

DESCRIPTION OF S. 2214  
RELATING TO  
PARTIAL EXCLUSION OF INTEREST AND DIVIDEND INCOME  
AND DEDUCTION FOR NONBUSINESS INTEREST EXPENSE

Scheduled for a Joint Hearing  
Before the  
Subcommittee on Taxation and Debt Management  
and  
Subcommittee on Savings, Pensions and Investment Policy  
of the  
Senate Committee on Finance  
on  
May 7, 1982

Prepared by the Staff  
of the  
Joint Committee on Taxation

May 5, 1982

JCX-13-82

## INTRODUCTION

S. 2214 (introduced by Senators Schmitt, Packwood, Symms, Grassley and Mattingly), relating to a partial exclusion for dividend and interest income in excess of certain interest expenses and to the deduction for certain types of nonbusiness interest expense, is scheduled for a joint hearing on May 7, 1982, before the Senate Finance Subcommittees on Taxation and Debt Management and on Savings, Pensions, and Investment Policy.

This document consists of a summary of the bill followed by a more detailed description which includes present law, issues, explanation of the bill, effective date, and revenue effect.

## I. SUMMARY OF S. 2214

Under present law, individuals may exclude from income up to \$100 (\$200 on a joint return) of dividend income. Beginning in 1985, taxpayers also will be able to exclude 15 percent of up to \$3,000 (\$6,000 on a joint return) of interest income in excess of all allowable interest deductions, other than interest incurred in acquiring or rehabilitating a dwelling unit or in carrying on a trade or business. The maximum exclusion of interest income thus will be \$450 (\$900 on a joint return). Also under present law, a deduction is allowed for interest paid on indebtedness, except that the deduction for interest on indebtedness incurred to purchase or carry investments is limited.

Under the bill, the dividend and interest exclusions in present law would be replaced with an exclusion of 25 percent of up to \$2,000 (\$4,000 on a joint return) of dividend and interest income in excess of all allowable interest deductions, other than interest incurred in acquiring or rehabilitating a dwelling unit or in carrying on a trade or business. The maximum exclusion of dividend and interest income thus would be \$500 (\$1,000 on a joint return). Also, under the bill, the deduction for interest paid would be allowed only for interest incurred in connection with a trade or business, investments, acquiring or rehabilitating a dwelling unit, acquiring a passenger automobile, and expenses for higher education. The deduction for other types of interest expense would be phased out over a four-year period.

## II. DESCRIPTION OF S. 2214

### Present law

#### Dividend and interest exclusions

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, taxpayers may exclude up to \$1,000 (\$2,000 on a joint return) of interest income earned on qualified savings certificates (sometimes referred to as "All-Savers" certificates) issued before January 1, 1983, by commercial banks, thrift institutions, or credit unions.

Beginning in 1985, taxpayers 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. 1/

Interest income eligible for the exclusion generally includes interest on (1) bank deposits; (2) insured deposits and share accounts in mutual savings banks, credit unions, and other savings or thrift institutions chartered under Federal or State law; (3) bonds, debentures, and certain other debt instruments of U.S. corporations; (4) U.S. obligations or obligations of State or local governments (unless the interest is excludable from gross income); (5) shares in a trust maintained by a corporation established under Federal law (e.g., the Government National Mortgage Association); and (6) prepaid premiums or life insurance proceeds left on deposit with an insurance company.

#### Interest paid deduction

Under present law, taxpayers may deduct amounts paid or incurred as interest on indebtedness. In the case of interest paid in connection with a trade or business or attributable to property held for the production of rents and royalties, the deduction is taken in computing adjusted gross income and thus is allowable whether or not an individual itemizes deductions. Other interest expense is allowable only as an itemized deduction.

A limit applies to an individual's deduction for investment interest, i.e., interest on amounts borrowed to acquire or carry property held for investment. This limit generally is the individual's net investment income for the year plus \$10,000 (\$5,000 for a married taxpayer filing a separate return). Investment income includes dividends, interest, rents, royalties and net short-term capital gain attributable to the disposition of investment property, but does not include amounts derived from conducting a trade or business. Before applying the limitation, investment income must first be reduced by expenses (other than interest) directly connected with its production. In addition, certain property subject to a net lease is treated as investment property, and the otherwise applicable deduction limit is increased to the extent certain expenses exceed rental income from the lease. Disallowed investment interest is carried forward to succeeding taxable years subject to the limitation on the deduction in the carryforward year.

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1/ H.R. 6056, The Technical Corrections Act of 1982, would clarify that an individual who does not itemize deductions would not be required to reduce interest income eligible for the exclusion by interest expense, and that a person itemizing deductions would be required to reduce such interest income by no more than the amount of his or her excess itemized deductions. The bill would also provide that for the purposes of determining the amount of other exclusions, itemized deductions, and credits, adjusted gross income would not be reduced by the amount of the net interest exclusion.

## Issues

The bill raises two general issues: (1) whether, in place of the present law dividend and net interest exclusions, an individual should be permitted an exclusion from income equal to 25 percent of the excess of dividend and interest income over certain types of deductible interest expenses, and (2) whether the deduction for interest paid should be limited to interest expenses incurred in connection with a trade or business, investments, housing, automobiles and educational expenses.

### Explanation of the bill

#### a. Partial exclusion of dividends and interest

Under the bill, the present law dividend exclusion and net interest exclusion would be repealed. Instead, individuals could exclude from income 25 percent of their net interest and dividend income up to \$2,000 (\$4,000 on a joint return). Thus, taxpayers could exclude up to \$500 (\$1,000 on a joint return) of net dividend and interest income in any year. Net interest and dividend income would be the amount of interest and dividends 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.

This provision would be fully effective for interest and dividends received in taxable years beginning after 1982. For interest and dividends received in 1982, a 12.5 percent exclusion would be available.

Interest and dividends eligible for exclusion under the bill would be the same items eligible for the present dividend and 15-percent net interest exclusions.

#### b. Elimination of deduction for certain interest

Under the bill, a deduction would be allowed only for certain types of interest ("qualified interest"). These would include interest incurred in (1) carrying on a trade or business, (2) acquiring or carrying property held for investment, (3) acquiring, constructing, reconstructing or rehabilitating a dwelling unit, (4) acquiring a passenger automobile, and (5) paying higher education expenses of the taxpayer or his dependent. The present limit on the deduction for investment interest would be retained.

Higher education expenses would be defined as (1) tuition and fees required for a student's enrollment or attendance at an institution of higher education; (2) fees, books, supplies and equipment required by the student for a course of instruction at the institution; and (3) a reasonable allowance for the student's meals and lodging. For this purpose, institutions of higher education include accredited universities and colleges, junior colleges, and post-secondary technical and training schools.

Under the bill, denial of the deduction for interest that is not qualified interest would be phased in. For 1982, 87-1/2 percent of the nonqualified interest paid or incurred by the taxpayer within the year would be deductible. For 1983, a deduction would be allowed for 50 percent of nonqualified interest. For 1984, the applicable percentage would be 25. For taxable years beginning after 1984, only qualified interest would be eligible for the deduction.

Effective date

The provisions of the bill would be effective for taxable years beginning after December 31, 1981.

Revenue effect

It is estimated that the bill would reduce fiscal year receipts by \$160 million in 1982 and \$755 million in 1983, and would increase fiscal year receipts by \$290 million in 1984, \$2,876 million in 1985, \$5,898 million in 1986, and \$6,305 million in 1987.