426	162	12.21	.73
$20 to $30	1,682	220	8.00	.80
$30 to $50	2,074	257	5.24	.80
$50 to $100	967	360	3.18	.86
$100 to $200	294	395	1.29	.60
Above $200	76	434	.43	.20
Total	6,839	$243	8.09	.73

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

4. Deduction for Nonbusiness, Nonmortgage Interest

Present Law

Interest paid on debt incurred in connection with a trade or business, or property held for the production of rents and royalties, generally is deductible in computing adjusted gross income. Interest paid on other indebtedess generally is allowed as an itemized deduction.

An individual's deduction for interest paid on amounts borrowed to acquire or carry property held for investment ("investment interest") generally is limited to the individual's net investment income received for the year, plus $10,000 ($5,000 for a married taxpayer filing a separate return). Disallowed investment interest is carried forward to succeeding taxable years subject to the limitation on the deduction in the carryforward year.

Possible Proposal

Limitations could be applied to the deductibility of interest which is not incurred in carrying on a trade or business. The deduction for personal interest, such as finance charges on personal items, could be limited, for example, to $1,000 per year ($2,000 for married taxpayers filing a joint return). The deduction for investment interest, i.e., interest on amounts borrowed to acquire or carry property held for investment, could be limited to the sum of net investment income for the year plus the portion of the $1,000 limitation not used for the deduction of personal interest. Disallowed investment interest could be carried forward to succeeding taxable years.

Alternatively, the deduction for all nonbusiness interest, whether paid on personal or investment indebtedness, could be limited to the sum of net investment income plus $1,000 ($2,000 for married couples filing a joint return).

An exception from these limitations could be provided for interest on housing debt. This would be debt incurred in acquiring, constructing, reconstructing, or rehabilitating an apartment house, condominium, cooperative, or principal residence. A *de minimis* rule could exclude from the housing debt exception interest on debts incurred for ordinary repairs and maintenance or for minor rehabilitation (e.g., expenditures that do not exceed the greater of $5,000 or 25 percent of the adjusted basis of the dwelling unit). For debt incurred before the effective date of the proposal, for which it could be very difficult to trace the use of loan proceeds, the presumption of use for housing could be created wherever the loan was secured, when incurred, by a lien against the residence.

With respect to the purchase of a replacement residence which qualifies the taxpayer for nonrecognition of capital gain on the sale of the old residence, the interest deduction would not apply to that portion of the mortgage on the replacement residence equal to any gain on the sale which is not invested in the replacement residence.

The limitation could be phased in over several years to allow taxpayers sufficient time to reduce interest expense which would not qualify for the deduction.

The dollar limitation could be replaced by specific exceptions for interest paid on debt incurred for specific purposes, such as the purchase of a passenger automobile or for higher education.

Pros and Cons

Arguments for the proposal

1. The present-law unlimited deduction encourages consumer borrowing, that is, negative savings.

2. Since the deduction presently is available even for borrowing to purchase assets which do not produce income, such as consumer durables, present law encourages the purchase of these assets relative to the purchase of income-producting assets, such as stocks and bonds, which would provide funds for business investment. Thus, limiting the deduction for personal interest would increase the productivity of the economy.

3. The exception for housing interest would preserve the present homeownership incentives in the tax law.

4. The interest deduction has a greater effect on after-tax interest rates for high-income taxpayers than for low-income taxpayers.

Arguments against the proposal

1. Because credit is fungible, it would be very difficult to trace whether the proceeds of specific loans were used for investment rather than personal purposes, and for housing rather than other purposes.

2. Taxpayers who do not exceed the investment interest limit and who also incur some personal interest would be able to rearrange their portfolios so that interest is characterized as investment, rather than personal interest. Since investment interest would be deductible up to the amount of investment income, while personal interest would be deductible only up to a fixed dollar amount, this proposal could allow interest deductions to wealthy individuals who do not need to borrow in order to buy a car or appliances.

3. The proposal would draw arbitrary lines, such as between interest on debt used to buy built-in furniture and appliances that are fixtures (interest would be deductible) and interest on debt used to buy freestanding furniture or appliances (interest would not be deductible).

4. Individuals who have large outstanding debts, undertaken in reliance on existing tax law, would be unfairly treated by the proposal.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
Limitation on nonbusiness, nonmortgage interest deduction (single/married):					
$1,000/$2,000	.4	3.0	3.2	3.4	3.7
$1,500/$3,000	.3	2.1	2.2	2.4	2.5
$2,000/$4,000	.2	1.5	1.6	1.7	1.9

[1] Assumes effective date of Jan. 1, 1983.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Deduction for Nonbusiness, Nonmortgage Interest

[1981 income levels, 1984 rate schedules]

Income class	$1,000/$2,000 limit on nonmortgage, nonbusiness interest in excess of investment income			
	Number of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases		Percentage increase in tax liability for all taxpayers
		Amount [1]	Percentage increase	
Below $10	6	$485	261.72	0.05
$10 to $20	543	167	19.45	.30
$20 to $30	1,214	749	12.57	.68
$30 to $50	1,759	367	9.62	1.01
$50 to $100	587	1,072	11.98	1.63
$100 to $200	99	3,451	12.75	1.84
Above $200	17	10,914	13.70	1.10
Total	4,225	519	11.64	1.01

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

5. Deductions for State and Local Taxes

Present Law

An individual who itemizes deductions can deduct State and local general sales taxes (for example, on items of personal clothing) and personal property taxes (for example, annual ad valorem taxes on automobiles and boats used for personal purposes) even though the taxes are not related to business or investment activities. The deductible amount of sales taxes may be computed from tables furnished by the Internal Revenue Service or may be the exact amount of taxes paid.

State, local, and foreign taxes incurred in a business or investment activity generally may be deducted in the year paid or accrued, even if the liability arises from the acquisition or disposition of a capital asset. One exception is that individuals and certain corporations are required to capitalize real property taxes incurred during the construction period of real property.

Possible Proposals

1. The deduction for State and local sales taxes paid on items not used in business or investment activities could be repealed. Also, the special rule for taxes incurred in a business or investment activity could be repealed so that taxes other than income and real property taxes, such as sales or other taxes properly chargeable to capital account, could be added to the basis of the asset and recoverable in the same manner as other capital expenditures.
2. The deduction for State and local personal property taxes on property which is not used in a business or investment activity could be repealed. Taxes on real property would continue to be deductible as under present law.
3. The deduction for nonbusiness income taxes could be repealed.

Pros and Cons

Arguments for the proposals

1. Repealing nonbusiness sales and personal property tax deductions would discourage consumption and promote saving, and thus would improve the productivity of the economy.
2. Most taxpayers use tables based on average consumption patterns to compute their sales tax deduction in order to avoid the complicated burden of keeping records of hundreds of retail transactions. Thus, the sales tax deduction does not improve the equity of the income tax system because it does not reflect each individual's actual burden of sales taxes.
3. The sales and personal property tax deductions decrease equity. Individuals with equal income should pay the same income

tax regardless of how they spend their income for personal purposes (e.g., whether for taxable or nontaxable items).

4. The deduction for personal property taxes discriminates against States which impose nondeductible, flat annual automobile registration fees (which may vary by weights), rather than personal property taxes which vary according to the value of the vehicle.

5. The deduction for nonbusiness State and local income taxes does not improve the equity of the tax system and reduces Federal revenues substantially.

6. Repealing these deductions would simplify the income tax computation. For example, repeal of the sales tax deduction would reduce the number of itemizers by approximately 8 percent.

7. Taxes that are part of the cost of acquiring or disposing of a capital asset should be treated like other capital expenditures. Captial expenditures are not generally currently deductible, but rather are recoverable after a period of years, e.g., through depreciation or on disposition of the asset.

Arguments against the proposals

1. States which rely disproportionately on sales and personal property taxes would be discriminated against by the proposals. All but five States have general sales taxes. Approximately 30 States have nonbusiness personal property taxes.

2. States would be discouraged from raising revenue by means of sales and personal property taxes. This would be undesirable because the sales tax, especially, is considered by some to be a fair tax.

3. The indirect revenue sharing provided by the Federal tax deductions for these State and local taxes is necessary at a time when other forms of Federal assistance are being reduced.

4. State and local income taxes are an unavoidable cost of earning income and are properly deductible under the Federal income tax.

5. The deductibility of sales and personal property taxes improves the equity of the tax system by allowing taxable income to be adjusted for these mandatory payments.

6. In many areas, personal property taxes on household goods supplement a jurisdiction's real property tax on homes. Thus, personal property taxes should be deductible as long as real property taxes remain deductible.

7. The repeal of the sales tax deduction would have a disproportionate effect on taxpayers (itemizers) who purchase automobiles, airplanes, or boats, since deductions for sales tax paid in connection with purchases of these items may be claimed in addition to the amount shown in the sales tax table.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983[1]	1984	1985	1986	1987
1. Repeal sales tax deduction	0.8	5.2	5.8	6.6	7.5
2. Repeal personal property tax deduction	.1	.6	.6	.7	.7

[1] Assumes effective date of Jan. 1, 1983.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Sales and Personal Property Taxes

[1981 income levels, 1984 rate schedules]

Income class	Repeal sales tax deduction: Number of taxpayers with tax increases (thousands)	Repeal sales tax deduction: Average tax increases for taxpayers with tax increases: Amount [1]	Repeal sales tax deduction: Average tax increases for taxpayers with tax increases: Percentage increases	Repeal sales tax deduction: Percentage increase in tax liability for all taxpayers	Repeal personal property tax deduction: Number of taxpayers with tax increases (thousands)	Repeal personal property tax deduction: Average tax increases for taxpayers with tax increases: Amount [1]	Repeal personal property tax deduction: Average tax increases for taxpayers with tax increases: Percentage increase	Repeal personal property tax deduction: Percentage increase in tax liability for all taxpayers
Below $10	1,862	$23	8.10	.74	743	$5	1.85	.06
$10 to $20	5,105	44	3.86	.74	2,064	11	1.02	.07
$20 to $30	7,281	81	3.57	1.33	3,244	22	1.01	.16
$30 to $50	9,536	145	3.28	2.16	4,296	41	.94	.27
$50 to $100	3,150	263	2.46	2.14	1,416	75	.71	.27
$100 to $200	581	445	1.49	1.39	247	139	.49	.18
Above $200	154	651	.65	.61	63	542	.54	.21
Total	27,670	124	2.60	1.57	12,074	37	.79	.21

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

6. Charitable Deduction for Nonitemizers

Present Law

For 1982–1986, individuals who do not itemize deductions may deduct a certain amount of charitable contributions. From 1982–1984, the amount of contributions that nonitemizers may take into account is subject to a dollar cap. Furthermore, until 1986, only a percentage of the amount of contributions otherwise deductible is allowed as a deduction to nonitemizers. The deduction for nonitemizers terminates after 1986.

The percentages, dollar caps, and resulting maximum deductions are shown in the following table:

Year	Percentage	Contribution cap	Maximum deduction
1982	25	$100	$25
1983	25	100	25
1984	25	300	75
1985	50		
1986	100		

Possible Proposals

1. Contribution caps could be imposed for 1985 and 1986. The contribution cap for 1985 could be $200, and the cap for 1986 could be $100. Thus, the maximum charitable contribution deduction for a nonitemizer would be $100 in 1985 (50 percent of the first $200 of contributions) and $100 in 1986 (100 percent of the first $100 of contributions).

2. The charitable deduction for nonitemizers could be repealed.

Pros and Cons

Arguments for the proposals

1. The adoption in ERTA of the charitable deduction for nonitemizers significantly complicates the "short form" tax return by requiring many additional taxpayers to keep records of contributions in order to compute their tax liability. The proposals would limit the effects of this precedent for complicating tax returns for nonitemizers.

2. The availability of an unlimited charitable deduction for nonitemizers could create a serious compliance problem for the Internal Revenue Service, since some taxpayers might be tempted to claim a deduction for cash contributions which could not be verified.

3. Limiting or repealing the charitable deduction for nonitemizers would have very little effect on charitable giving, since nonitemizers generally are low-bracket taxpayers who receive only a small tax reduction per dollar of contributions.

4. The zero bracket amount already includes an amount for the charitable contribution deduction, as for all other itemized deductions.

Arguments against the proposals

1. The proposals could result in reduced private sector charitable giving, the need for which has increased because of the desire to restrain government spending.

2. The proposals would be inequitable, since they would preserve the disparity in tax treatment between charitable contributors who can itemize deductions and those who cannot.

3. There is no reason to expect nonitemizers to overstate their charitable deductions any more than itemizers do. If the deduction presents a compliance problem, it should be addressed equitably for both groups of taxpayers.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Repeal charitable deduction for nonitemizers	([2])	0.2	0.7	2.7	4.3
2. Impose a $100 cap on charitable deduction for nonitemizers			.2	2.0	3.5

[1] Assumes effective date of Jan. 1, 1983.
[2] Less than $50 million.

Distribution by Income Class of Taxpayers With Tax Increases and Increased Revenue Under Proposals Related to Charitable Deduction for Nonitemizers

[1981 income levels, 1985 rate schedules]

Income class	Repeal charitable deduction for nonitemizers				Limit deduction for nonitemizers to $100			
	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases: Amount[1]	Average tax increases for taxpayers with tax increases: Percentage Increase	Percentage increase in tax liability for all taxpayers	No. of taxpayers with tax increases (thousands)	Average tax increases for taxpayers with tax increases: Amount[1]	Average tax increases for taxpayers with tax increases: Percentage Increase	Percentage increase in tax liability for all taxpayers
Below $10	13,656	$10	3.28	2.62	2,598	$24	8.63	1.23
$10 to $20	18,105	22	1.80	1.41	6,312	36	3.19	.82
$20 to $30	9,672	42	1.55	.98	4,491	62	2.36	67
$30 to $50	3,939	77	1.53	.51	2,305	98	1.96	.38
$50 to $100	373	121	1.11	.12	246	142	1.30	.10
$100 to $200	37	195	.68	.04	29	204	.74	.03
Above $200	5	241	.22	.01	4	258	.22	.01
Total	45,782	28	1.66	.63	15,986	52	2.37	.41

[1] Under 1983 rate schedules, amounts would be approximately 5 percent larger.

7. Taxation of Unemployment Benefits

Present Law

Under present law, the amount of State and Federal unemployment insurance benefits included in adjusted gross income for income tax purposes is equal to the lower of (a) the amount of unemployment benefits paid, or (b) one-half of the excess of adjusted gross income, unemployment benefits, and excludable disability income over $20,000 for single taxpayers, $25,000 for married taxpayers filing jointly, or zero for married taxpayers filing separately.

Possible Proposal

The income thresholds limiting the inclusion of unemployment benefits in adjusted gross income could be reduced.[1]

Pros and Cons

Arguments for the proposal

1. Unemployment benefits are a substitute for wages and should be included in adjusted gross income like other wage substitutes, such as sick pay and vacation pay.
2. The personal exemptions, zero bracket amount, and rate schedules are adequate to reduce tax liability for unemployment benefit recipients who have little other income.

Arguments against the proposal

1. It would not be appropriate to increase the taxation of unemployment benefits when millions of individuals are experiencing prolonged unemployment. Unlike vacation pay and sick pay, unemployment benefits replace only a portion of lost wages.
2. The level of unemployment benefits is established by States in the knowledge that benefits are free from income tax for the vast majority of recipients. Increasing the taxation of benefits would put pressure on States to increase their benefit level to provide an adequate after-tax income for the unemployed. Increased benefits would lead to increased State unemployment insurance taxes on employers and, thus, a disincentive for employment.

[1] In H.R. 6369, as reported by the Committee on Ways and Means on May 25, 1982, the thresholds are reduced to $18,000 for joint returns and $12,000 for single returns.

Revenue Effect

[Fiscal years, billions of dollars]

Proposed threshold						
Joint returns	Single returns	1983 [1]	1984	1985	1986	1987
$20,000	$15,000	.4	.4	.3	.3	.4
18,000	12,000	.7	.7	.6	.6	.7
15,000	10,000	1.0	1.0	.9	.9	.9
12,000	8,000	1.3	1.3	1.1	1.1	1.1
Zero	Zero	2.6	2.6	2.3	2.2	2.3

[1] Assumes effective date of Jan. 1, 1982.

8. Deferred Nonrecognition Exchanges

Present Law

Under section 1031, gain is not recognized on an exchange of like-kind property held for use in a trade or business or for investment (excluding investment securities or certificates), except to the extent the taxpayer receives property that is not like-kind (boot). The assumption of liabilities by the other party in the exchange, net of liabilities assumed by the taxpayer in the exchange, is considered boot to the taxpayer.

The case of *Starker* v. *United States*, 602 F. 2d 1341 (9th Cir. 1979), held that an exchange of property in return for like-kind property to be designated by the taxpayer in the future qualifies as a like-kind exchange, even though the taxpayer eventually might receive boot rather than like-kind property in settlement of the other party's obligation in the exchange. The court further held that gain to the extent of boot received in later years must be recognized in the year of the original transfer. The Installment Sales Revision Act of 1980 would generally treat a similar transaction as an installment sale, thus deferring the recognition of gain on the boot until the year received.

Possible Proposal

A time limit could be imposed on the time by which property received in a sale or exchange could be granted nonrecognition treatment. Thus, for example, all property received after the close of the taxable year in which the exchange occurred could be treated as taxable boot.

Pros and Cons

Arguments for the proposal

1. A tax-free like-kind exchange should only be allowed for a contemporaneous exchange of property. The ability of the seller to receive property which may or may not be of like kind gives the taxpayer an option which defeats the purpose of the like-kind exchange provision to require an actual receipt of like-kind property.
2. The proposal would simplify reporting on deferred like-kind exchanges, since presently the treatment of payments cannot be fully ascertained before the transaction is completed.

Arguments against the proposal

1. So long as a taxpayer actually received like-kind property, the fact that the receipt is deferred should be irrelevant in determining the amount of gain to be recognized on an exchange.
2. The changes to the installment sales reporting provisions cause the recognized gain to be taken into account in the year pay-

ments are received, and thus there is no longer a possibility that the collection can be defeated by the improper running of the period of limitations as the *Starker* case held.

9. Certain Exchanges of Partnership Interests

Present Law

If certain business or investment property is exchanged for other property of a "like kind," there is no current tax and the potential gain is rolled over. Several cases hold that the like-kind exchange provision applies to certain exchanges of general parternership interests. As a result, the like-kind exchange provision may be used by some taxpayers in conjunction with technical partnership provisions to obtain tax shelter benefits. In general, this combination of provisions is being used by tax shelter investors to "step up" their depreciable basis in partnership assets without the recognition of gain, and thereby to obtain additional depreciation or cost recovery deductions.

The key to obtaining these benefits is the use of the section 754 election of partnership tax law in conjunction with the like-kind exchange provision. If a partnership has a section 754 election in effect, then a partner acquiring an interest in the partnership adjusts his share of the partnership's basis in the partnership assets (the "inside basis") to reflect the partner's basis in his newly acquired partnership interest (his "outside basis"). If the partnership does not have a section 754 election in effect, this adjustment is not made.

In order to take advantage of these provisions, an investor in a "burned out" tax shelter with a section 754 election in effect exchanges his partnership interest for an interest in a new tax shelter without a section 754 election in effect.

For example, assume ABC partnership buys an airplane for $1,000,000, paying $100,000 in cash and borrowing the $900,000 balance through a recourse mortgage. Partner A has a 10-percent interest in ABC and, initially, a basis of $100,000 in his partnership interest ("outside basis"), consisting of a $10,000 capital contribution and a $90,000 proportionate share of the mortgage liability. His share of the partnership basis in the airplane ("inside basis") is also initially $100,000.

Suppose that, after 5 years, the partnership has deducted $1,000,000 of depreciation, reduced the mortgage liability to $500,000, and taken tax losses of $600,000. (The other $400,000 of depreciation has been used to shelter the income used to pay down the mortgage.) A now has an outside basis of zero ($100,000 minus $60,000 of losses and minus $40,000 of liability reduction) and his share of the partnership's basis in the airplane is also zero. His share of the partnership's debt is $50,000.

At this point, the tax shelter has "crossed over," i.e., the taxable income exceeds the cash flow. Assuming the fair market value of the airplane is $600,000, a sale of the airplane (or a sale by A of his partnership interest) would result in $60,000 of ordinary income to A.

But, instead of selling his interest, A negotiates an exchange with D. D is a 10 percent partner in partnership DEF. DEF owns a new $1,000,000 airplane subject to a $900,000 mortgage. D's 10 percent interest (like A's) is worth $10,000 and D's inside and outside bases in DEF are both $100,000. Because of the favorable tax consequences of the transaction to A, he will probably pay D an additional cash consideration.

If A and D exchange their partnership interests, then, based on the cases mentioned above, they may argue that the like kind provision is applicable. Assuming the like-kind exchange provision is applicable, the tax consequences will be as follows:

1. Neither A nor D has a current tax.
2. D has an outside basis in his ABC partnership interest of $60,000 (his $10,000 cash investment plus his $50,000 share of the ABC mortgage). Because ABC has a section 754 election in effect, D can "step up" his share of ABC's basis in its airplane from zero to $60,000. Thus, D is in nearly the same economic position as he was as a partner in DEF. The cash payment from A makes up for any difference.
3. A has a $40,000 outside basis for his DEF partnership interest (his share of partnership liabilities has increased from $50,000 to $90,000) and a $100,000 inside basis. Since DEF does not have a section 754 election in effect, A does not "step down" his inside basis. Thus, A has increased his share of depreciable basis from zero to $100,000 and his capacity to deduct partnership losses from zero to $40,000, all without the payment of a tax. A has therefore reconstructed his "burned out" tax shelter. Once A's outside basis has been reduced to zero by additional tax losses and debt repayments, he can no longer deduct further tax losses. Subsequent principal payments on partnership debt, however, will trigger capital gain to A, allowing him to escape the recapture provisions of section 1245.

Possible Proposal

Like-kind exchange treatment could be denied for exchanges of partnership interests where one partnership (but not both) has a section 754 election in effect. The proposal would not affect the resolution of the more general issue of whether an exchange of partnership interests may qualify for the like-kind exchange treatment under current law.

Pros and Cons

Arguments for the proposal

1. The like-kind exchange rules and the partnership basis provisions may now have the unintended result of allowing unduly favorable tax consequences for certain exchanges of equity interests held in partnership form.

2. Certain exchanges of partnership property should perhaps qualify for like-kind exchange treatment. The limited approach of denying like-kind exchange treatment only when just one of the ex-

changing partnerships has a section 754 election in effect prevents abuses while not affecting the more general situation.

Argument against the proposal

The general purpose of the like-kind exchange provisions is to prevent imposition of tax when a taxpayer receives certain illiquid property with which he cannot easily pay tax. Since the ability of a taxpayer who exchanges partnership interests to pay tax does not depend on whether or not a partnership has a section 754 election in effect, the proposal is not justified.

10. Capital Gains Taxation

Present Law

Gains or losses on capital assets held for more than 12 months are considered long-term capital gains or losses (sec. 1222). For noncorporate taxpayers, only 40 percent of net long-term capital gains are included in taxable income, while 100 percent of net short-term gains are included. On the other hand, 100 percent of net short-term losses (up to $3,000) are deductible, while only 50 percent of net long-term losses (up to $3,000) may be deducted.

For corporate taxpayers, net long-term gains are subject to an alternative tax rate of 28 percent, while net short-term gains are taxed at regular rates.

Possible Proposals [1]

1. The alternative tax for corporate capital gains and the 60-percent deduction for noncorporate capital gains could be allowed only for gains on "productive" assets. Productive assets could be defined as stocks, bonds, property used in a trade or business, and real property used by the taxpayer for residential purposes or rented to others. Under this proposal, real property used for farming purposes would not be defined as a productive asset unless, during the year before the sale or exchange, the taxpayer materially participated in the operation of the property, and the taxpayer or tenant engaged in substantial farming activities on the property. Also, corporate stock would not be a productive asset if at any time during the two years before sale or exchange more than 20 percent of the corporation's assets consisted of assets other than cash, productive assets, inventory, and accounts receivable.
2. The percentage of noncorporate net long-term capital gains included in taxable income could be increased from 40 to 50 percent.

Pros and Cons

Arguments for the proposals

1. Taxpayers would no longer have a tax reason for investing in nonproductive assets.
2. The capital gains inclusion rate in taxable income was 50 percent prior to 1978. The present 40-percent inclusion rate in addition to the reduction in top bracket income tax rates, pursuant to ERTA, substantially reduces the effective tax on capital gains for high-income taxpayers.

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[1] The Senate Finance Committee bill would reduce the holding period distinguishing long-term from short-term capital gains from one year to 6 months.

Arguments against the proposals

1. Preferential tax treatment for capital gains encourages taxpayers to invest rather than consume. The Congress determined, in enacting these special provisions, that investment in all capital assets should be encouraged.

2. The proposal would prescribe which investments are deemed to be productive. This determination would be subjective and could result in administrative difficulties as well as undesirable distortions in capital markets.

B. Income Tax Provisions Primarily Affecting Corporations

1. Foreign Oil and Gas Income

Present Law

Foreign tax credit

U.S. corporations are subject to tax on their income from both U.S. and foreign sources. To the extent that their U.S. tax is attributable to foreign source income, they may offset that U.S. tax with a credit for any foreign income taxes they have paid. Foreign oil and gas income is subject to special rules that are intended to prevent credits for foreign oil extraction taxes from sheltering other income. Under these rules, however, extraction losses from one country do not offset extraction income from other countries. Therefore, for companies with extraction losses in one country, the rules may have the effect of allowing credits for foreign taxes incurred on highly taxed extraction income in a second country to offset U.S. tax on low-taxed oil-related income, such as shipping, refining, and financial services, in a third country.

Deferral of tax on income of foreign subsidiaries

Income of foreign subsidiaries of U.S. corporations is not subject to U.S. tax when earned; it is only taxed by the United States when and if it is repatriated as dividends. This system of not taxing the income of U.S.-controlled foreign corporations until it is repatriated is called "deferral." An exception to this general rule exists for certain tax haven income and tax avoidance transactions (the "subpart F" rules).

Senate Finance Committee Bill

The country-by-country loss feature of the rule for the foreign tax credit limitation affecting oil and gas extraction income would be repealed. Extraction income would be recharacterized as non-extraction to the extent of overall extraction losses in prior years. Oil companies thus would not be permitted to use credits or losses arising out of their foreign oil and gas extraction activities to shelter other income from U.S. tax.

The present anti-tax haven rules (subpart F) would be expanded so that oil companies would be subject to tax currently on all their foreign non-extraction oil income related to activities carried on in countries other than those where the oil and gas is extracted or consumed. U.S. tax on foreign shipping income would continue to be deferred to the extent the income is reinvested in shipping assets.

Alternative Proposals

1. Foreign oil and gas extraction income could be exempted from U.S. tax and related deductions and credits disallowed. Deferral of

U.S. tax on oil-related income of foreign subsidiaries of U.S. companies would be ended in a manner similar to the Senate Finance Committee bill.

2. The foreign tax credit for oil and gas income could be repealed, and a deduction allowed instead. The extraction income could be recharacterized as U.S. source income, so that foreign taxes imposed on other foreign income could not offset U.S. taxes on that extraction income.

Pros and Cons

Arguments for the proposals

1. The proposals would raise significant revenue mostly from major oil companies who currently pay little or no U.S. tax on their foreign earnings.

2. The special oil and gas foreign tax credit limitation rules do not effectively prevent foreign taxes paid on foreign extraction income from sheltering nonextraction oil-related income earned in low tax countries. By permitting the oil companies to shelter any nonextraction oil-related income which they are able to divert to low tax countries, such diversion is encouraged. This diversion of income is typically accomplished by having subsidiaries in these countries provide intracompany financial services, oil trading, refining, transshipping and other services.

3. There has been considerable controversy over whether the foreign oil taxes for which oil companies claim the foreign tax credit really are "income taxes" that qualify for the credit or whether they are more properly treated as royalties or excise taxes that may only be deducted. Because these companies have been treating the taxes as eligible for the foreign tax credit they have been sheltering substantially all their foreign income from U.S. tax. A proposal to exempt foreign oil and gas extraction income from tax would make unnecessary the distinction between creditable and noncreditable oil extraction taxes.

4. Independent U.S. refiners and U.S. based oil producers argue that they are at a competitive disadvantage to the major international oil companies whose overseas operations receive the favorable present law treatment.

Arguments against the proposals

1. The per-country special loss feature of the separate oil foreign tax credit limitation was adopted to encourage oil companies to explore in non-OPEC countries in order to diversify their sources of production. Some of this incentive would be removed by the proposal.

2. By increasing the U.S tax burden on foreign oil income, the cost of imported oil could be raised.

3. The oil companies have argued against an exemption or the taxing of their undistributed low taxed foreign income on the grounds that they would be treated differently than companies in other industries.

4. Taxing undistributed oil-related income would put U.S. based international oil companies at a competitive disadvantage vis-a-vis foreign based companies.

5. Repeal of the foreign tax credit for extraction income would violate a basic concept of our tax system, and would make U.S. companies noncompetitive with foreign companies.

Revenue Effect[1]

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Senate Finance bill	0.2	0.5	0.6	0.6	0.7

[1] The revenue effect of the first alternative proposal is very similar to the effect of the provision in the Senate Finance Committee bill.

2. Possessions Corporations

Present Law

General rules

Certain income that certain U.S. corporations ("possessions corporations") earn in Puerto Rico and the possessions of the United States is effectively exempt from Federal income tax. This is accomplished by granting electing U.S. corporations a tax credit equal to (and thus fully offsetting) the U.S. tax attributable to income from the active conduct of a trade or business in a possession, the disposition of a possession business, and investment income related to investments in the possession or the business. The credit is available only if 80 percent or more of the gross income of the corporation for the prior three years was derived from any sources within a possession and 50 percent or more of the gross income of the corporation for the prior three years was derived from the active conduct of a trade or business within a possession.

The election may not be revoked for 10 years without the permission of the Internal Revenue Service. An electing corporation may not join in a U.S. consolidated tax return. Foreign income taxes paid on income which is subject to the special tax credit may not be credited or deducted for Federal income tax purposes.

Dividends that a possessions corporation pays to its U.S. parent are eligible for the 100 percent dividends received exclusion, and thus are exempt from tax.

In the Virgin Islands, a somewhat different set of rules applies. Corporate "inhabitants" of the Virgin Islands are exempt from U.S. taxation rather than being eligible for the possessions credit.

Transfer of intangibles

Under present law, taxpayers have taken the position that they may make tax-free transfers of intangible assets created in the United States (such as patents, secret processes, and trademarks) to an electing corporation, and that no allocation of income generated by those intangibles to the U.S. parent is required. The view of the Internal Revenue Service is that it may make an allocation to the U.S. parent of all or a portion of the income attributable to the intangibles. This issue is now before the U.S. Tax Court. Because a possessions corporation is a domestic corporation, a ruling is not required to obtain tax-free treatment on the transfer.

Senate Finance Committee Bill

Income of a corporation that qualifies for the possessions credit would not include income allocable to intangibles. Such income would be allocated to the U.S. shareholders of a qualifying corporation or to the qualifying corporation itself as noncreditable U.S. source income. In addition, the current rule that permits a qualifying corporation to earn up to 50 percent passive income would be changed to permit only 10 percent passive income. The lower passive income limitation would be phased in over a three-year period. Similar rules would be provided for U.S. corporations effectively exempt from tax because they are inhabitants of the U.S. Virgin Islands.

Alternative Proposals

1. The credit could be repealed. Alternatively, one or some combination of proposals 2 through 6 could be adopted.
2. A possessions corporation could be required to pay a royalty to its U.S. parent for intangibles transferred to it by its parent.
3. In order to tie the possessions credit more closely to employment, the credit could be limited to an amount equal to a fixed amount of wages paid to employees of the possessions corporation. For example, the possessions credit could be limited to a percentage of the first $10,000 of wages paid to each employee of the corporation.
4. The credit could be limited to exempt only one-half or some other percentage of the possession income of a possessions corporation.
5. The Senate Finance Committee bill provisions could be adopted, but with a safe harbor based on a worldwide or U.S. overall profit as a percentage of sales.
6. The Senate Finance Committee provisions could be modified so that the possessions credit would not be available for income attributable to intangible assets unless the intangible property was developed by the possessions corporation, or was acquired by the possessions corporation by purchase or license or through a bona fide cost-sharing arrangement. Furthermore, taxable income from the conduct of an active trade or business of a possessions corporation would only be subject to the rules of section 482.

In addition, the current rule that permits a possessions corporation to earn up to 50 percent passive income could be changed to permit 35 percent passive income phased in over a three-year period. A foreign tax credit could be allowed for any Puerto Rico "tollgate" tax imposed on this income. The dividends from a possessions corporation could be treated on a separate company basis, as is the case for DISC.

Pros and Cons

Arguments for the proposals

1. While the possessions credit has attracted Puerto Rican investment that has increased employment, the revenue cost per affected employee is greater than average wages paid. For example, in 1978, the Federal tax expenditure per Puerto Rican employee averaged $12,667 in all manufacturing industries as compared with an average compensation of possessions corporation employees of $10,667. The disparity in some instances was much greater. In intangible intensive industries, such as pharmaceuticals, the tax expenditure

per-employee in 1978 averaged $43,261 as compared to an average employee compensation of $13,618. A public service employment outlay program this inefficient would have been terminated long ago. Some cutback in the credit increasing its efficiency in increasing employment, or outright repeal of the credit, is warranted.

2. The ability of possessions corporations to retain earnings and shelter passive income should be limited. A significant portion of the revenue cost of the possessions credit is attributable to passive income. It is inequitable to continue to permit companies to earn significant amounts of passive income free of tax.

3. The possible proposals to limit the availability of the possessions credit for income from intangibles are justified because no legitimate policy is served by permitting tax-free generation of income related to intangibles developed or created in the United States since that income is not derived from increased Puerto Rican employment or economic activity.

4. The proposal to impose an employment-related limit on the credit would target it more directly at the problem, namely, Puerto Rican unemployment.

Arguments against the proposals

1. Puerto Rico is in a poor economic condition and any curtailment of incentives to invest there can only make the situation worse. The incentives ERTA provides for U.S. investment have already reduced the relative advantage of possessions corporations. Repeal of the credit could result in the loss of of jobs.

2. The full incentive now provided by the possessions credit is necessary to offset the application of the U.S. minimum wage to a significant portion of the Puerto Rican work force. The minimum wage pushes the real cost of labor in Puerto Rico closer to the mainland level and undercuts Puerto Rico's competitive position as a low wage site for investment.

3. The availability of the credit to shelter interest income from tax provides an inducement to deposit funds in Puerto Rican commercial banks. These funds are then available for investment in Puerto Rico. Without this incentive, capital would be more expensive and investment would be hindered.

4. Puerto Rico forgives or reduces its business taxes to attract investment. Any increase in U.S. taxation of this investment through changes in the possessions credit would undercut these incentives and would have the effect of transferring revenue from Puerto Rico to the United States Treasury.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. Limit passive investment income to 10 percent (Senate Finance bill)	(2)	0.1	0.3	0.3	0.3
2. Repeal credit for income from intangibles (Senate Finance bill)	.4	.9	1.0	1.1	1.2
3. Repeal of section 936	.7	1.4	1.5	1.6	1.8
4. Limit credit to $10,000 per full-time employee	.4	.9	1.0	1.1	1.2

[1] Assumes an effective date of Jan. 1, 1983.
[2] Increase of less than $50 million.

3. Credit for Incremental Research Expenditures

Present Law

A taxpayer may elect to deduct currently the amount of certain research expenditures in its trade or business. In addition, pursuant to ERTA, the taxpayer may claim a 25-percent income tax credit for its qualified research expenditures, to the extent exceeding the average of such expenditures in a base period. The credit expires after 1985. A taxpayer's expenditures eligible for the credit include "in-house" expenditures for certain research wages and supplies used in research, plus certain expenditures for research use of computers, laboratory equipment, and other personal property.

Under present law, the amount of the credit does not reduce the amount of the deduction allowed for research expenditures.

Possible Proposals

Deduction adjustment

No deduction could be allowed for that portion of the taxpayer's qualified research expenditures paid or incurred during a taxable year which is equal to the amount of credit allowable for that year.

For example, assume that a taxpayer has qualifying research expenditures during the year of $1 million, and that the base period amount is $600,000. Under present law, the research credit is 25 percent of the $400,000 increase in research expenditures, or $100,000, and the full $1 million amount is deductible. Under the proposal, the $1 million deduction would be reduced by the $100,000 credit, leaving a deduction of $900,000. (The deduction would be disallowed by the full amount of the credit allowable for the year without regard to tax liability limitations on use of the credit in that year.)

Adjustment in credit rate

The rate of credit could be reduced, for example, from 25 percent to 15 percent.

Treatment of leasing expenses

Expenditures for the right to use personal property in research, such as expenditures to lease laboratory equipment, could be limited to payments for the use of computer time by a person other than the principal user of the computer.

Pros and Cons

Arguments for the proposals

Deduction adjustment

1. The allowance of the credit, which reduces the taxpayer's income tax liability by an amount equal to the specified percentage of incremental research expenditures, may be viewed as equivalent to a Federal payment to a taxpayer of the credit amount. Accordingly, since the taxpayer in effect does not pay for its research expenditures to the extent a credit is provided, the taxpayer's deduction should be reduced by that amount.

2. A reduction in the deduction would more nearly equalize the tax benefits provided for research expenditures by smaller, less profitable companies having taxable income at the lowest bracket, and for research expenditures by larger, more profitable companies with taxable income at the highest bracket.

For example, in the case of a company in the 15-percent bracket for 1983 (taxable income below $25,000), the present-law full deduction plus credit will reduce the cost of a $1 increase in research expenditures to $0.60, or 29 percent less than what the cost to the company would have been with only the deduction available ($0.85); while for a company in the 46-percent bracket (taxable income (greater than $100,000), the present-law full deduction plus credit will reduce the company's cost to $0.29, or 46 percent of the cost with only the deduction available ($0.54). Under the proposal, the reduced deduction plus credit would reduce the cost of a $1 increase in research expenditures for the smaller company to $0.64, or a 25-percent reduction in cost (compared to the tax benefit of the full deduction but without the credit); while the reduced deduction plus credit would reduce $1 in incremental costs for the more profitable company to $0.40, or a 25-percent reduction in cost (compared to the tax benefit of the full deduction but without the credit). Thus, the proposal would eliminate the discrepancy between lower-income and higher-income companies in the percentage cost reductions provided by the credit.

Adjustment in credit rate

If full or partial adjustments to basis are provided for ACRS purposes, then the appropriateness of the magnitude of the additional incentive for research investment should be reconsidered. A 25-percent credit plus expensing, even for incremental expenditures, is greater than necessary to stimulate worthwhile additional research.

Treatment of leasing expenses

1. The research tax credit covers research wages, supplies, and amounts paid for the rights to use personal property. Qualifying expenditures do not include property subject to depreciation, on the theory that those assets are receiving favorable treatment under ACRS. However, any leasehold for depreciable property that the taxpayer would have otherwise purchased produces a 25-percent tax credit. This is inconsistent with the rule that depreciable property is not included in the research credit base and skews the investment decision in favor of leasing.

2. There is precedent in tax law for adjusting the deduction. For example, under ERTA, the amount of the 15-percent or 20-percent credit for certain qualified rehabilitation expenditures reduces the basis of the property for deduction (depreciation) purposes. Similarly, under the targeted jobs credit, the employer's deduction for wages is reduced by the amount of the credit.

Arguments against the proposals

Deduction adjustment

A deduction disallowance equal to the amount of the credit would reduce the tax incentives for research expenditures. The Congress determined, in enacting the credit in ERTA, that substantial tax incentives for research expenditures were needed to overcome the reluctance of many companies to allocate funds for the uncertain rewards of research programs.

Adjustment in credit rate

1. It would be inappropriate to reduce the tax credit only a year after it was enacted and 3½ years before it is due to sunset. There has been no opportunity to demonstrate the effectiveness of the credit.

2. Research expenditures are fundamental to maintaining a dynamic economy, competitive among domestic industries and competitive with foreign producers.

Treatment of leasing expenses

The expenses of leasing equipment for research may be a significant portion of total research expenditures for some companies, and hence should be included in the credit base.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Deduction adjustment	0.1	0.3	0.3	0.1	[1]
Rate reduction to 15%	.1	.2	.2	.1	[1]
Leasing expenses restriction	[1]	[1]	[1]	[1]	[1]

[1] Increases of less than $50 million.

4. Credit for Employee Stock Ownership Plans (ESOPs)

Present Law

An employee stock ownership plan (ESOP) is a tax-qualified plan under which employer stock is held for the benefit of employees. An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax-credit ESOP.

For taxable years ending after 1982, an electing employer is allowed an income tax credit for 100 percent of contributions to a tax-credit ESOP. Contributions are limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the limit is one-half of 1 percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of 1 percent. No credit is provided with respect to compensation paid or accrued after 1987.

Possible Proposals

1. The tax credit for ESOP contributions could be reduced from 100 percent to, for example, 50 percent of the amount contributed. The remaining half of the contribution could be deducted by the employer.

2. The ESOP credit could be phased down to 50 percent in 1983, 25 percent in 1984, and terminate thereafter. The balance of the contribution could be deducted by the employer.

3. The scheduled increase in the ESOP contribution limit from one-half of one percent to three-quarters of 1 percent of covered payroll could be repealed.

Pro and Cons

Argument for the proposals

The tax credit grants an employer a credit equal to the value of securities or cash transferred, thus permitting the employer to make these contributions without incurring any costs. It is not appropriate for the government to pay the entire cost of purchasing this stock.

Arguments against the proposals

1. A reduced credit level would provide too little incentive for the establishment of tax-credit ESOPs.

2. Making frequent changes in the ESOP area creates uncertainty and discourages the establishment of tax-credit ESOPs.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
1. Reduce ESOP credit to 50 percent of contributions	.2	.4	.8	1.0	1.2
2. Reduce ESOP credit to 50 percent of contributions in 1983, 25 percent of contributions in 1984, and terminate thereafter	.2	.6	1.1	1.5	1.6
3. Repeal increase in limit above 0.5 percent		(1)	.2	.6	.8

[1] Increase of less than $50 million.

5. Domestic International Sales Corporations (DISCs)

Present Law

Background

A U.S. corporation qualifies as a Domestic International Sales Corporation (DISC) if at least 95 percent of its assets at the end of the taxable year and gross receipts for the taxable year are export-related. Typically, DISC's are wholly owned subsidiary corporations through which parent corporations channel their export sales, though individuals and unrelated corporations may also be DISC shareholders. A DISC is not itself subject to corporate income tax, but its shareholders are taxed on the DISC income when it is actually or deemed distributed to them.

Description

The tax savings from using a DISC result principally from two interrelated aspects of the DISC provisions: (1) special allocation rules which allow at least half of the total combined profit of the DISC and a related person from export sales to be attributed to the DISC; and (2) the deferral of tax on one-half of the DISC's profits attributable to exports exceeding 67 percent of average export receipts in a base period, and certain other items. The base period in 1980 was 1973–76; in 1981, 1974–77; in 1982, 1975–78; and so forth. This incremental rule does not apply to DISCs with taxable income of $100,000 or less, and is phased out over the $100,000 to $150,000 taxable income range.

The deferral of tax continues as long as the undistributed DISC income is invested in qualified assets; the duration may be indefinite, and in such cases constitutes the practical equivalent of a tax exemption. The DISC taxable income that is not eligible for deferral, including at least one-half of its taxable income, is deemed to be distributed annually to its shareholders.

Income from the export of certain property is not eligible for DISC deferral. Such property includes oil, gas, hard minerals, products subject to export control under the Export Administration Act of 1969, and certain services. DISC deferral on exported military goods is limited to half the amount which would otherwise be allowed.

Senate Finance Committee Bill

The Senate Finance Committee bill did not directly amend the DISC provisions. However, DISC was included as one of the corporate tax preferences that would be reduced by 15 percent.

Possible Proposals

1. The deferral of DISC income could be repealed, and DISC income deferred in prior years could be recaptured over a 10 year period.
2. The amount of DISC taxable income that a DISC can defer could be reduced from the present 50 percent to a lower percentage such as 40 percent.
3. The allocation rules could be changed so that no more than one-half of the total combined export profit of the DISC and its related supplier could be allocated to the DISC.
4. The incremental rule could be changed so that DISC benefits are available only for exports over 100 percent of base period exports rather than the present 67 percent.
5. Military sales could be totally excluded from DISC.

Pros and Cons

Arguments for the proposals

1. DISC has proved extremely expensive in terms of annual revenue loss. Treasury Department reports have indicated that its overall impact in stimulating exports has been small in comparison to this annual revenue cost, especially when offsetting movements in exchange rates are taken into account.
2. The allocation to the DISC should be limited to no more than 50 percent of export profits to insure that all export profits are subject to some U.S. tax.
3. DISC should be made available only to incremental exports to limit the windfall element and to provide a continued incentive to increase exports.
4. Military sales should be excluded from DISC because an incentive is unnecessary in many cases.

Arguments against the proposals

1. DISC has increased exports and, thus, employment levels.
2. DISC should not be cut back because it is one of the few meaningful export programs of the United States and curtailing it will send the wrong signal to companies attempting to increase their exports.
3. The currently available level of DISC benefits is necessary to partially offset the variety of export promotion devices employed by other countries.
4. The United States is presently engaged in a variety of trade negotiations (including negotiations involving GATT) and it would be inappropriate to scale down DISC while these negotiations are going on.
5. Military sales should not be eliminated from DISC because competition for military sales is substantial and the benefits are needed to keep U.S. exporters competitive.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
Repeal—DISC with 10-year recapture	0.4	1.6	2.4	2.3	2.3

6. Percentage Depletion

Present Law

Under present law, persons owning economic interests in mines, oil and gas wells, other natural deposits, and timber may deduct an allowance for depletion in computing taxable income. For most natural resources other than timber, taxpayers may elect either percentage or cost depletion.

Under cost depletion, the taxpayer deducts his basis in the property over the life of the mineral resource. The percentage depletion allowance is calculated as a fixed, statutory percentage of the taxpayer's gross income from the mineral property (but not in excess of 50 percent of its taxable income from the property). The percentage varies from 5 to 22 percent of gross income, depending upon the mineral.

The allowance for cost depletion may not result in recovery of more than the taxpayer's basis in the property. On the other hand, the percentage depletion allowance is computed without regard to the taxpayer's basis in the property and may, therefore, exceed the taxpayer's cost basis in the property.

In the case of oil and gas wells, the allowance for percentage depletion is computed only with respect to (1) up to 1,000 barrels a day of oil or gas production by independent producers and royalty owners, and (2) natural gas sold under a fixed contract. The percentage of gross income allowable as a percentage depletion deduction for independent producers and royalty owners is currently 18 percent. This percentage is scheduled to decline to 16 percent in 1983 and 15 percent in 1984 and thereafter. Persons who are retailers or refiners are excluded from independent producer status and are, therefore, not allowed percentage depletion with respect to any oil or gas production. Percentage depletion on oil and gas wells is limited to 65 percent of taxable income.

Possible Proposal

The percentage depletion allowance could be repealed for all production of natural resources, for oil and gas production, or only for production of natural resources other than oil and gas.

Pros and Cons

Arguments for the proposal

1. Percentage depletion allows depletion deductions in excess of cost depletion and in excess of the property's adjusted basis.

2. Percentage depletion, because it can exceed cost basis, subsidizes production in the industries covered by that allowance, and thereby favors investment in those industries.

3. Because percentage depletion subsidizes production, it encourages lower prices and therefore higher consumption of scarce minerals.

Arguments against the proposal

1. Some mineral industries are currently suffering from the effects of the recession. This action would further reduce their return on investment.

2. Repeal of percentage depletion would require that marginal mines and wells be closed. Once a mine is closed, reopening is not economically justified unless the price rises to much higher than previous levels.

3. Natural resources industries require high-risk investments which should be encouraged by the tax system for reasons of national security.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
Repeal percentage depletion on:					
Oil and natural gas	0.8	1.5	1.7	2.0	2.1
Other minerals	.5	.9	1.0	1.1	1.2

7. LIFO Conformity Requirement

Present Law

The last-in, first-out (LIFO) inventory method is one method that taxpayers can use to determine the cost of goods sold during a year. The cost of goods sold during a year is substracted from total sales receipts to determine income from sales. Under the LIFO method, the cost of goods sold during a year is presumed to consist of the most recent (last) inventory costs first (hence "LIFO"), and then older inventory costs. Thus, a taxpayer using the LIFO method matches the most current inventory costs with the revenues from current sales. In times of rising inventory costs, this results in a lower measure of sales income than under other inventory methods such as the first-in, first-out (FIFO) method, the average cost method, and the specific identification method.

Under present law, taxpayers who elect to use the LIFO method for tax purposes are required to also use that method for purposes of reporting income to shareholders, partners, other proprietors, and for credit purposes. This is known as the LIFO "conformity" requirement. Thus, a taxpayer who elects to use the LIFO method for tax purposes because it may result in a smaller measure of taxable income may not use another inventory method that may show a larger measure of income for business purposes such as income reports to shareholders or creditors.

In *Insilco Corporation* v. *Commissioner,* 73 T.C. 589 (1979), the U.S. Tax Court held that the LIFO conformity requirement was not violated when a parent company (that has not elected to use LIFO for tax purposes) uses an inventory method other than LIFO to report to its shareholders the consolidated income of the parent company and its subsidiaries, even if one or more of the subsidiaries has elected to use LIFO for tax purposes. The Government's appeal of the Tax Court decision was dismissed by the U.S. Court of Appeals for the Second Circuit on April 17, 1980.

Possible Proposal

The LIFO conformity requirement could be amended to require that a parent corporation may use only the LIFO method to report the income of a LIFO subsidiary to the shareholders or creditors of the parent corporation. If the parent corporation used a method other than LIFO to report the subsidiary's income, the subsidiary's election to use LIFO would be terminated. The proposal could apply to reports made after the date of enactment.

Pros and Cons

Arguments for the proposal

1. Without the proposed modification, it might be possible for corporations to avoid completely the LIFO conformity requirement simply by forming a subsidiary corporation to which operating businesses with inventories would be transferred. The subsidiary corporation could elect to use the LIFO method and the parent corporation then could use any inventory method it chose to report consolidated income to its shareholders.

2. Without the proposed modification, many corporations that have not elected LIFO because of the conformity requirement might be encouraged to switch to LIFO at a substantial loss of revenue to the Government.

Arguments against the proposal

1. The LIFO conformity requirement no longer serves its original purpose because the LIFO method is now recognized as an acceptable method of accounting for all taxpayers. Also, many non-LIFO income disclosures are now permitted under Treasury regulations.

2. It is not clear that corporations would be able to avoid the LIFO conformity requirement simply by forming an operating subsidiary. Insilco Corporation was an operating company. It would be a different case if a corporation transferred all of its business operations to a subsidiary, leaving only a shell behind to make consolidated income reports to its shareholders. In such a case the courts could very well ignore the existence of the parent corporation and treat the income report as a report of the subsidiary to its shareholders.

8. Graduated Corporate Tax Rates

Present Law

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The highest corporate tax rate is 46 percent, and it applies to taxable incomes greater than $100,000. Below $100,000 of taxable income, the graduated tax rates apply to four taxable income brackets of $25,000, as shown in the table below.

Taxable income	Tax rate (percent)
0 to $25,000	16 (15 after 1982)
$25,000 to $50,000	19 (18 after 1982)
$50,000 to $75,000	30
$75,000 to $100,000	40
Over $100,000	46

Possible Proposal

Corporate taxable income in excess of $100,000 but less than $200,000 could be subject to a surtax of 19.25 percent.

Pros and Cons

Argument for the proposal

Businesses with taxable income over $100,000 are large enough to not need the benefit from graduated rates. Large business should pay a tax equivalent to 46 percent of all income.

Argument against the proposal

Under the proposal, the marginal tax rate on income between $100,000 and $200,000 would be 65.25 percent (the 46-percent regular tax rate plus the $19.25 surtax). This is a very high marginal tax rate which severely reduces the incentive to increase profits.

9. Intangible Drilling Costs

Present Law

Under present law, an operator who pays or incurs intangible drilling or development costs (IDCs) in the development of an oil or gas property or certain geothermal wells, may elect to either expense or capitalize such amounts. For this purpose, IDCs include all expenditures by an operator for wages, fuel, repairs, hauling, etc., in connection with the excavating, grading, drilling, shooting, or cleaning of wells, and all other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas (or geothermal energy). Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings), or items which are part of the acquisition price of an interest in the property.

Generally, if IDCs are not expensed, but are capitalized, then they can be recovered through depletion or depreciation, as appropriate. However, if IDCs are capitalized and are paid or incurred with respect to a nonproductive well ("dry-hole"), then they may be deducted, at the election of the operator, as an ordinary loss in the taxable year in which the dry hole is completed.

An integrated oil company is, for depletion purposes, any company (1) which has retail sales of oil or gas (or any product derived therefrom) either directly or through a related person totaling more than $5,000,000 in the taxable year, or (2) which either directly or through a related person refines crude oil and has refinery runs in excess of 50,000 barrels in any day during the taxable year.

If an operator elects to expense IDCs and then disposes of the property, the amount of any IDCs expensed is recaptured as ordinary income but not in excess of the amount which would have been deducted had the IDCs been capitalized and depleted.

Possible Proposals

1. The election to expense IDCs could be repealed. Recovery of such expenses would have to be made through depletion or depreciation deductions. The proposal would leave the dry hole loss deduction election in place.

2. The repeal of the election to expense IDCs could be limited to integrated oil companies.

3. Alternatively, the IDC expense election could be repealed and replaced by a requirement that IDCs be capitalized and amortized over some statutory period (e.g., 5, 10 or 15 years).

Pros and Cons

Arguments for the proposals

1. The election to expense IDCs is an unnecessary tax preference granted to the oil industry. They should have to use the general tax rules applicable to all taxpayers, which include capitalization of expenditures such as IDCs.

2. Decontrol of oil prices and the price of decontrolled gas make it unnecessary to encourage drilling by way of this tax preference to the oil and gas industry.

Arguments against the proposals

1. Drilling for oil is highly risky. The option to expense IDCs is necessary to help reduce this risk and encourage drilling.

2. Most new oil wells are drilled by independent drillers who depend upon this deduction to maintain their cash flow. If the expense option is removed, the number of wells drilled will be reduced.

3. The benefits of the IDC election are no more generous than those available on other investments under ACRS and the investment credit.

10. Foreign Tax Credit

Present Law

Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being fully taxed twice on their foreign income—once by the foreign country where the income is earned, and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits cannot offset U.S. tax on domestic income.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result. Some countries avoid double taxation by exempting foreign source income from tax altogether. However, most countries, including the United States, avoid double taxation through a foreign tax credit system, providing a dollar-for-dollar credit against home country tax liability for income taxes paid to a foreign country.

The credit is available only with respect to foreign income, war profits, or excess profits taxes and for certain taxes imposed in lieu of them (for ease of reference, referred to generally as foreign income taxes). Other taxes paid by the taxpayer are generally not creditable but are treated only as deductible expenses.

Possible Proposals

1. The foreign tax credit could be repealed. Taxpayers would treat foreign taxes as a deductible expense.

2. The foreign tax credit limitation could be changed to limit the use of high foreign taxes imposed by a foreign country to offset U.S. tax on low taxed foreign income. For example, the limitation could be the lesser of the per-country or overall limitations, or separate limitations could be provided for active and passive income, or for high and low taxed income.

Pros and Cons

Arguments for the proposals

1. The granting of a credit, as opposed to a deduction, for foreign income taxes creates an incentive to invest abroad as opposed to in the United States.

2. Foreign income taxes can be viewed as a cost of doing business that should be deductible rather than creditable.

3. U.S. taxpayers doing business abroad do not pay any U.S. tax if their foreign tax rate equals or exceeds the U.S. tax rate. Thus, they do not carry their share of the U.S. tax burden.

Arguments against the proposals

1. The foreign tax credit helps to create neutrality as between foreign and domestic investment. Repeal would create a strong bias against foreign investment. It will make U.S. firms noncompetitive and seriously damage the ability of U.S. firms to do business abroad. The United States would be the only industrialized country that would not grant relief from double taxation. Also, repeal would conflict with all of our treaties.

2. The basic concept of the foreign tax credit of retaining only a residual right to tax recognizes that the country where income is earned provides the environment for earning of that income, and has the primary right to tax that income.

3. Although U.S taxpayers earning foreign income may supply less revenue to the Treasury than if they earned domestic income, such taxpayers pay total income taxes (to U.S. and foreign governments) that equal or exceed what they would pay on domestic income. Therefore, the foreign tax credit does not discriminate in favor of those taxpayers.

4. Without a foreign tax credit. U.S. taxpayers earning foreign income would pay higher combined taxes than both foreigners earning foreign income and U.S. taxpayers earning domestic income. This would seriously impair their competitive position.

11. Deferral of Taxation on Foreign Income

Present Law

The United States subjects to current tax the worldwide income of U.S. corporations. As a general rule, income earned by a U.S.-controlled foreign corporation ("CFC") is not taxed to its U.S. shareholders until it is distributed in the form of dividends. This is referred to as "deferral" of tax on the earnings of CFCs. There are, however, exceptions under which U.S. shareholders are currently taxed on certain undistributed tax haven income of CFCs and on the passive income of foreign personal holding companies. (Losses of CFCs may not offset income of their U.S. shareholders.)

Possible Proposal

The "deferral" of tax on earnings of CFCs could be repealed. The earnings of a CFC would be taxed currently to its shareholders whether or not they are paid to the U.S. shareholders (usually parent companies) as dividends. A foreign tax credit would be allowed against U.S. tax imposed on that income.

Pros and Cons

Arguments for the proposal

1. Deferral makes taxation depend on an artificial factor: whether a U.S. taxpayer has chosen to use the device of a foreign corporation.
2. Deferral creates a tax incentive for U.S. taxpayers to invest in low tax situations overseas rather than in the United States.
3. Terminating deferral will reduce the incentive for U.S. taxpayers to avoid U.S. tax by undercharging foreign affiliates for various items.
4. Deferral allows U.S. taxpayers to decide when certain income will be taxable. This flexibility allows taxpayers to arrange their income to suit their tax purposes rather than to reflect reality.
5. Eliminating deferral would simplify the tax law.

Arguments against the proposal

1. Deferral encourages exports (and thus U.S. jobs), because some CFCs sell U.S. goods abroad and benefit from deferral.
2. Many industrialized countries defer or eliminate tax on foreign earnings. Eliminating deferral will put U.S. taxpayers overseas at a disadvantage in competing with local and other foreign competitors.
3. Ending deferral would violate principles of comity among nations by effectively subjecting foreign entities to tax even in cases not conducive to tax avoidance.

4. Ending deferral would create additional complexity and burdens on taxpayers and the Internal Revenue Service. It would require audits of all CFCs and require the maintenance of additional records by taxpayers.

C. Excise Taxes

1. Windfall Profit Tax Provisions

Present law

1. Prior to ERTA, royalty owners were entitled to a tax credit against the first $1,000 in windfall profit tax liability for 1980 production. ERTA provided a credit of up to $2,500 for 1981, and, effective after 1981, established a permanent exemption of 2 barrels per day of royalty production (3 barrels in 1985 and thereafter).

2. Under pre-ERTA law, newly discovered crude oil (generally oil discovered after 1978) was taxed at a rate of 30 percent. Under ERTA, the rate will be phased down from 30 percent in 1981 to 15 percent in 1986 and thereafter (27.5 percent in 1982, 25 percent in 1983, 22.5 percent in 1984, and 20 percent in 1985).

3. Under pre-ERTA law, up to 1,000 barrels of oil produced by and independent producer were entitled to lower rates (tier 1: 50 percent instead of 70 percent; tier 2: 30 percent instead of 50 percent). Stripper oil (i.e., oil from a property with an average per-well daily production of 10 barrels or less during any consecutive 12-month period after 1972) was taxed as tier 2 oil. ERTA exempted from the tax all stripper oil produced by independents.

4. Present law provides an exemption from the windfall profit tax for most production located north of the Alaskan and Aleutian Mountain ranges in Alaska.

Possible Proposals

1. Repeal the ERTA windfall profit tax amendments with respect to royalty owners, newly discovered oil, and independent stripper oil.
2. Replace the royalty owner exemption with a credit of up to $1,000 or $2,500
3. Establish a rate for newly discovered oil between 15 and 30 percent.
4. Limit the stripper exemption to 10 barrels per day per producer.
5. Repeal the Alaskan oil exemption.

Pros and Cons

Arguments for the proposals

1. Royalty owner credit:
    a. The current 2-barrel-per-day exemption provides benefits that could exceed $7,000 for individual royalty owners.
    b. The exemption mechanism (as compared to a credit) creates administrative difficulties.

c. There is no rationale for providing special tax treatment for royalty owners, since this credit does not result in additional oil production.

2. The rate reduction for newly discovered oil should be scaled back or repealed because the 30-percent rate was low enough to attract substantial investment in new oil properties.

3. Under the windfall profit tax, taxable windfall profit is limited to 90 percent of the net income attributable to oil. This net income limit insures that stripper properties will not be abandoned prematurely because of the tax. The exemption for stripper oil is, therefore, unnecessary to provide incentive to produce this oil.

4. The stripper oil exemption encourages producers to reduce production in order to qualify for the exemption.

5. The exemption for Alaskan oil benefits a small number of large producers who are operating in Alaska.

Arguments against the proposals

1. The ERTA amendments in general tend to encourage oil production, thereby tending to reduce U.S. dependency on foreign oil, reduce prices (through increased production), and fight inflation.

2. The royalty owner amendment:

a. benefits many small or low income taxpayers, and

b. helps achieve the original intent of the windfall profit tax by causing a greater share of the tax burden to fall on large oil companies.

3. The rate reduction for new oil is needed to encourage expanded oil exploration, which is becoming increasingly expensive and risky in the United States, particularly in view of the recent drop in oil prices.

4. The stripper well exemption helps encourage continued production from marginal wells at a time when domestic oil production should be encouraged when at all possible.

5. Repeal of the Alaskan exemption would discourage development of the potentially vast resources in the Arctic where costs are very high.

Revenue Effect

[Fiscal years, billions of dollars]

	1983[1]	1984	1985	1986	1987
1. Royalty credit:					
(a) Repeal	0.3	0.5	0.5	0.5	0.5
(b) Limit to $2,500 per year	([2])	.1	.1	.1	.1
2. Repeal rate reduction for newly discovered oil	.1	.2	.3	.4	.5
3. Repeal stripper exemption	.2	.3	.3	.3	.3

[1] Assumes effective date of Jan. 1, 1983.
[2] Less than $50 million.

2. Energy Consumption Taxes

Present Law

Overview

Under present law, there are a variety of excise taxes imposed on the consumption of fuels or fuel minerals. These taxes are allocated to trust funds to finance spending for specific purposes. These excise taxes include (1) the black lung excise tax on coal, (2) the environmental excise taxes on petroleum and certain chemicals, (3) the excise taxes on the sale of gasoline, diesel fuel and other special fuels, and (4) the excise tax on fuel used in commercial transportation on designated inland and intracoastal waterways. (A 3⅓-percent manufacturers excise tax on electrical energy was repealed by the Revenue Act of 1951.)

Tax on mined coal

The black lung excise tax on coal is $1 per ton in the case of coal from underground mines and 50 cents per ton in the case of coal from surface mines, or if less, 4 percent of the price for which the coal is sold. The receipts from this tax on coal are placed in the Black Lung Disability Trust Fund to pay for benefits to miners who suffer from pneumoconiosis or their survivors.

Environmental taxes

The environmental excise taxes on petroleum and certain chemicals are imposed at a rate of 0.79 cent per barrel on crude oil and imported petroleum products, at a rate of $4.87 per ton on a variety of chemicals produced from petroleum, at a rate of $3.44 per ton for methane, and at various rates on selected inorganic chemicals. The receipts from the environmental excise taxes are deposited in the Hazardous Substance Response Trust Fund which may be used in response to toxic oil and chemical spills and other environmental damage associated with toxic substances.

Motor fuels taxes

Excise taxes of 4 cents per gallon are imposed on motor fuels, with exemptions for various off-highway uses, gasohol (through 1992), and buses. Under present law, these excise taxes are scheduled to be reduced to 1.5 cents a gallon on October 1, 1984. The receipts from these taxes are deposited in the Highway Trust Fund through September 30, 1984.

Inland waterways fuel tax

An excise tax of 6 cents per gallon is imposed on fuel used in commercial transportation on designated inland and intracoastal waterways. The tax is scheduled to increase to 8 cents per gallon on October 1, 1983 and to 10 cents per gallon on October 1, 1985. The receipts from this tax are deposited in the Inland Waterways Trust Fund.

Possible Proposals

There are a number of different ways in which new or additional energy consumption taxes could be imposed on energy consumed in the United States, whether imported or domestically produced. Under any option, part or all of the portion of an energy tax which would be derived from highway motor fuels could be transferred to the Highway Trust Fund.

Ad valorem tax

An ad valorem tax could be imposed as a percentage of the amount paid for coal, hydroelectric power, natural gas, nuclear power, and petroleum. Such a tax could be imposed on the value at the wellhead, mine, or power plant. Alternatively, the tax could be imposed on the value later in the production and distribution chain.

Motor fuels taxes

1. The motor fuels excise taxes could be increased from the present 4 cents per gallon to some higher level (e.g., by 2, 5, or 10 cents per gallon), with the revenues to be used for highway or other transportation purposes.
2. The motor fuels excise taxes could be indexed according to changes in the producer price index; alternatively, the tax could be set as a percentage (ad valorem) of the price (manufacturer or wholesaler level).
3. There could be selected increases in the highway trust fund taxes to make them a fairer way of allocating the costs of highways, with the total revenue increase equivalent to a 2, 5, or 10 cent per gallon increase in the motor fuels tax.

Oil tax

An oil tax could be imposed on the importation of crude oil and petroleum products, or alternatively, on consumption of both imported and domestically produced oil and petroleum products.

Combination of energy taxes

A combination of any of the foregoing options could be constructed to produce an energy consumption tax which would have approximately the same per capita impact on various sections of the United States.

Administration and exemptions

In imposing a broad-based energy tax, it would be necessary to decide several basic issues related to the administration of such a tax. These would include the point in the distribution chain for imposition of the tax, and the exemptions necessary to prevent double taxation or taxation of energy that is lost or reinvested in production of taxable energy.

The options with respect to the point at which such a broad-based energy tax could be imposed are:

(1) on the person first recovering the energy product (as in the windfall profit tax and the excise tax on coal);

(2) on the first purchaser of the energy resource (similar to the windfall profit tax withholding system);

(3) on the person who first uses or processes the crude energy resource (as in the case of the environmental excise taxes);

(4) on the person producing or delivering energy in a consumable form (as is the case with the gasoline tax); or

(5) at whatever point between the producer and the ultimate consumer results in the fewest number of taxpaying entities.

The choice of where the tax is imposed will affect the relative burden of the tax on consumers of various fuels, will determine the number of taxpayers, and may influence the method used to assess and collect the tax. For example, a tax at the wellhead or mine mouth would involve many individual producers and suggest withholding by the first purchaser, a level which has relatively fewer taxpayers, as a method to collect the tax. In addition, an ad valorem tax at that point would not be imposed on value added by refining or transportation. Alternatively, a tax on producers of consumable energy products could involve fewer taxpaying entities (e.g., refineries rather than oil producers) and suggests a self-assessment system like that used for the gasoline tax. Such a tax would, if imposed on an ad valorem basis, tax value added by refining and transportation.

Because one form of energy may be converted to another or used to produce additional energy, a broad-based energy tax could have exemption provisions to prevent double taxation of energy. Examples to such exemptions in present law are the windfall profit tax exemption for powerhouse fuel, the fuel tax exemption for gasoline sold to producers of gasoline, and the refund or credit rules under the environmental excise taxes. In addition, exemptions could be provided for taxable substances that are not used for energy purposes, such as methane used to produce fertilizer. Finally, an exemption could be provided for exports.

Pros and Cons

Arguments for the proposals

1. Energy consumption has various costs which are not reflected in energy prices and thus are not taken into account by consumers in making decisions about energy consumption. These costs include higher prices which must be paid to foreign producers, decreased national security associated with high oil import levels, the high cost of new power plants, and pollution of the environment. Energy consumption taxes would increase prices to reflect these costs, and thus would reduce these costs as consumption of energy declined.

2. The incentives for lower energy use provided by energy consumption taxes would reduce the need for government subsidies for particular energy projects.

3. An oil import fee would raise the net price to domestic producers of energy and thereby stimulate exploration and production ac-

tivity with respect to domestic energy sources. This would reduce our dependence on foreign sources of fuel.

4. The tax on gasoline and other highway motor fuels has not been increased since 1959 and thus has decreased as a percentage of gasoline prices and relative to consumer prices generally. However, the costs of highway construction and repairs and other costs paid for by the Highway Trust Fund, which is financed mainly by the motor fuels taxes, have continued to escalate. If the tax rate had been indexed to the CPI in 1959, the rate would now be more than 13 cents per gallon.

Arguments against the proposals

1. Any excise tax on the consumption of energy would lead to an increase in the cost of energy, the rate of inflation, and governmental and private outlays that are indexed for inflation.

2. Any option which is not neutral in its impact on various regions of the country would be unfair to consumers in the more heavily affected areas.

3. Energy taxes (like many consumption-based taxes) are regressive, affecting low-income households relatively more severely than high-income households.

According to the 1971–72 Consumer Expenditure Survey, gasoline expenditures are 6.6 percent of income for the tenth of the population with the lowest income and are only 2.0 percent of income for the tenth of the population with the highest income.

4. Taxation of coal would discourage energy users from switching to coal from oil and gas, and would thus increase our dependence on imported oil.

5. There would be high administrative and compliance costs associated with the establishment of a new tax.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983 [1]	1984	1985	1986	1987
1. *Increase motor fuels taxes by:*					
(a) 2 cents per gallon	1.2	1.7	1.7	1.7	1.7
(b) 5 cents per gallon	3.1	4.3	4.2	4.2	4.2
(c) 10 cents per gallon	6.1	8.6	8.3	8.2	8.2
2. *Tax on imported petroleum:*					
(a) $2 per barrel	3.0	4.3	4.2	4.2	4.2
(b) $5 per barrel	7.4	10.4	10.0	9.9	9.9
3. *Tax on domestic and imported petroleum (1983–1985):*					
(a) $2 per barrel	5.0	8.4	8.4	3.4	....
(b) $5 per barrel	12.3	20.6	20.6	8.2	....
4. *Tax on coal, hydroelectric and nuclear power, natural gas, and petroleum (1983–1985):*					
5 percent of value	6.9	11.9	13.7	5.8	....

[1] Assumes effective date of Jan. 1, 1983.

3. Alcohol Taxes

Present Law

Under present law, excise taxes are levied on the production or importation of three major types of alcoholic beverages: distilled spirits, wine, and beer. Also, an occupational tax is imposed on persons involved with the production or marketing of alcoholic beverages.

The alcohol excise tax rates have not been increased since 1951 (distilled spirits) and 1955 (wine and beer). The following is a summary of the excise taxes imposed on alcoholic beverages and the alcohol occupational taxes:

ALCOHOLIC BEVERAGE TAXES

Item	Tax Imposed
Distilled spirits	$10.50 per proof gallon.
Beer	$9.00 per barrel generally.[1]
Still wines:	
Up to 14 percent alcohol	$0.17 per wine gallon.
14 to 21 percent alcohol	$0.67 per wine gallon.
21 to 24 percent alcohol[2]	$2.25 per wine gallon.
Champagne and sparkling wines	$3.40 per wine gallon.
Artificially carbonated wines	$2.40 per wine gallon.

[1] $7 per barrel for certain small brewers.

[2] Wines containing more than 24 percent alcohol are taxed as distilled spirits.

ALCOHOL OCCUPATIONAL TAXES

Item	Tax Imposed
Brewers	$110 a year; $55 for less than 500 barrels a year.
Still manufacturers	$55 a year, plus $22 per still.
Wholesale dealers:	
Liquors and wines	$255 a year.
Beer	$123 a year.
Retail dealers:	
Liquors and wines	$54 a year.
Beer	$24 a year.

For example, the Federal excise tax on a one-fifth gallon bottle of 80-proof liquor is $1.68; on 6 12-ounce containers of beer, about 12 cents; and on a 750-milliliter bottle of still wine (less than 14 percent alcohol), about 3.4 cents.

Possible Proposals

1. The alcoholic beverage excise taxes could be increased by 33⅓ percent, 50 percent, or 100 percent. Doubling the tax rates would result in the following:

Item	Tax imposed
Distilled spirits	$21.00 per proof gallon.
Beer	$18.00 per barrel generally.[1]
Still wines:	
Up to 14 percent alcohol	$0.34 per wine gallon.
14 to 21 percent alcohol	$1.34 per wine gallon.
21 to 24 percent alcohol [2]	$4.50 per wine gallon.
Champagne and sparkling wines	$6.80 per wine gallon.
Artificially carbonated wines	$4.80 per wine gallon.

[1] $14 per barrel for certain small brewers.
[2] Wines containing more than 24 percent alcohol are taxed as distilled spirits.

2. The tax rates in the first proposal could be indexed for inflation, using either the CPI or the GNP deflator, effective January 1, 1984.
3. The alcohol beverage excise taxes could be imposed as ad valorem taxes equal to a percentage of manufacturer's price. A percentage which would result in the same effective rates for 1983 as would result under the first proposal could be selected.

Arguments for the proposals

1. The present excise tax on distilled spirits has not been increased since 1951; the taxes on wine and beer have not been increased since 1955. Inflation since those changes were made has resulted in a 70-percent decrease in the effective rates of the taxes imposed on alcoholic beverages. An increase in these taxes is therefore appropriate. If the tax rate on distilled spirits had been indexed to the CPI in 1951, the rate would now be more than $38 per proof gallon. Further, the alcoholic beverage taxes should remain relatively constant as a percentage of price; therefore, indexing or changing these taxes to ad valorem taxes is appropriate.
2. While excise taxes are generally viewed as affecting the poor more than the wealthy, i.e., as regressive, the alcohol excise taxes are imposed on discretionary purchases. Arguments against regressive taxes are less persuasive in the case of taxes imposed on discretionary purchases than in the case of taxes affecting necessities.
3. Taxes on alcoholic beverages should be increased and made more nearly equivalent in terms of alcoholic content to reflect the costs borne by the Federal Government as a result of the consumption of alcoholic beverages.

Arguments against the proposals

1. Excise taxes imposed at a flat rate are regressive, i.e., they cost the poor a larger percentage of available income than the taxes cost wealthier individuals making the same purchases. According to the 1971–72 Consumer Expenditure Survey, alcohol expenditures are 2.2 percent of income for the tenth of the population with the lowest income and are only 0.9 percent of income for the tenth of the population with the highest income.

2. Indexing the tax rates would mean more frequent changes, which are likely to make tax administration and compliance more costly and complex.

3. State and local governments impose excise taxes on alcoholic beverages. Increasing the Federal tax rates could preempt possible tax increases at the State and local levels.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Double tax on distilled spirits	1.6	2.6	2.7	2.7	2.8
Index distilled spirits tax at new rate		.2	.6	1.1	1.6
Double tax on beer	.8	1.2	1.1	1.1	1.1
Index beer tax at new rate		.1	.3	.5	.7
Double taxes on wine	.1	.2	.2	.2	.2
Index wine tax at new rate		(1)	(1)	(1)	(1)

[1] Increase of less than $50 million.

4. Luxury Taxes

Present Law and Background

Present law

Under present law, there are no special Federal excise taxes that apply to purchases of luxury articles such as expensive jewelry, fur coats, yachts, etc.

Background

Prior law imposed Federal excise taxes on automobiles and certain luxury articles. Examples of these taxes included the following:

(1) A 7-percent manufacturers excise tax on automobiles (10 percent prior to 1965);

(2) A 10-percent retailers excise tax on jewelry, various precious and semi-precious stones, watches, clocks, sterling silverware, silver-plated holloware, and certain other items;

(3) A 10-percent retailers excise tax on articles made of fur on the hide or pelt, and on articles of which fur is the component material of chief value;

(4) A 10-percent retailers excise tax on "toilet preparations" (such as cosmetics), handbags, and luggage;

(5) A 10-percent manufacturers excise tax on radio and television sets, phonographs, records, and certain other items;

(6) An annual $10-per-device occupational tax on persons who maintained or permitted the use of coin-operated amusement devices at any place occupied by them; and

(7) A $250-per-year occupational tax on persons who operated slot machines or other coin-operated gaming devices.

The manufacturers excise tax on automobiles was repealed by the Revenue Act of 1971. Items 2–6 above were repealed by the Excise Tax Reduction Act of 1965, and the occupational tax on slot machines and other coin-operated gaming devices was repealed by the Revenue Act of 1978.

Possible Proposals

1. A 10-percent excise tax could be imposed on purchases of certain luxury articles. Under this proposal, articles subject to tax could include the following:

(a) coin-operated amusement devices and home video games (including software used with such devices and games);

(b) automotive vehicles (other than trucks taxed under sec. 4061), including recreational vehicles and trailers, to the extent that the manufacturer's retail list price exceeds a threshold amount (e.g., $15,000);

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(c) boats and yachts (to the extent not subject to tax under the proposed Dingell-Johnson Fund amendment to sec. 4161);

(d) jewelry, including watches, leather handbags and wallets, and toilet preparations (i.e., cosmetics);

(e) articles made of fur on the hide or pelt and articles of which fur is the component material of chief value;

(f) airplanes other than airplanes used for transportation of persons or property for hire.

The taxes on automotive vehicles, boats and yachts, airplanes, coin-operated amusement devices, and home video games could be imposed on the manufacturer or importer of the taxable article. The taxes on jewelry, leather goods, and toilet preparations could be imposed on the retail sale of the taxable article.

2. A 10-percent excise tax could be imposed on purchases of the luxury articles listed in the first proposal, except that the tax could be applied only to the excess of the price of the taxable article over a threshold dollar amount in certain cases. Under this proposal, the threshold amounts could be as follows:

(a) automotive vehicles, $20,000;

(b) boats and yachts, $10,000;

(c) jewelry, $1,000;

(d) articles made of fur on the hide or pelt and articles of which fur is the component material of chief value, $1,000; and

(e) airplanes, $10,000.

Pros and Cons

Arguments for the proposal

1. An excise tax on luxury consumer articles could discourage such purchases and thereby encourage greater savings and investment in more productive assets.

2. Various provisions of the income tax law enable some individuals to reduce substantially their tax liabilities, thereby better enabling them to purchase luxury articles. An excise tax on such articles could assist in providing a fairer overall distribution of the tax burden.

Arguments against the proposal

1. A luxury tax could entail high collection and enforcement costs relative to the amounts of revenue generated.

2. Any tax on "luxury" articles would be arbitrary in that there are disagreements as to the type of articles which should be subject to the tax.

3. An excise tax applying only to certain types of goods would distort consumer expenditures in ways that do not necessarily serve any public purpose.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983	1984	1985	1986	1987
Amusement devices and video games, 10 percent of price	([1])	([1])	([1])	([1])	([1])
Automotive vehicles, 10 percent of price over $20,000	.1	.1	.2	.2	.2
Boats and yachts, 10 percent of price over $10,000	.1	.1	.1	.1	.1
Jewelry, 10 percent of price over $1,000	([2])	.1	.1	.1	.1
Fur, 10 percent of price over $1,000	([2])	([2])	([2])	([2])	([2])

[1] Not available at this time.
[2] Increase of less than $50 million.

5. Excise Tax on Bows and Arrows

Present Law

Under present law, an 11-percent manufacturers excise tax is imposed on the sale by a manufacturer, producer, or importer of any bow which has a draw weight of 10 pounds or more and of any arrow which measures 18 inches overall or more in length (sec. 4161(b)).

Possible Proposal

The excise tax on arrows could be expanded to include arrows less than 18 inches in overall length when the arrow is suitable for use with a taxable bow.

Pros and Cons

Argument for the proposal

The present tax on arrows discriminates between arrows primarily with long bows and those primarily used with cross bows. Both lengths of arrows are used in the sport of archery; therefore, the excise tax should apply equally to them.

Arguments against the proposal

1. Revenues from the excise tax on bows and arrows are automatically appropriated for State wildlife preservation programs. An increase in the tax would not help offset the Federal deficit.

2. It is inappropriate to increase taxes to fund a program for which no determination has been made that additional funds are required at this time.

D. Employment Taxes

1. SECA tax

Present Law

For calendar year 1982, employers and employees are each subject to social security (FICA) taxes of 6.70 percent on the first $32,400 of the employee's wages, for a maximum FICA tax of $2,170.80 each and a combined maximum of $4,341.60 per employee. Self-employed individuals are subject to social security (SECA) taxes of 9.35 percent of net self-employment income up to $32,400, for a maximum SECA tax of $3,029.40 per individual. The tax rates are specified in the statute (see table below), and the limit on taxable wages is adjusted each year according to the percentage increase in average wages. Social security benefits depend on an individual's lifetime history of taxable wages or self-employment earnings.

For income tax purposes, the expenses of compensation or purchased services, including wages, the employer FICA tax, and payments to self-employed individuals, are deductible as a business expense. The employee FICA tax and the SECA tax are not deductible.

Possible Proposal

The rate of the SECA tax could be increased to slightly less than the combined employer-employee FICA tax rate, as shown in the following table.

An above-the-line income tax deduction could be allowed for one-half of an individual's SECA liability.

SOCIAL SECURITY TAX RATES, BY CALENDAR YEAR

[In percent]

Item	1983-84	1985	1986-89	1990 and later
Present law:				
Employer and employee rates, combined	13.40	14.10	14.30	15.30
Self-employed rate	9.35	9.90	10.00	10.75
Proposal:				
Self-employed rate	12.56	13.17	13.35	14.21

The proposed SECA rates shown in the table have been chosen by formula to make more nearly equal the income and social security tax treatment of employees and the self-employed, as illustrated in the example shown in the following table.

EXAMPLE OF 1983 INCOME AND SOCIAL SECURITY TAX TREATMENT OF EMPLOYEE AND SELF-EMPLOYED INDIVIDUAL UNDER PRESENT LAW AND PROPOSAL

Item	Employee	Self-employed individual	
		Present law	Proposal
A. *Cost of services:*			
Wages	$10,000		
Employer FICA	670		
Payments for services		$10,670	$10,670
Total cost to employer	10,670	10,670	10,670
B. *Worker's earned income minus social security taxes:*			
Earned income to	10,000	10,670	10,670
Employee FICA	670		
SECA		998	1,340
Earned income minus social security taxes	9,330	9,672	9,330
C. *Worker's adjusted gross income:*			
Earned income	10,000	10,670	10,670
Deduction for half of SECA taxes			670
Adjusted gross income	10,000	10,670	10,000
D. *Social security trust fund contributions:*			
Employee FICA	670		
Employer FICA	670		
SECA		998	1,340
Total trust fund contribution	1,340	998	1,340

If, in 1983, an employer pays $10,000 of wages to an employee, the employer's wage and social security tax cost of employment, deductible from income tax as a business expense, would be $10,670 ($10,000 of wages plus $670 of employer FICA tax). For the employee, adjusted gross income for income tax purposes is $10,000 and employment income minus social security tax is $9,330 ($10,000 minus $670 of employee FICA tax).

Assume now that the employer considers contracting with a self-employed individual to perform the same work for the same wage/tax cost to the business—$10,670, which also is the amount deductible from income tax as a business expense. Under the proposal, SECA tax liability would be $1,340 (12.56 percent of $10,670), the same as the combined employer-employee FICA liabilities; the individual's employment income minus social security tax would be the same—$9,330 ($10,670 of income minus $1,340 of SECA tax); and the individual's adjusted gross income would be the same—$10,000 ($10,670 of income minus a $670 deduction for one-half the SECA liability).

In contrast, under present law, the self-employed individual's social trust fund contributions are lower than those made on behalf of the employee; his employment income net of social security taxes is higher, but his adjusted gross income (and, thus, income tax liability) is higher. Regardless of the income tax bracket of the worker, net after-tax income for the self-employed individual in the example is always greater than or equal to the net after-tax income of the employee. Under the proposal, social security and income tax treatment of employees and self-employed individuals would be made more nearly equal, although creditable wages for social security benefit purposes would continue to be higher for the self-employed individual.

Pros and Cons

Arguments for the proposal

1. Under the current system, social security benefits are provided to self-employed individuals for about 75 percent of the amount paid to provide employees with equivalent benefits. The self-employed are not paying a fair price for their benefits.

2. The present tax treatment of self-employed individuals accounts for a significant portion of the financial difficulties of the social security system, and removal of the subsidy to self-employed individuals would alleviate these difficulties.

3. The proposal would eliminate a tax incentive to claim independent contractor status and would reduce classification disputes with the Internal Revenue Service.

Arguments against the proposal

1. The proposal would adversely affect self-employed individuals who operate small businesses, such as some farmers and direct sellers.

2. The proposed income tax deduction for one-half the SECA liability would be of more benefit to, and would offset more of the SECA increase for, high bracket taxpayers than low bracket taxpayers. Thus, the proposals together would increase combined income and SECA tax liability more for low bracket than high bracket taxpayers.

Revenue Effect

[Fiscal years, billions of dollars]

Item	1983[1]	1984	1985	1986	1987
Rate increase for SECA tax (trust fund receipts)	0.6	3.0	3.3	3.6	4.0
Income tax deduction for half of SECA tax	−.3	−1.5	−1.6	−1.8	−2.0
Total (unified budget receipts)	.3	1.5	1.7	1.8	2.0

[1] Assumes effective date of Jan. 1, 1983.

E. Other Items

1. Estate and Gift Taxes

a. Modification of unified credit

Present Law

The gift and estate taxes are "unified," that is, a single progressive rate schedule applies to cumulative gifts and bequests. Generally, gift or estate tax liability is determined by first computing the gross gift or estate tax and then subtracting the unified credit and any other allowable credits to determine the amount of the gift or estate tax.

Present law, as amended by ERTA, increased the unified credit from $47,000 for estates of individuals dying in 1981 to $192,800 for estates of individuals dying in 1987 and subsequent years. With a unified credit of $47,000 in 1981, no gift and estate taxes were imposed on cumulative transfers of up to $175,625. With a unified credit of $192,800 for post-1986 years, no gift and estate taxes will be imposed on transfers of up to $600,000.

The unified credit has increased each year since the estate and gift taxes were unified in 1976. The amounts of property that could pass free of gift and estate tax between 1977 and 1981 were as follows: $120,000 (1977), $134,000 (1978), $147,000 (1979), $161,000 (1980) and $175,625 (1981). Before unification of the taxes in 1976, a $30,000 lifetime exclusion from gift tax was provided and $60,000 of property was exempt from estate tax.

The scheduled unified credit increases between 1982 and 1987, and the value of property that can pass free of tax by virtue of the credit, are as follows:

Gifts made and individuals dying in—	Unified credit	Equivalent exemption
1982	$62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and thereafter	192,800	600,000

Possible Proposals

1. The increases in the gift and estate tax unified credit scheduled to take effect in 1985-1987 could be eliminated. Under the pro-

posal, for gifts made and for estates of individuals dying in 1984 and thereafter, no gift and estate taxes would be imposed on transfers of up to $325,000. Under this proposal, 1.8 percent of the estates of individuals dying in 1984 (the year in which the $325,000 unified credit would be effective) would pay estate tax.

2. Alternatively, the increases in the unified credit enacted by ERTA could be rescinded. Thus, a unified credit of $47,000 would be restored. This would permit property valued at $175,625 to be transferred without incurring gift and estate tax.

Pros and Cons

Arguments for the proposals

1. The increases in the unified credit enacted in 1981 were intended to offset the effects of inflation on property values. The rate of inflation is significantly lower at the present time than was anticipated last year; therefore, the scheduled increases in the unified credit are unnecessary.

2. The gift and estate taxes are a necessary part of a progressive tax system, since persons who receive the greatest benefit from special income tax relief provisions are most likely to accumulate the property subject to those taxes. The scheduled increases in the unified credit distort this purpose of the gift and estate taxes.

3. Under present law, the basis to an heir in an asset acquired from a decedent is "stepped up" to its fair market value as of the decedent's death (or alternate valuation date). As a result, any appreciation that occurs while the asset was held by the decedent is not subject to income tax. Allowing appreciated property valued in excess of $325,000 to pass free of income, gift, or estate tax is inappropriate.

Arguments against the proposals

1. Estates valued at $600,000 or less often include interests in closely held businesses. Although the current use valuation and installment payment provisions provide special relief for some of those estates, this relief alone is insufficient to prevent forced disposition of the businesses to pay estate taxes.[1]

2. Death is an inopportune time to impose a tax, because needs for cash are typically high at that time. Thus, the estate tax should not apply to small and mid-sized estates (i.e., those with assets valued at $600,000 or less), because the need for cash is likely to be most acute in them.

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[1] Under the current use valuation provision, up to $750,000 of the value of farm and other business real property may be excluded from estate tax (sec. 2032A). This amount is in addition to the unified credit.

Under the installment payment provision, estate tax attributable to a closely held business can be paid over up to 14 years. Tax attributable to up to $1 million of such value is permitted a special 4-percent interest rate.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
Freeze credit at exemption equivalent of:					
$325,000			(1)	.6	1.2
$175,625	.9	1.6	2.3	3.1	4.1

[1] Increase of less than $50 million.

b. Modification of maximum rate

Present Law

The gift and estate taxes are "unified," that is, a single progressive rate schedule applies to cumulative gifts and bequests. Generally, gift or estate tax liability is determined by first computing the gross gift or estate tax and then subtracting the unified credit and any other allowable credits to determine the amount of the gift or estate tax.

For gifts made and individuals dying before 1982, the maximum gift or estate tax rate was 70 percent. ERTA reduced that rate as follows:

Gifts made and individuals dying in—	Maximum rate
1982	65 percent.
1983	60 percent.
1984	55 percent.
1985 and thereafter	50 percent.

Possible Proposals

1. The 70-percent maximum gift and estate tax rate could be restored.

2. The scheduled decreases in the maximum gift and estate tax rate could be eliminated. Thus, the maximum rate would be 60 percent for gifts made and estates of individuals dying after 1982.

Pros and Cons

Arguments for the proposals

1. When the present-law scheduled increases in the gift and estate tax unified credit and decreases in the maximum tax rate are fully in place, the effective gift and estate tax rates will range from 37 percent (rate on first transfers over $600,000) to 50 percent (rate on transfers exceeding $2.5 million). The gift and estate taxes should have a more progressive rate structure than present law provides.

2. The gift and estate tax are a necessary part of an overall progressive tax system, since persons who receive the greatest benefit from special income tax relief provisions are most likely to accumulate the property subject to those taxes. Because of such special income tax provisions, lower effective income tax rates often are

paid by wealthy individuals. A higher maximum gift and estate tax rate insures proper operation of the progressive tax system.

Arguments against the proposals

1. As a basic principle, no tax rate should exceed 50 percent. Additionally, the maximum gift and estate tax rates should not exceed the maximum income tax rate, since a progressive tax system requires that the three taxes complement each other. The maximum income tax rate is 50 percent.
2. Death is an inopportune time to impose a tax, because needs for cash are typically high at that time. A higher maximum estate tax rate acts to exacerbate these problems.

Revenue Effect

[Fiscal years, billions of dollars]

	1983	1984	1985	1986	1987
Keep top rate at:					
70 percent	0.2	0.4	0.6	0.9	1.1
60 percent		(1)	.1	.4	.6

[1] Increase of less than $50 million.

c. Alternate valuation date

Present Law

The value of property included in a decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor may elect to have values determined as of the alternate valuation date, which is the date six months after the date of decedent's death.

The alternate valuation date election originated in the 1930's and was intended to lessen the impact of the estate tax when property values decline shortly after the decedent's death. Nevertheless, because an heir's income tax basis in inherited property is "stepped up" to the property's fair market value on the decedent's date of death or the alternate valuation date (i.e., to the property's estate tax value), the alternate valuation election can be used as an income tax avoidance device. In many cases where the estate tax consequences of the election may be relatively insignificant, executors may elect alternate valuation for the purpose of maximizing income tax basis where property values are higher on the alternate valuation date.

Possible Proposal

The alternate valuation provision could be amended to permit that election to be made only in cases where the estate tax liability of the electing estate is thereby reduced.

Pros and Cons

Arguments for the proposal

1. The proposal would fulfill the original intent of the alternate valuation provision—to prevent imposing estate tax based upon a property value far in excess of the property's value at the time the tax is actually paid.

2. Permitting the alternate valuation date to be elected solely to increase income tax basis causes revenue loss by permitting larger cost recovery deductions and lower capital gains taxes to heirs without serving any estate tax purpose.

Arguments against the proposal

1. The extra expense and complexity of having to value all property in an estate on two dates—the date of death and the alternate valuation date—is sufficient to deter estates from electing the alternate valuation provision solely to increase income tax basis.

2. It is inappropriate to look to potential income tax consequences when determining whether an estate tax provision is to be available since the income and estate taxes operate independently of one another.

Revenue Effect

This proposal would increase receipts by less than $50 million annually.

d. Basis of inherited property

Present Law

Under present law, an heir's income tax basis in inherited property is "stepped up" to the property's fair market value on the date of the decedent's death or the alternate valuation date (i.e., to the property's estate tax value).

The Tax Reform Act of 1976 provided that instead of this stepped-up basis, an heir's income tax basis in inherited property was generally equal to the decedent's basis with an adjustment for estate taxes paid by the decedent's estate. A special "fresh-start" rule was included under which the basis in assets held on December 31, 1976, was adjusted to their fair market value as of that date. The 1976 Act provision was repealed in the Crude Oil Windfall Profit Tax Act of 1980.

Possible Proposal

The carryover basis rule could be reenacted with a fresh-start rule adjusting the basis of assets held on December 31, 1982, to their fair market value as of that date.

Pros and Cons

Arguments for the proposal

1. After the increases in the unified credit made by ERTA are fully phased in in 1987, up to $600,000 of property value will be able to be transferred free of gift and estate tax. It is not appropriate to permit this amount of appreciation to pass untaxed (either by the income tax or the estate tax).

2. Permitting a step-up in basis at death encourages retention of assets until that time even in cases where disposition of the assets before that time might be more appropriate from an economic viewpoint. The resulting "lock-in" interferes with the efficiency of capital markets.

Arguments against the proposal

1. At death, records are frequently not available with which to establish basis in assets owned by a decedent. Therefore, it would be administratively difficult for executors and heirs to comply with the requirements of the carryover basis provision.

2. To comply accurately with a carryover basis provision, individuals would be required to retain written records on all assets acquired by them. The Congress should not impose such an extensive record-keeping burden on the public.

2. Deduction for Business Meals and Entertainment

Present Law

Business meals

In general, present law provides that expenditures for business meals are deductible to the extent that they are ordinary and necessary, not extravagant or lavish, and are paid or incurred in connection with the taxpayer's trade or business or income producing activities. Business meals generally are deductible when furnished to an individual under circumstances conducive to business discussions, taking into account the surroundings in which furnished, the trade, business, or income producing activities of the taxpayer, and the business relationship of the individual to whom such meal is provided.

Business entertainment

Ordinary and necessary expenses paid or incurred during the taxable year generally are deductible if they bear a reasonable and proximate relation to the taxpayer's trade or business, or to activities engaged in for profit, and so long as the expenses are reasonable in amount. Ordinary and necessary business expenses which are deductible may include the cost of entertainment.

In addition to the general ordinary and necessary standard for deductibility, special rules apply to entertainment expenses. Generally, expenses for an entertainment "activity" are deductible under the special rules only if, and to the extent that, the expenses are directly related to or associated with the active conduct of a trade or business. Deductions for expenses paid or incurred with respect to a facility that is used in conjunction with an activity which is of a type ordinarily considered to constitute entertainment, amusement, or recreation generally are not allowable. (However, deductions generally are allowed, in the case of a club, if the taxpayer can establish that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the entertainment, amusement, or recreation was directly related to the active conduct of such trade or business.)

Possible Proposal

The deduction for otherwise qualified expenses paid or incurred for business meals and entertainment could be limited to 50 percent of those expenses.

Pros and Cons

Arguments for the proposal

1. The present law treatment of meal and entertainment expenses encourages taxpayers to charge personal expenses to the Treasury.

2. Unfairness and abuse result under present law because meal and entertainment deductions are allowed for expenses that are essentially for the personal benefit and enjoyment of individuals who do not include any amount in income as a result of the expenditures.

3. The personal benefits of meal and entertainment deductions accrue largely to upper-income taxpayers.

4. The provisions of present law make effective and uniform administration of the tax laws extremely difficult.

Arguments against the proposal

1. Business entertaining is customary and is necessary to obtain new business or to continue existing business relationships. Because expenses for business meals and entertainment are legitimate and necessary costs of doing business, the deduction for those expenses should not be limited.

2. If purely personal expenses are being claimed by taxpayers, a substantial portion of the problem could be resolved by a more effective audit program and by providing greater guidance through rulings and regulations.

3. The restaurant industry could be affected adversely.

3. Business Travel Expenses

Present Law

Away from home travel expenses, including the cost of first class airfare, are generally deductible if they are paid or incurred during the taxable year in connection with the taxpayer's trade or business, or in pursuit of a nonbusiness activity engaged in for profit. If a trip is related primarily to the taxpayer's business, transportation expenses are deductible even though the taxpayer engages in some nonbusiness activities during the course of the trip. Conversely, if the trip is primarily nonbusiness in nature, then no amount of the transportation expenses are deductible even if the taxpayer engages in some business activity during the trip. However, business expenses incurred during the course of a primarily nonbusiness trip are deductible if they otherwise meet applicable requirements for deductibility. In general, the same substantiation rules which are applicable in the case of entertainment expenses apply to travel expenses. Special rules apply to foreign business travel and to foreign conventions.

Possible Proposal

The amount deductible for commercial air travel could be limited to the cost of coach airfare (i.e., the lowest-price generally available airfare).

Pros and Cons

Arguments for the proposal

1. For most people, first class air travel is a luxury. Generally, there is no business necessity for such luxury.
2. The allowance of a deduction for the full amount of first class airfare provides a tax subsidy for first class travel.

Arguments against the proposal

1. There is frequently a need for working space while traveling. First class seating provides this extra space. Thus, the additional cost incurred is for a business necessity rather than a luxury.
2. The airline industry may be adversely affected by a shift in demand from first class to coach travel. They may be further affected if businessmen who presently travel first class on commercial airlines choose to use privately owned aircraft or other forms of transportation.

4. Tax Rate on Regulated Futures Contracts

Present Law

Regulated futures contracts (RFCs), under the treatment prescribed by ERTA, are marked to market, i.e., gains and losses on open positions at the close of the taxable year are taken into account for tax purposes. Regardless of the length of time the taxpayer has held any position, all gains and losses are treated as 60-percent long-term and 40-percent short-term capital gains and losses. There are several exceptions to these rules, primarily for hedging transactions.

Regulated futures contracts are positions in commodities that are traded on exchanges designated as contract markets by the Commodity Futures Trading Commission.

The 60-percent long-term, 40-percent short-term treatment prescribed under present law results in a 32-percent effective rate of tax on net gains from RFCs for which the 50-percent marginal tax rate applies.

Possible Proposal

The percentage of gains and losses from RFCs that are subject to short-term treatment could be increased. If the long-term, short-term portions were reversed, i.e., if 60 percent of gains and losses were treated as short-term and 40 percent as long-term, the effective rate of tax on net gains would be 38 percent for a taxpayer to whom the 50-percent marginal tax rate applies.

Pros and Cons

Argument for the proposal

Gains on futures contracts ought not to receive preferential treatment relative to other types of income.

Arguments against the proposal

The mark-to-market system was established last year. The Congress should study how it is working before changing it.

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
I. Areas Addressed by Administration Proposals					
A. *Accounting for long-term contracts*					
Administration proposal					
Legislation and regulations	2.0	4.4	4.5	3.9	3.8
Regulations only	1.9	4.2	4.3	3.7	3.6
Senate Finance bill	.9	2.2	2.5	2.4	2.6
B. *Tax-exempt bonds for private activities*					
Administration proposals	([2])	.4	1.3	2.5	3.8
Senate Finance bill	.1	.4	.8	1.4	2.2
C. *Taxation of life insurance companies*					
Administration proposal [3]	2.6	2.5	2.7	2.9	3.2
Senate Finance bill [1,2]	1.5	1.5	2.2	2.9	3.2
Alternative stopgap proposals [4]	1.2	.6			
D. *Construction period interest and taxes*					
Administration proposal	.5	1.0	1.0	1.0	.9
Senate Finance bill	.6	1.2	1.3	1.2	1.0
E. *Minimum tax*					
Administration proposal [1]	2.3	4.8	4.5	3.7	3.8
Senate Finance bill:					
a. Corporate preference reform	.5	.8	.8	.8	.7
b. Individual minimum tax	([2])	.2	.3	.3	.3
F. *Accelerated corporate income tax payments*					
Administration proposals	1.0	1.0	1.2	.9	.1
Senate Finance bill	.7	1.0	1.2	.8	.1

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
G. *Business energy tax incentives* (Administration proposal)	.1	.3	.5	.5	.5
H. *Amortization of original issue discount on bonds*					
Senate Finance bill	.1	.2	.4	.5	.7
I. *Stripping of interest coupons from bonds*					
Administration proposal/Senate Finance bill	.1	.1	.1	.1	.2
J. *Medicare tax on Federal employees*					
Administration proposal/Senate Finance bill	.6	.8	.9	1.1	1.2
K. *Airport and Airway Trust Fund taxes* [6] *					
Administration proposal	.8	1.0	1.1	1.3	1.4
Senate Finance bill	.8	1.0	1.1	1.2	1.4
Ways and Means Committee bill (H.R. 4800)	.3	.1			
L. *Withholding on interest and dividends*					
Administration proposal	2.3	2.0	2.4	2.9	3.4
Senate Finance bill	4.3	3.6	4.1	4.7	5.3
II. Areas Addressed by Senate Finance Committee Proposals					
A. *Compliance*					
H.R. 6300	2.0	3.5	4.7	5.8	6.5
Senate Finance bill	2.4	3.6	4.8	5.7	6.1
10 percent withholding on independent contractors	.6	.7	1.0	1.2	1.3
B. *Income tax proposals primarily affecting individuals*					
1. Tax-qualified pension plans:					
a. Limits on contributions, benefits, and loans (Senate Finance bill)	.2	.6	.7	.8	.8
b. Estate tax exclusion for retirement savings		.1	.1	.1	.1

2. Medical expense and casualty loss deductions:					
a. Increase floor under medical expenses deduction to 10 percent; impose 10 percent floor under casualty loss deduction (Senate Finance bill)	.3	3.0	3.2	3.5	3.8
b. Increase floor under medical expense deduction to 5 percent; impose 5 percent floor under casualty loss deduction; repeal separate deduction for health insurance	.3	2.3	2.6	2.7	3.0
c. Repeal separate deduction for health insurance and impose floor under sum of medical expenses and casualty losses:					
5 percent	.3	2.2	2.4	2.6	2.8
10 percent	.4	3.6	3.9	4.2	4.6
3. Public utility dividend reinvestment plans (Senate Finance bill)	.1	.4	.4	.3	....
C. *Income tax proposals primarily affecting corporations*					
1. Capital cost recovery—investment tax credit:					
a. Basis adjustment for investment credit: [11]					
i. Basis adjustment for 100% of credits	.7	2.5	4.9	8.1	11.2
ii. Basis adjustment for 50% of credits (Senate Finance bill)	.3	1.2	2.5	4.0	5.6
b. Reduction in regular investment credit to: [11]					
i. 4 and 7 percent	2.3	5.6	7.1	8.2	9.3
ii. 5 and 8 percent	1.5	3.5	4.4	5.1	5.8

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
c. Tax liability limitation (Senate Finance bill)	.2	.3	.2	.2	.2
2. Capital cost recovery—depreciation:					
a. Repeal of 1985 and 1986 accelerations of depreciation under ACRS (Senate Finance bill) [11]			1.5	9.6	17.4
b. Depreciation allowances for structures:					
i. 20-year life with 175% rate (200% for low-income housing) (all structures)	.2	1.1	2.5	4.0	5.5
ii. 15-year life with 125% rate (150% for low-income housing)	.2	.7	1.4	2.2	3.0
iii. Straight-line over 18 years (15 years for low-income housing)	.3	1.2	2.4	4.0	5.6
c. Open accounts depreciation method	([7])	([7])	([7])	([7])	([7])
3. Safe-harbor leasing: [10]					
Senate Finance bill	1.1	2.9	4.2	5.7	7.2
4. Tax treatment of mergers and acquisitions (Senate Finance bill)	.7	.8	.7	.7	.6
D. *Excise taxes**					
1. Windfall profit tax—repeal of TAPS adjustment (Senate Finance bill)	.1	.1	.2	.1	.1
2. Tobacco taxes:					
a. Double cigarette taxes (Senate Finance bill)	1.3	1.8	1.9	1.9	1.9
b. Double tax on tobacco products, including pipes	1.3	1.9	1.9	1.9	2.0
c. Index tobacco products tax at doubled rate		.2	.5	.8	1.1
d. Impose ad valorem tax on tobacco products	1.3	2.1	2.4	2.7	3.1

e. Increase tobacco excise taxes by 125 percent	1.6	2.4	2.4	2.4	2.5
f. Increase cigarette tax by 33⅓ percent	.4	.6	.6	.6	.6
3. Telephone tax (Senate Finance bill)	.3	.9	1.6	1.6	1.5
4. 2% tax on telephone services	.3	.5	1.0	1.4	1.5
5. Taxes on fishing and boating equipment (Senate Finance bill)	([2])	([2])	([2])	([2])	([2])
E. *Employment taxes*					
1. Federal unemployment tax (FUTA) (Senate Finance bill)	1.4	2.4	2.9	2.8	2.6
III. Other Proposals					
A. *Income tax proposals primarily affecting individuals*					
1. July 1983 rate reductions and indexing:					
a. Repeal July 1, 1983, rate reduction	7.2	32.4	34.9	36.9	40.0
b. Delay July 1, 1983, rate reduction to October 1, 1983	6.7	.3			
c. Delay July 1, 1983, rate reduction to January 1, 1984	7.2	7.1			
d. Repeal July 1, 1983, rate reduction and replace with two 5% rate reductions on July 1, 1983, and July 1, 1984, with indexing delayed to Jan. 1, 1986	3.5	12.1	8.8	14.4	15.5
e. Repeal July 1, 1983, rate reduction and advance indexing to July 1, 1983	4.3	13.5	11.9	12.8	14.1
f. Repeal July 1, 1983, rate reduction and advance indexing to January 1, 1984	7.2	23.7	20.6	21.9	23.9
g. Cap tax cuts at $700 in 1982, $1,400 in 1983	5.9	12.6	9.2		
h. Repeal indexing			8.9	23.4	39.6
i. Allow indexing only for inflation in excess of 3%			3.7	10.0	17.5

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983-87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
j. Substitute proposal No. 4 for July 1, 1983 rate reduction and repeal indexing	1.2	15.0	35.1	60.6	95.1
2. Dividend and interest exclusions:					
a. Repeal dividend exclusion	.2	.6	.6	.6	.6
b. Repeal net interest exclusion			1.1	3.1	3.4
3. Exclusion for employer health plan payments:					
a. $250/cap for family coverage:					
i. Indexed for CPI	([9])	1.4	2.5	3.2	4.5
ii. Not indexed	([9])	1.4	2.6	3.7	5.2
b. $200/month cap for family coverage:					
i. Indexed for CPI	([9])	2.5	4.3	5.7	7.9
ii. Not indexed	([9])	2.5	4.5	6.3	8.9
c. $150/month cap for family coverage:					
i. Indexed for CPI	([9])	4.3	7.2	8.5	10.3
ii. Not indexed	([9])	4.3	7.6	9.7	12.3
4. Deduction for nonbusiness, nonmortgage interest (single/married):					
a. $1,000/$2,000	.4	3.0	3.2	3.4	3.7
b. $1,500/$3,000	.3	2.1	2.2	2.4	2.5
c. $2,000/$4,000	.2	1.5	1.6	1.7	1.9
5. Deductions for State and local taxes:					
a. Repeal sales tax deduction	.8	5.2	5.8	6.6	7.5
b. Repeal personal property tax deduction	.1	.6	.6	.7	.7

6. Charitable deduction for nonitemizers:					
a. Repeal	(2)	.2	.7	2.7	4.3
b. Limit deduction to $100			.2	2.0	3.5
7. Lower threshold for taxation of unemployment benefits (married/single):					
a. $20,000/$15,000	.4	.4	.3	.3	.4
b. $18,000/$12,000	.7	.7	.6	.6	.7
c. $15,000/$10,000	1.0	1.0	.9	.9	.9
d. $12,000/$8,000	1.3	1.3	1.1	1.1	1.1
e. Zero	2.6	2.6	2.3	2.2	2.3
B. *Income tax provisions primarily affecting corporations*					
1. Foreign oil and gas income (Senate Finance bill)	.2	.5	.6	.6	.7
2. Possessions corporations:					
a. Limit passive investment income to 10 percent (Senate Finance bill)	(2)	.1	.3	.3	.3
b. Repeal credit for income from intangibles (Senate Finance bill)	.4	.9	1.0	1.1	1.2
c. Repeal of section 936	.7	1.4	1.5	1.6	1.8
d. Limit credit to $10,000 per full-time employee	.4	.9	1.0	1.1	1.2
3. Credit for incremental research expenditures:					
a. Deduction adjustment	.1	.3	.3	.1	(2)
b. Reduce rate to 15%	.1	.2	.2	.1	(2)
c. Leasing expenses restriction	(2)	(2)	(2)	(2)	(2)

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
4. Credit for employee stock ownership plans (ESOPs):					
a. Reduce ESOP credit to 50% of contributions	.2	.4	.8	1.0	1.2
b. Reduce ESOP credit to 50% of contributions in 1983, 25% of contributions in 1984, and terminate thereafter	.2	.6	1.1	1.5	1.6
c. Repeal increase in limit above 0.5 percent		(2)	.2	.6	.8
5. Domestic international sales corporations (DISCs), repeal with 10-year recapture	.4	1.6	2.4	2.3	2.3
6. Repeal percentage depletion on:					
Oil and natural gas	.8	1.5	1.7	2.0	2.1
Other minerals	.5	.9	1.0	1.1	1.2
C. *Excise taxes**					
1. Windfall profit tax provisions:					
a. Royalty credit:					
i. Repeal	.3	.5	.5	.5	.5
ii. Limit to $2,500 per year	(2)	.1	.1	.1	.1
b. Repeal rate reduction for newly discovered oil	.1	.2	.3	.4	.5
c. Repeal stripper exemption	.2	.3	.3	.3	.3
2. Energy consumption taxes:					
a. Increase motor fuels taxes by:					
i. 2 cents per gallon	1.2	1.7	1.7	1.7	1.7
ii. 5 cents per gallon	3.1	4.3	4.2	4.2	4.2
iii. 10 cents per gallon	6.1	8.6	8.3	8.2	8.2
b. Tax on imported petroleum:					
i. $2 per barrel	3.0	4.3	4.2	4.2	4.2

ii. $5 per barrel	7.4	10.4	10.0	9.9	9.9
c. Tax on domestic and imported petroleum (1983–85):					
i. $2 per barrel	5.0	8.4	8.4	3.4	....
ii. $5 per barrel	12.3	20.6	20.6	8.2	....
d. Tax on coal, hydroelectric and nuclear power, natural gas and petroleum (1983–85):					
5 percent of value	6.9	11.9	13.7	5.8	....
3. Alcohol taxes:					
a. Double tax on distilled spirits	1.6	2.6	2.7	2.7	2.8
b. Index distilled spirits tax		.2	.6	1.1	1.6
c. Double tax on beer	.8	1.2	1.1	1.1	1.1
d. Index beer tax		.1	.3	.5	.7
e. Double taxes on wine	.1	.2	.2	.2	.2
f. Index wine tax		(2)	(2)	(2)	(2)
4. Luxury taxes:					
a. Amusement devices and video games, 10% of price	(5)	(5)	(5)	(5)	(5)
b. Automotive vehicles, 10% of price over $20,000	.1	.1	.2	.2	.2
c. Boats and yachts, 10% of price over $10,000	.1	.1	.1	.1	.1
d. Jewelry, 10% of price over $1,000	(2)	.1	.1	.1	.1
e. Fur, 10% of price over $1,000	(2)	(2)	(2)	(2)	(2)
D. *Employment taxes*					
1. SECA tax (unified budget receipts)	.3	1.5	1.7	1.8	2.0

IV. ESTIMATED REVENUE EFFECTS OF POSSIBLE OPTIONS TO INCREASE REVENUE, FISCAL YEARS 1983–87—Continued

[In billions of dollars]

Proposal	1983	1984	1985	1986	1987
E. *Other items*					
1. Estate and gift taxes:					
a. Freeze credit at exemption equivalent of $325,000			(2)	.6	1.2
b. Freeze credit at exemption equivalent of $175,625	.9	1.6	2.3	3.1	4.1
c. Keep top rate of 70%	.2	.4	.6	.9	1.1
d. Keep top rate of 60%		(2)	.1	.4	.6
e. Alternative valuation date	(2)	(2)	(2)	(2)	(2)

1 Figures reflect Administration estimate.
2 Increase of less than $50 million.
3 Increases 1982 fiscal year receipts by $.9 billion (effective as of Jan. 1, 1982).
4 The proposal is only for a two-year stopgap period (1982 and 1983). Increases 1982 fiscal year receipts by $.5 billion.
5 Not available at this time.
6 Net increase in revenues over present-law taxes.
7 The revenue effect would depend on the details of the proposal—for example, the declining balance percentages to be applied to the accounts.
8 Indeterminate, but possibly significant, gain.
9 Assumes an effective date of Jan. 1, 1984.
10 Increases 1982 fiscal year receipts by $.2 billion (effective date of Jul. 1, 1982). The estimate includes interactions with Finance Committee modifications to ACRS.
11 These estimates do not take into account interaction with safe-harbor leasing.
12 Increases 1982 fiscal year receipts by .5 billion.
*The figures represent net increases in budget receipts after allowing for lower income tax receipts.

APPENDIX

Estimated Taxable Returns, Total Tax Liability,[1] Average Tax Liability, and Percentage of Taxpayers Who Itemize Deductions in 1983 and 1984 (Under Present Law)

[1981 income levels]

Expanded income [2] (thousands)	1983 law				1984 law [3]	
	Taxable returns (thousands)	Percentage itemizing deductions	Total tax liability (millions)	Average tax liability	Total tax liability (millions)	Average tax liability
Below $5	4,308	10.8	$406	$94	$399	$93
$5 to $10	12,840	11.7	5,743	447	5,477	428
$10 to $15	13,097	16.5	13,159	1,005	12,524	958
$15 to $20	10,745	30.2	18,433	1,715	17,462	1,627
$20 to $30	16,829	45.0	46,534	2,765	44,080	2,624
$30 to $50	13,575	72.7	66,831	4,923	63,833	4,705
$50 to $100	3,581	90.9	40,368	11,273	38,687	10,806
$100 to 200	631	94.9	19,432	30,796	18,656	29,566
$200 and above	165	96.4	16,660	100,970	16,385	99,909
Total	75,770	38.0	227,567	3,003	217,501	2,875

[1] Tax liabilities do not reflect the refundable portion of the earned income credit and are not adjusted for 1981 changes in individual retirement accounts (IRA), capital cost recovery, and other provisions, the effects of which cannot be estimated from tax return data which are presently available.

[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income.

[3] "Number of taxable returns" and "percentage itemizing deductions" under 1984 law are very similar to figures for 1983 law.