[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: RATE STRUCTURE AND OTHER INDIVIDUAL INCOME TAX ISSUES

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

AUGUST 12, 1985

U.S. GOVERNMENT PRINTING OFFICE

50-801 O WASHINGTON : 1985 JCS-36-85

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

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INTRODUCTION

This pamphlet[1] was prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and the Senate Committee on Finance in connection with the respective committee reviews of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets. It describes and analyzes tax provisions and proposals relating to the tax treatment of individuals, including the rate structure, tax treatment of the elderly and disabled, fringe benefits and other exclusions, itemized and other deductions, the presidential campaign checkoff, and the political contributions tax credit.

The pamphlet describes present law tax provisions and the various tax reform proposals made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department Report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals. The pamphlet also includes analysis of the issues raised by proposals for tax reform.

The first part of the pamphlet is an overview of issues related to reform of the individual income tax, including equity, efficiency and economic growth, and simplification. The second part discusses the basic rate structure, including the rate schedules, zero bracket amount, personal exemptions, two-earner deductions, earned income credit, income of minor children, child care credit, and income averaging. The tax treatment of the elderly and disabled, including the treatment of social security, workers' compensation, and black lung benefits, is discussed in part three. Part four covers exclusions for fringe benefits (including employer-provided health insurance), scholarships and fellowships, and prizes and awards. The fifth part discusses deductions for personal expenditures, including State and local taxes, nonbusiness interest, charitable contributions, medical expenses, casualty losses, and certain adoption expenses. Proposals relating to travel and entertainment expenses (which would apply to businesses as well as to individuals), employee business expenses, and other miscellaneous itemized deductions are covered in part six. Finally, part seven discusses the presidential campaign checkoff and the political contributions tax credit.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Rate Structure and Other Individual Income Tax Issues* (JCS-36-85), August 12, 1985.

I. OVERVIEW OF ISSUES RELATED TO REFORM OF THE INDIVIDUAL INCOME TAX

A. Equity

A common assertion is that taxes (other than user-related taxes charged to beneficiaries of specific programs) should be imposed in accordance with an individual's ability to pay taxes. Under this view, which is sometimes called horizontal equity, individuals with equal ability to pay taxes should pay equal amounts of tax. (A corollary of this result would be that in comparing any two taxpayers with different levels of ability to pay, the individual with the greater ability to pay should in fact pay more tax than the other.)

An additional dimension of equity, sometimes called vertical equity, is the actual amount by which the tax liability of a taxpayer with the greater ability to pay exceeds that of another taxpayer with a lesser ability to pay taxes. In other words, vertical equity involves the distribution of relative tax burdens among income classes.

1. Aspects of horizontal equity

Several issues are involved in assessing whether a tax system achieves horizontal equity. These include (a) measurement of the ability to pay taxes, (b) treatment of the family unit, (c) simplicity of the tax system, and (d) compliance with the tax law.

a. Income as a measure of ability to pay taxes

To apply concepts of equity to the design of a tax system, it is necessary to measure each individual's ability to pay taxes. In the United States, the amount of an individual's income has traditionally been accepted as a valid measure of ability to pay taxes.

In this context, income is viewed as the annual financial ability to purchase goods and services, other than those goods and services which are necessary to earn the income. Thus, for this purpose, income generally is measured by first adding the individual's gross receipts and any appreciation in the value of assets owned by the individual, and then subtracting the amounts spent by the individual on goods or services that are costs of generating the gross receipts and appreciation.

Although there are problems in obtaining all the information necessary to produce an accurate measure of income as so defined (particularly with rerpect to unrealized appreciation in asset value), income is a commonly accepted measure of ability to pay taxes. It is often asserted that individuals with a relatively high ability to pay for goods and services which satisfy needs for private consumption also have a relatively high ability to purchase those goods and services which provide for public consumption needs, i.e., goods and services provided by the government. If it is then agreed that those with a relatively high ability to pay for these goods and services should also be required to make a relatively high contribution toward defraying their cost, it follows that the revenues necessary to pay for government spending should be raised by an income tax. Under this view, maximum horizontal equity can be achieved by using a broadly defined concept of income as the amount from which tax liability is directly calculated.

Others respond, however, that broadly defined income is not the most appropriate basis for taxation. First, it is asserted that the individual's actual consumption of goods and services, rather than potential consumption (i.e., income), is a fairer basis for taxation. Second, it is argued that an income tax fails to take account of the time and effort expended on earning income, so that two taxpayers with equal incomes should not necessarily be viewed as having the same ability to pay taxes. Third, some disagree over the proper definition of the expenses of earning income to be subtracted in determining the tax base. Finally, some believe that, in certain cases, the use of tax incentives to encourage changes in taxpayers' behavior is more important than considerations of horizontal equity.

Such arguments, among others, have led to the enactment of certain exclusions and deductions in computing taxable income and various tax credits which reduce tax liability if the taxpayer engages in certain preferred activities. Notwithstanding these deviations from notions of horizontal equity, income has been commonly accepted as a principal basis for taxation in the United States.

b. Definition of the taxpaying unit

Actual implementation of a system which imposes equal tax liabilities on individuals with equal ability to pay may involve adjustments for such factors as family size, type of taxpayer (unmarried vs. married, with or without dependents), age, and disability. These issues are discussed in Part II.A.1., below.

c. Simplification

A third aspect of horizontal equity is simplification. In order that individuals having equal ability to pay actually bear equal tax liability, the tax system must be understandable and the outcome of calculations must be predictable; otherwise, differences in liabilities will occur based solely on misunderstandings of the law. In addition, under a tax system which is complicated, tax liability may vary with opportunities for investments of time and resources (e.g., in tax shelters), as well with ability to pay taxes. Thus, in addition to other advantages, simplicity in a tax system makes horizontal equity more likely.

On the other hand, achieving greater equity sometimes may require distinctions that decrease the simplicity of the tax system. For example, adjustments for family size and type of taxpayer introduce a certain amount of complexity. In addition, certain kinds of noncash income may be difficult to value for purposes of taxation, although taking account of such income arguably is necessary for achieving as accurate a measure as possible of ability to pay taxes and for maintaining taxpayer confidence in the fairness of the system. As another example, a major source of complexity in an income tax is determining the expenses of earning income, which generally are deducted in computing tax liability.

d. Compliance and enforcement

A final aspect of horizontal equity is the extent to which taxpayers comply with the law. Even if a tax system uses a comprehensive measure of ability to pay, makes appropriate adjustments for family structure, and is simple and understandable, taxpayers with equal ability to pay will not in actual practice have equal tax burdens if some taxpayers do not comply with the law. Thus, the effects of audits, penalties, and other measures to achieve compliance with the law are an important aspect of achieving horizontal equity.

2. Aspects of vertical equity

Vertical equity—the degree to which individuals with greater abilities to pay taxes should have larger tax liabilities—is a much more subjective notion than horizontal equity. Since there is no widely accepted yardstick for making comparisons among taxpayers with different incomes, the degree to which tax liability should increase with income is a value judgment.

The concept of progressivity is often discussed in this context. A progressive tax is one for which the ratio of tax liability to the tax base (e.g., income) rises as the tax base rises. Many argue that this is appropriate. On the other hand, other contend that the ratio of taxes to income should be constant (a proportional tax system). Still others may believe that it is acceptable for the ratio of taxes to income to decline as income rises (a regressive system).

One argument for progressivity asserts that if individuals could examine the vertical equity issue from the point of view of the beginning of their lives, when they did not know their capabilities and resources or exactly where they would end up in terms of the income distribution, they would be willing to agree to laws under which government would mitigate, to some extent, whatever inequalities emerged from a market economy. Progressivity is criticized, however, by those who view an individual's income as essentially the fruit of his or her own labor and property. Under this view, the government should have very little role in reducing the inequality of the amounts with which individuals are left after taxes, since individuals are entitled to whatever income arises from their own labor or property.

The latter view, in turn, is contested by those who contend that labor and property have value only because society establishes laws and regulations which allow each individual to engage in economic activity with relatively little interference from others. To be sustained, these laws and regulations must be accepted even by those who are relatively unsuccessful. Thus, because society establishes the framework which allows labor and property to be valuable resources, it is argued that society also can establish a progressive tax system and other mechanisms to achieve a more equitable distribution of income.

Whatever the actual distribution of tax liability under a tax system, perceptions of vertical equity may be as important as the actual results under the system. If many individuals perceive that favorable opportunities for tax reduction are available to taxpayers with more income than they have, perceptions of equity may be affected. For example, under the current tax system, the availability of tax shelters that lower tax liability associated with fully taxed forms of income has been cited as a reason for dissatisfaction with the tax system.

In sum, although equity is an integral part of tax policy, it involves subjective judgments over which there is likely to be considerable disagreement.

3. Level of marginal tax rates

Another element of equity may be the rate at which an individual's additional income is taxed by the government. Assuming other factors are equal, it is likely that many individuals believe that lower tax rates are fairer than higher tax rates. Many argue that it is unfair for a high portion of each additional dollar of income earned by an individual to be absorbed as increased tax liability.

In passing the Economic Recovery Tax Act of 1981, the Congress lowered the highest marginal rate in the tax schedules from 70 percent to 50 percent. Much of the discussion of this change involved the belief that a marginal tax rate as high as 70 percent caused undue interference with the incentives for efficient economic performance. However, another important source of support for this rate reduction was the belief that it was unfair for the tax system to claim more than half of each additional dollar earned by taxpayers. Presumably, this indicates that one accepted equity objective of tax policy is to keep marginal tax rates below some threshold level.

4. Equity in the structure of tax incentives

A final aspect of equity concerns provisions in the tax law which have been designed to encourage particular activities by businesses and individuals. The Congress has enacted various exclusions, deductions, and credits because it concluded that the desirability of facilitating particular activities through tax benefits outweighs the advantages of basing the tax liability calculation on a more comprehensive definition of income.

The structure of incentive provisions in the tax code can involve important issues of equity. For example, some argue that to be considered fair, a tax incentive should reduce the cost of the preferred activity by an equal percentage for each taxpayer; for example, the residential energy credit in present law operates in this manner. Judged solely by this criterion, provisions such as the charitable contributions deduction and the mortgage interest deduction may be viewed as inequitable. This is because such deductions, under a system of progressive tax rates, reduce the cost to the taxpayer of, for example, charitable donations or housing payments, by a greater percentage for higher-income individuals than for lower-income individuals.

Many tax provisions affecting individuals appear to be subsidizing particular activities, rather than improving the measurement measures of ability to pay taxes. For example, it can be argued that the allowance of certain itemized deductions and the favorable tax treatment of Individual Retirement Arrangements (IRAs) constitute either explicit incentives or deductions for expenditures that represent significant personal benefits. Thus, from this point of view, if such activities are to be recognized in computing tax liability, then a uniform rate of cost reduction should apply. Two of the major Congressional tax reform proposals—the Bradley-Gephardt bill and the Kemp-Kasten bill—contain rate structures intended to achieve this result.

On the other hand, it has been argued that upon closer examination, some of these provisions are not subsidies; rather, they represent appropriate adjustments in the proper measurement of income. For example, the subtraction of certain amounts, such as certain employee business expenses, is deemed necessary in measuring ability to pay taxes. Thus, to achieve equity, it may be necessary to allow certain deductions from income even though such treatment provides a tax benefit which increases with income. Similarly, it is argued that deductions are appropriate for charitable contributions of cash, since the donor experiences no direct private benefit from the funds given to charitable organizations, and for extraordinary medical expenses and casualty losses, since such expenditures can significantly affect the individual's ability to pay tax.

B. Efficiency and Economic Growth

1. Overview

Another widely accepted goal of tax policy is to minimize interference with marketplace incentives to engage in specific types of economic activity. This goal is known as economic efficiency.

Virtually any tax which meets accepted equity criteria creates some interference with economic incentives. In order to have no such effect, a tax would have to be determined on the basis of some characteristic over which an individual has no control. For example, a head tax equal to a fixed amount per person would have no incentive effects, since it could not be avoided, but it also would be regarded by most as extremely unfair. On the other hand, a tax which increases with income may be viewed as creating a disincentive for earning additional income. Even taxes on consumption may be seen as creating disincentives for earning additional income, since they reduce the potential amount of goods and services which may be purchased with the income earned from a given amount of property or work effort.

Similar considerations may exist with respect to balancing vertical equity and efficiency. For example, it has been argued that a progressive tax system creates considerable inefficiency by encumbering additional income with higher tax rates. In the extreme case, a 100-percent tax on additional income would eliminate any incentive to earn that income.

Yet, from the point of view of equity, as discussed above, many argue that progressive tax rates are essential to establish a proper relationship between tax burdens and ability to pay. Therefore, given the notions of horizontal and vertical equity that are commonly accepted, there is frequently a conflict between the efficiency and equity goals of tax policy. Balancing these competing considerations is one of the most difficult aspects of formulating a tax system.

The concept of economic efficiency uses as a benchmark the production of goods and services which would occur in a market economy in the absence of taxes. Economists generally regard this allocation of resources as a useful reference point because, under certain conditions, it insures that available economic resources are utilized in such a way as to produce the highest possible amount of consumer satisfaction. Relative to this benchmark, taxes change the incentives to engage in various types of economic activity (e.g., work, investment, and consumption of specific goods and services), and thus reduce the ability of the economy to satisfy consumer demands.

Thus, some inefficiency is inherent in virtually all taxes which are acceptable from the standpoint of equity. However, a major goal of tax policy is to reduce this inefficiency to as low a level as possible.

2. Exclusions from the tax base

Effect on efficiency of the economy

The above discussion suggests that in the absence of other objectives, using a broad definition of income as the tax base minimizes the shifts in economic activity which may occur as a result of the tax system. However, some present-law exclusions and deductions were enacted specifically to encourage desirable activities which, it was argued, may have been underprovided by the market in the absence of a subsidy provided by the Federal Government.

In judging the efficiency of a particular exclusion, deduction, or credit, the possible efficiency gains of the provision, attributable to stimulating the desired activity, must be weighed against the efficiency losses that would occur as marginal tax rates are raised to make up the revenue loss of the provision. In many cases, it is not clear whether the stimulation of a specific activity because of an exclusion or deduction increases or decreases the efficiency of the economy.

For example, some contend that the exclusion from the tax base of employer-provided health insurance contributes to inefficiency in the economy in several ways. First, the exclusion encourages employers to increase benefits under their health plans, so that individuals pay little or nothing each time they consume a service; this, it is argued, leads individuals to demand additional medical services, merely because they are treated as free, even if these services do not contribute significantly to their health. Further, by giving the same tax benefit for all health plans, the exclusion subsidizes not just additional health benefits, but also the additional costs incurred by inefficient health plans relative to efficient health plans. As a result, additional resources may be drawn into the health care sector without substantial compensating benefits, thereby reducing the production of goods and services for which consumers are willing to pay more. Thus, in addition to the efficiency costs of the higher marginal rates necessary to make up the revenue loss of this exclusion, it is argued that additional inefficiencies are created by unnecessary diversion of resources into the health care sector.

On the other hand, others contend that tax incentives for employer-provided health insurance are desirable to compensate for underprovision of insurance which would occur if the determination of the amount of health insurance was left to the market. First, it is argued that the particular problems of adverse selection in insurance markets (e.g., the tendency of healthy individuals to go without insurance in order to avoid the cost of premiums that are increased by the higher medical costs of unhealthy insured individuals) would lead many individuals to buy too little insurance. Second, underprovision could lead to increased demand on public medical facilities by uninsured individuals faced with large medical bills, or increased political demand for a national health insurance program. If this occurred, a new source of inefficiency could result from the replacement of a system which reflects diverse preferences of employees with a uniform benefit package. Third, whether or not a national health insurance program were established, a reduction in group insurance provided by employers could lead some individuals to purchase individual supplementary coverage, which may be more inefficient because of additional administrative and sales costs.

Means of providing desired subsidy

Even if it is decided that a particular type of activity should be encouraged or facilitated by government support, a decision must be made as to whether the tax system is the most efficient mechanism for delivering the subsidy. In certain cases there are advantages to providing subsidies through the tax system, since it provides an administrative mechanism, already in place, reaching a large majority of the American public. The speed and dependability of conveying subsidies through the tax system has been contrasted with the possibly protracted and inaccessible operations of bureaucracy which would distribute subsidies made available through a spending program.

On the other hand, the tax system may be a cumbersome mechanism for distributing subsidies in cases where standards or criteria are important in improving the efficiency of a subsidy, since tax incentives are designed so that every taxpayer eligible receives the benefit. Thus, no role is retained for the discretion of program administrators who, in the case of spending programs, often try to weigh conflicting objectives and improve the targeting of subsidies in making grant and contract determinations. Additional inefficiencies may result from administration of this program by the revenue agency, which may be required to deal with policy objectives outside of its normal area of expertise. Finally, as discussed elsewhere in this pamphlet, extensive use of the income tax for delivering subsidies may adversely affect individuals' perceptions of the equity of the tax system.

Taxation of income from capital

An important set of issues involving exclusions from the tax base involves the taxation of income from capital. (These issues are discussed in a separate pamphlet.)[2] These involve the effect of inflation on the measurement of capital income, the issues that arise when some capital income is taxed on an accrual basis and other portions are taxed on a realization basis, the relationship between the individual and corporate income taxes, and the appropriate rate of tax on income from capital as compared to the income from labor. Although these topics involve complex issues, similar considerations balancing the efficiency costs of higher tax rates versus the gains or losses from various aspects of narrowing the tax base are an important part of the analysis.

3. Lowering marginal tax rates

Many economists agree that high marginal tax rates can cause considerable economic inefficiency, both by impeding incentives for work and saving, and by magnifying the effects caused by differences between that tax base which would be chosen purely for efficiency reasons and the base which actually is implemented in the law.

An individual's marginal tax rate is the rate applicable to the next dollar of income received. If an individual is subject to a 25-percent marginal rate, then the return from additional work effort or saving is reduced by 25 percent. For example, if this individual is considering working on an overtime assignment which pays $40, then the reward for this work effort after Federal income taxes is $30. A higher marginal tax rate would further adversely affect the return on this work effort.

Similarly, the marginal tax rate affects investment decisions; thus, if an individual with a 25-percent marginal rate invests in a security with a 10-percent return, the return after Federal income taxes would be 7.5 percent. The same reasoning may be used to show that marginal tax rates also influence relative returns from activities which are heavily taxed versus those which are lightly taxed. This is especially important because many of these differences result not from a deliberate intent to encourage certain activities, but rather because of measurement problems inherent in a tax system. For example, valuations of some types of noncash compensation, measurement of capital income, and distinguishing the business portion of traveling expenses from the personal portion can present difficulties.

Lower marginal rates reduce the possible effects of any mismeasurement which may occur. With high marginal rates, for example, there is more incentive to invest in lightly taxed investments or to take jobs in which a high proportion of compensation is tax-free than would be the case with low marginal rates.

C. Simplification

1. Overview

A third goal of tax policy is simplicity. Ideally, a tax system should be easy both for individuals to understand and for the IRS to administer, and the computation of tax liabilities for most tax-

[2] Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985.

payers should not require tedious, time-consuming computations or recordkeeping.

As discussed above, a complicated tax system may result in inefficiencies because of high compliance costs, as well as a perception of unfairness because of the likelihood that similarly situated taxpayers will have different tax liabilities. Under a complicated tax system, many taxpayers invest large amounts of time and money both to exploit opportunities to minimize their tax liability, and to feel satisfied that the positions taken on their returns are supportable. A significant portion of the resources devoted to compliance with the tax law could be redirected to more productive economic activities if the tax law were simplified.

A complicated tax system may result in similarly situated taxpayers reporting unequal tax liabilities because of differing abilities to understand the rules or pay for professional tax assistance, or, indeed, because some professional tax advisers may not be thoroughly trained in the nuances of the statute, regulations, rulings, and case authorities. Thus, complexity introduces a source of inequity into the tax system, affecting both actual tax liabilities and perceptions of equity.

Taxpayers may suspect that others are paying less tax not because they have less income, but rather because they have better access to knowledge about the details of the system. If these feelings are widespread, they may contribute to a feeling that the system is not fair. At the same time, taxpayers may resist efforts to eliminate the deductions or credits that contribute to complexity, because they perceive that their taxes may be increased as a result of simplification.

Despite its many virtues, simplicity may involve a sacrifice of equity and efficiency. For example, one of the most difficult areas of the current income tax is the set of statutory and regulatory provisions designed to define what is an ordinary and necessary expense of earning income and thus properly deductible in computing taxable income. Because many aspects of business expenses have personal elements, complicated rules have been crafted to determine the circumstances under which all or a portion of expenses for lodging, food, automobiles, and travel generally are deductible.

There are various approaches for avoiding rules of this type. One method would be use of a gross receipts tax, under which no expenses of doing business could be deducted in computing taxable income. Although this system has been used in the past in a number of European countries, these countries have virtually abandoned it because of fundamental conflicts with commonly accepted notions of equity and efficiency. First, gross receipts is not an adequate measure of the ability to consume or accumulate personal wealth, simply because it fails to account for those expenses that clearly are necessarily incurred to earn the gross receipts. Second, it penalizes taxpayers who purchase their business supplies from others (thus incurring a tax on the purchase), rather than producing the supplies themselves. Thus, such a tax could discourage the development of industries that were not highly vertically integrated, even if less integration were more efficient than a high degree of integration.

Another approach to the problems of defining ordinary and necessary business expenses would be to allow virtually every expense of an income earner to be deducted, on the grounds that it bears some relationship to earning income. Of course, this solution would drastically narrow the tax base, which would then bear little resemblance to the ideal measure of the ability to purchase goods and services, and would significantly reduce revenues.

Another example of inherent complexity involves tax rules for business and other transactions which would themselves be complex even in the absence of an income tax. For example, many of the issues surrounding corporate liquidations or reorganizations pose considerable problems of interpretation without regard to tax consequences. Thus, designing tax rules to determine tax liability in such situations automatically involves a great deal of complexity.

In general, some complexity—or perhaps a substantial amount of complexity—is inherent in any tax system that attempts to achieve some minimally acceptable degree of equity and efficiency, especially in a complex economy.

2. General areas of complexity in the present income tax

The features of the present income tax that appear to be associated with complexity, in addition to those mentioned above, include elections, distinctions between capital and ordinary gain or loss, valuation questions, recordkeeping requirements, rules restricting favorable tax treatment, and itemized deductions generally.

Elections

The Congress or the Internal Revenue Service often provide for elective treatment of particular transactions or items when a compromise is necessary among basic goals of tax policy, but the outcome of that compromise appears to be best resolved according to the individual wishes of taxpayers. Elections involve complexity because affected individuals must invest time and resources in computing their tax liability in two or more different ways.

One example of an election in the present system is the itemized deduction for State and local sales taxes. Individuals may keep records of all their expenditures that were subject to a general State or local sales tax. Alternatively, individuals may elect to deduct an amount computed from a table published by the IRS; this amount is based on the taxpayer's income (including certain income not reported on the tax return), family size, and State or locality of residence.

The first method, if rigorously pursued, results in a more exact determination of sales taxes paid and, in that manner, better serves the objectives of the sales tax deduction. Requiring all taxpayers claiming the deduction to use this method, however, would impose recordkeeping and computation burdens on those who complied; it also could give rise to inequities if a significant number of taxpayers simply estimated the amount of sales tax expense because of the difficulty of verification. The elective method involving the table is simpler, but less exact.

Another example of an "election"—but one that is mandatory—is the present alternative minimum tax for individuals. The Congress has enacted numerous provisions of the tax law designed to encourage particular activities. These provisions introduce into the determination of tax liability significant considerations other than ability to pay taxes. The alternative minimum tax was enacted in response to the equity implications of incentive provisions that are in the tax law. Essentially, the minimum tax resolves the conflict between the equity and incentive goals of the tax system on a taxpayer-by-taxpayer basis, depending on individual facts and circumstances.

The minimum tax, in effect, limits the degree to which incentive provisions are allowed to cause tax liability to deviate from that determined solely under ability-to-pay principles. Yet this solution involves considerable complexity, since taxpayers who have a chance of being liable for the minimum tax must compute their tax liability under both the regular and minimum taxes. In addition, the optional nature of these two systems imposes the necessity for complex tax planning for taxpayers who wish to minimize their tax liability, especially with respect to transactions with consequences in more than one year.

Capital vs. ordinary gain or loss

Distinctions between the treatment of ordinary gain or loss versus capital gain or loss are an important source of complexity in the tax law.[3] This complexity stems from the desire to limit selective realization of losses (while allowing delayed taxation of gains) and also to provide preferential treatment to the income from some types of transactions.

Valuation questions

Valuation questions arise in part because of the inherent complexity of certain business transactions for which tax rules must be provided. For example, when an individual purchases a business from another individual, the purchase price of the business must be allocated among particular assets to determine the tax treatment of the seller's gain and the buyer's basis for depreciation and other purposes. As another example, because transactions between related parties often do not occur at prices resembling market prices, means must be devised for estimating market prices for these transactions in order to establish an accurate reflection of the income of each party.

In addition, valuation questions may arise under provisions which were enacted for equity or incentive objectives. For example, individuals who suffer nonbusiness casualty losses may claim an itemized deduction for the amount of the loss exceeding a floor; this requires determining the fair market value of the property before and after the casualty. In this case, present law reflects a determination that equity considerations outweigh uncertainty and complexity resulting from the necessity for determinations of fair market value.

Another area involving the need for market valuation is the taxation of noncash income, such as taxable fringe benefits provided

[3] These distinctions are discussed in detail in a separate pamphlet (see note 2, *supra*).

to employees. In some cases, the complexity associated with such valuation appears to have had a significant impact on the rules governing the treatment of particular types of benefits. On the other hand, an approach of taxing only cash compensation while excluding in-kind compensation could create incentives for new compensation patterns which would give rise to significant equity and efficiency concerns, as well as reducing income and social security tax revenues.

Recordkeeping requirements

As discussed above, an important aspect of equity involves the degree of compliance with and enforcement of the rules of the tax law. In this regard, the Congress has required taxpayers to keep certain records for the purpose of informing the IRS of the amount of income received or to substantiate the amount of deductions claimed. The impact of these rules depends in part on the extent to which the information normally would be collected for business or financial reasons and not simply for tax administrative needs. For example, employers generally keep payroll records for personnel and other reasons, apart from the tax law requirement of providing employees with annual statements of wages received.

On the other hand, special recordkeeping requirements apply in several areas because of the objectives of the tax system. For example, deductions for travel and entertainment expenses generally are allowed only if records are kept which contain sufficient detail to substantiate the business purpose of the expenditure. These requirements were imposed partly to reduce the amount of deductions being claimed for personal rather than business expenditures.

Restrictions on favorable tax treatment

Some areas of complexity result from the rules which the Congress enacts in order to target to the intended beneficiaries a provision generally providing more favorable tax treatment than that allowed under the normal rules. Two examples are the rules for income averaging and for qualified pension and other retirement plans.

Income averaging is designed to reduce tax liability for individuals whose income in the present year is substantially above the level of previous years. At the same time, limitations are provided to exclude from the benefit of the provision individuals whose income fluctuation is predictable or otherwise not appropriate for tax relief.

First, taxpayers are not eligible for income averaging if they have not supported themselves during each year covered by the averaging provision. Second, adjustments and exclusions for various income and deduction items are required in order to eliminate from the calculation the effect of items which do not cause actual changes in ability to pay. Finally, an extremely complex set of computations is necessary for individuals whose marital status changes during the period, since the provision is not intended to compensate for income fluctuations due to that source. Thus, targeting the benefits of income averaging to the intended set of individuals requires a complex set of rules.

A second illustration of this complexity is the panoply of rules applicable to qualified pension and other retirement plans. Individuals covered by qualified plans receive favorable tax treatment; i.e., a portion of the employer's earnings is set aside for retirement benefits without current taxation to the employer or employees, and investment income on the amounts set aside are free from tax. Only plans that satisfy a lengthy list of requirements are eligible for this tax treatment.

The requirements include adequate coverage of the entire workforce rather than just the highly compensated or owners, rules for vesting of the benefits after a prescribed maximum number of years, limitations on plan benefits, requirements that a minimum amount of assets actually be set aside in recognition of the obligations of the plan to covered workers, and restrictions on what may be done with the assets that are set aside. These restrictions, while complex, are designed to target the tax benefit of this provision to situations in which the retirement security of employees is actually being increased as a result of the plan.

Itemized deductions

Some of the provisions discussed above, such as income averaging, apply to limited numbers of taxpayers. By contrast, itemized deductions increase complexity for a substantial number of individuals, and many discussions of complexity have focused on itemized deductions because of their widespread impact. Although itemizers may favor these deductions because of their effect in reducing tax liability, such individuals may be equally, if not more, satisfied with a system which produced the same net tax liability but did not impose the complexity associated with itemized deductions.

Itemized deductions impose recordkeeping burdens and tax planning opportunities both for those who actually itemize and those who believe that there is chance that they may accumulate sufficient deductions by the end of the year to become eligible to itemize. The complexity associated with these deductions is discussed under the relevant section later in this pamphlet. If it is thought desirable to reduce this complexity, individual deductions can be modified or repealed, or the zero bracket amount (standard deduction) can be increased to reduce the number of taxpayers eligible to itemize without increasing any individual's tax liability.

II. BASIC RATE STRUCTURE

A. General Considerations

The principal factors determining the distribution of tax liability by income class are the rate schedules (including the zero bracket amount), the personal exemption, and the earned income credit. In addition, the second-earner deduction and the child care credit are among other features of the law that play an important role in determining the relative tax liability of different types of families.

This section discusses several specific issues which arise in connection with proposed changes in these provisions. These include (1) the relationship among the tax burdens of married and unmarried individuals, with and without children, (2) the income level at which taxpayers first become liable for Federal income taxes (the "tax threshold"), and (3) the measurement of changes in the distribution of tax liability.

1. Adjustments for different types of taxpayers

Assuming income is accepted as the basis for measurement of ability to pay taxes, questions still arise as to what, if any, adjustments should be made to reflect the differing situations of taxpayers of different types (married vs. unmarried, with or without dependents) and families of different sizes. The present tax system responds to these concerns by making three sets of adjustments—(1) reductions in the amount of taxable income according to the number of individuals in the taxpaying unit, (2) adjustments in rate schedules according to the type of taxpaying unit, and (3) distinctions according to the source of the income.

Adjustments for family size

The present system adjusts for family size largely by allowing the subtraction from taxable income of a flat personal exemption amount per family member. This amount, which is adjusted annually for inflation, is $1,040 for 1985. Thus, for example, a married couple with two children with taxable income of $25,000, and a married couple with three children and taxable income of $26,040, are deemed to have the same ability to pay taxes and are thus required to pay the same amount of tax.

The fact that this $1,040 adjustment is the same for all income levels does not reflect any empirical finding that the amount which married couples actually spend on their children is constant. Rather, the judgment implicit in the current system is that the tax calculation should recognize some minimum level of the additional costs attributable to each dependent. In effect, additional amounts that higher income couples are able to spend on their children generally are treated, in effect, as nondeductible consumption. As a result, a two-child couple with $100,000 of income and a three-child couple with $101,040 of income are deemed to have the same ability to pay taxes. This treatment of dependents has not been perceived generally to be a source of horizontal inequity in the tax system.

Assuming the adjustment in taxable income for dependents should be equal for taxpayers at all income levels, as is the personal exemption under present law, then it is necessary to set the amount of the adjustment. This determination involves judgments as to the additional subsistence costs attributable to each additional child that should be recognized by the tax system.

One reference point that is sometimes used with respect to low-income individuals is the poverty level. The amount of income considered to mark the poverty level has been computed annually by the Federal Government since the 1960s. On the basis of data indicating that nonfarm families generally spend about one-third of their income for food, the poverty level originally was computed as three times the amount of money necessary to purchase the lowest cost nutritionally adequate diet formulated by the Department of Agriculture, with certain adjustments, including an adjustment for family size. The poverty line is adjusted annually for inflation. The average addition to the poverty level for each family member from the second to the eighth is estimated to be approximately $2,000 in 1986.

Even if this 2,000 figure were taken as an indication of the appropriate subtraction to be made from income in order to adjust for the differing ability to pay of different family sizes, however, it could be an overestimate of the appropriate amount of the personal exemption. This is the case if the tax system, through exclusions of certain sources of income and deductions allowed before the computation of tax liability, already allows adjustments which reflect family size differences.

For example, a portion of the $2,000 figure used for poverty-level measurement may reflect the extra housing and medical costs which generally are incurred as family size increases. Present law separately provides deductions for at least part of these expenses (mortgage interest, property taxes, and medical expenses). Thus, to avoid double counting for a taxpayer who itemizes deductions, the personal exemption would need to reflect only that portion of the $2,000 not attributable to otherwise deductible housing and medical expenses. If this view were adopted, the zero bracket amount (standard deduction) could be varied by family size in order to reflect any remainder of the desired family size differential.

Pooling of income

The second issue in the treatment of the different types of taxpayers is whether to treat each individual as a separate taxpayer, taxable only on his or her income, or whether to aggregate the income of all family members and compute tax on their combined incomes. The current tax system generally adopts an intermediate position—the income of spouses is generally added together, but children are treated as separate taxpayers.

Generally, this issue is important only in a system where the tax rate varies with the amount of income of the taxpaying unit. If all income were taxed at the same flat rate, then simple subtractions from income to reflect the number of taxpayers and dependents could account for much of the ability-to-pay differentials of family of different sizes. When different rates are applied to different amounts of income, however, decisions must be made as to how to equate the incomes of different types of families.

The following example illustrates this issue. Suppose that for an unmarried taxpayer, considerations of vertical equity (discussed further in Part II-B) lead to a decision that the first $10,000 of income should be taxed at 10 percent, and the excess over $10,000 should be taxed at 20 percent. A decision then must be made as the treatment of a married couple. One option is to treat each spouse as a separate taxpayer, so that each person's tax liability is computed separately without regard to the amount of income received by the spouse. Although a number of States use this principle in the design of their income taxes, this treatment has been rejected at the Federal level.

In contrast, the Federal income tax generally reflects the view that the tax liability of a married couple should be based on the combined income of the couple, regardless of the share contributed by either spouse. This treatment (joint filing) has been adopted partly for administrative reasons; e.g., difficulties often arise in determining which spouse should be treated as earning interest and dividends.

There also has been a belief that ability to pay taxes of a married couple is best measured by the combined income of that couple, regardless of who earned it. This reflects a judgment that married couples pool their income for the purposes of deriving mutual satisfaction from it, so that the combined income of a married couple is the best index of ability to pay taxes. Thus, two couples with the same aggregate amount of income generally are taxed equally, regardless of the source of the income.[4] A prominent exception to this general rule is the deduction for two-earner married couples, discussed below.

Marriage tax penalty issue

Once the decision is made that combined income of a couple is the best index of ability to pay taxes, then it is necessary to decide what should be the relationship between the rate schedule for unmarried individuals and the separate rate schedule for married couples.

For example, if $10,000 is selected the appropriate income level at which a higher tax rate should begin for single persons, it is necessary to make a corresponding judgment for married couples. Before 1969, the answer to this issue would have been $20,000, since the rate schedules for married couples were constructed to produce the same result as if the two spouses divided their com-

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[4] Joint filing was enacted in 1948. Prior to that time, married individuals were taxed separately. However, in a number of States, community property laws had allowed each spouse to be treated as receiving half the income of the other spouse, thus, reducing the tax liability of couples in these States relative to couples in States where this treatment was not allowed. In order to achieve uniformity of tax treatment throughout the United States, the Congress, rather than overriding community property laws, provided that all married couples could obtain the benefits of income splitting by filing joint returns. Separate filing by married persons was, and continues to be, allowed, but the loss of income splitting means that this almost always leads to a tax increase in comparison to filing jointly.

bined income equally between them and then paid tax as single persons.

However, in 1969, the Congress readjusted the rate schedules to change the balance in favor of unmarried individuals. This readjustment was made largely because of arguments that (1) under the pre-1969 system, an unmarried individual had tax liabilities more than 40 percent higher than that of a married couple with the same taxable income, and (2) married couples enjoy certain economies in living together that generally are not available to unmarried individuals. Thus, for example, the relationship under the current rate structure would make the dividing point between the brackets approximately $18,000; it reflects the implicit judgment that a married couple with $18,000 of combined income (i.e., $9,000 each if divided equally) and an unmarried person with $10,000 of income have the same ability to pay taxes.

It should be noted that a logical consequence of the post-1969 relationship between the married and single rate schedules is the existence of a "marriage tax penalty" for couples whose incomes are relatively equal. In the preceding example, two unmarried individuals each earning $10,000 would have all their income taxed at a 10-percent rate, while, if they married, $2,000 of their combined income would be taxed at a 20-percent rate, resulting in a higher tax liability than before marriage. This follows from the view, embedded in the current structure of rate schedules, that the pooling of income and expenses accompanying marriage has increased these individuals' ability to pay taxes.

Partly in response to this marriage tax penalty, the Congress in 1981 adopted a provision for a limited deduction from income for two-earner married couples. This represents a deviation from the general principle that the share of each spouse in total income is not separately identified and taxed. In addition to adjusting for the marriage tax penalty described above, the rationale for this deduction was that two-earner couples with a given amount of income have additional costs and less leisure than other couples with equal amounts of income.

Unmarried individuals with children

The present tax system provides a third rate schedule, applicable to an unmarried individual living with a child or dependent relative (a "head of household"). Unlike the treatment of married couples, for whom the existence of a dependent results only in an adjustment to taxable income (an extra personal exemption) which is equal at all income levels, individuals eligible for the head of household filing status receive the benefit of increases in the dollar amounts separating tax brackets. These dollar amounts are between the figures applicable to other unmarried individuals and to married couples. The difference between the tax liability of an unmarried head of household and other unmarried individuals is very small at low income levels and is largest at high income levels. In effect, the existence of a dependent living with an unmarried individual results in implementation of the income-splitting concept described above in connection with married couples filing joint returns.

Treatment of minor children's income

The final element of the treatment of the different types of taxpayers involves the treatment of income received by minor children. Essentially, children living with their parents are taxed as separate taxpaying units, regardless of their age, so that their tax rates are independent of the income of their parents. Thus, the pooling of income concept applied to married couples is not extended to their children.

Further, two personal exemptions may be available for dependent children—one deductible from the parents' income and one deductible from any income of the child. Also, the child's return is allowed a standard deduction, in addition to the parents' itemized or standard deduction, to the extent of the child's earned income. These issues are discussed in more detail in a later section of this pamphlet.

Summary

The adjustments for family size and type present tax system represents a series of compromises among competing objectives. The treatment of dependents varies according to marital status in that for married couples adjustments are allowed which do not vary by income level, but the first dependent of an unmarried individual leads to an adjustment which does vary by income level. This treatment presumes that heads of households are more comparable to married couples than to other unmarried individuals. Although pooling of income generally follows from the concept that a couple's ability to pay taxes should depend on its combined income without regard to which spouse received it, a deduction based on which spouse earned the income is allowed in the case of two-earner married couples. Finally, the concept of pooling of income is applied to the income of spouses, but not to income received or earned by minor children living with their parents.

2. Tax threshold and the poverty level

One aspect of vertical equity is whether there should be an income level below which individuals have no tax liability. If it is agreed that such a "tax threshold" should be a feature of the system, then some element of progressivity is automatically introduced into the system. It has often been argued that a minimum amount of income necessary for subsistence should not be subject to tax. As noted above, the concept of the poverty line has been developed in order to provide a concrete indication of this minimum subsistence level of income.

During the 1960s and 1970s, the Congress sought to eliminate any Federal income tax liability for families whose income was below the poverty level. The approaches used to achieve this goal included increases in the personal exemption, increases in the standard deduction (now termed the zero bracket amount), and enactment of and increases in the earned income credit. During most years of the 1970s, the tax threshold for a family was above the poverty line, and actually exceeded the poverty line by 22 percent in 1977. In recent years, however, these provisions have not kept pace with inflation, and as a result the income tax threshold has fallen well below the poverty line.[5]

Under the present law, the tax threshold generally is lower than the poverty level. For 1986, the tax threshold (under present law) for a married couple with two children is projected to be $9,573, while the poverty line for such a family is projected to be $11,502. If the Congress determines that the poverty line serves as an appropriate target for the tax threshold, then one or more of the personal exemption, the earned income credit, and the zero bracket amount (ZBA) could be adjusted to achieve the desired result.

Two issues arise in designing adjustments in the tax threshold. First, some argue that the tax threshold should be computed without regard to the earned income credit. Under this view, the earned income credit is intended solely as an offset to the social security payroll taxes paid by low-income families with children and should not be taken into account in computing the income tax threshold. If this view is accepted, then only adjustments in the personal exemption and the ZBA could be made to match the tax threshold to the poverty line.

Second, if it is decided that the personal exemption should not be increased to the full amount by which the poverty level increases on account of additional family members (estimated to be approximately $1,800 in 1986), then the tax threshold could be set equal to the poverty line for a given family size, rather than all family sizes. For example, even if the personal exemption remains at $1,080 for 1986, the ZBA for married couples could be increased to $7,200, so that the tax threshold (without regard to the earned income credit) for a married couple with two children would be $11,520. This would lift the tax threshold above the poverty line for married couples with one or two children, while leaving the threshold for larger families under the poverty line.

3. Measuring changes in distribution of tax liability

The degree of progressivity in a tax system is the extent to which the average tax rate rises as income rises. The chief determinants of progressivity are (1) the structure of tax rates, and (2) the extent to which exclusions, deductions, and tax credits, which may deviate from a pure equity measure of income but which are introduced into the tax computation in order to accommodate another goal of tax policy, rise or fall with income. In a comprehensive reform of the tax system, relatively little discussion of the vertical equity implications of each deduction or exclusion is necessary because the tax rate can be adjusted to achieve the desired distribution of tax liability by income class.

In order to investigate empirically the change in the vertical equity of a tax system that would occur in response to a change in the system, it is necessary to make some simplifying assumptions.

The first important assumption is that changes in before-tax incomes and relative prices which might occur are sufficiently small so as to not significantly affect conclusions which may be drawn from an analysis which assumes that these factors are unchanged.

[5] For additional background on this issue, see: Joint Committee on Taxation, *Federal Tax Treatment of Individuals Below the Poverty Level* (JCS-17-85), June 5, 1985.

For example, if taxes on individuals are lowered as part of tax reform, individuals may well respond by changing their work patterns, and savings and investment patterns, resulting in changes in their income. If these changes were relatively uniform by income class, however, it is quite likely that a static analysis of income distribution effects of the tax change would continue to be valid.

As another example, this type of assumption is necessary where a tax reform package contains changes, including changes in the corporate income tax, that may change the relative prices of different goods and services. Again, it is necessary to assume that such relative price shifts do not affect one income class relatively more than another, so that the effects of relative increases in prices are balanced by relative price decreases to the same extent for taxpayers at all income levels.

The second assumption involves the special case of a change in the tax system that lowers the aggregate amount of taxes on individuals. In addition to the type of assumption discussed in the previous paragraphs, the question arises as to the best measure of distribution in analyzing a change during which each individual's taxes are reduced.

Many analysts have used the distribution of after-tax income as the best index of distribution. For example, if the 20 percent of taxpayers with the highest incomes have 40 percent of the after-tax income both before and after a tax change, many would argue that the tax change had no effect on the distribution of income.

In order for this stability in the distribution of after-tax income to be maintained in the face of a change in aggregate tax burdens, each group of taxpayers must experience an equal percentage change in after-tax income. Suppose, for example, that the average tax rate for all individuals is 20 percent and is cut to 16 percent. This change would produce an average increase of five percent in after-tax income, from 80 percent of before-tax income to 84 percent of before-tax income. Thus, in order to maintain the same distribution of after-tax income, each income group would have to have a reduction in tax liability sufficient to produce a five percent increase in after-tax income.

The distribution of tax cuts necessary to achieve this result depends on the initial progressivity of the tax system. For example, under a proportional tax system, each income class would have an average tax rate of 20 percent before the tax cut, so that a 20-percent tax cut in each income class would increase the distribution of after-tax income by a uniform percentage and leave the income distribution unchanged.

Under a progressive tax system, however, a different pattern of tax reductions is necessary to leave the income distribution unchanged. Specifically, a larger percentage reduction is required in the lower income groups than in the upper income groups. For example, suppose that in a lower income group the tax rate is 10 percent and in the higher income group the tax rate is 30 percent. If after-tax income is to go up by five percent in both groups, then after-tax income in the lowest group must go from 90 to 94.5 percent of before-tax income. This requires a reduction in the tax rate from 10 percent to 5.5 percent, a 45 percent reduction in tax liability.

In the higher income group, a five-percent increase in after-tax income requires an increase from 70 to 73.5 percent of after-tax income. This is achieved by a reduction in the tax rate from 30 percent to 26.5 percent, an 11 percent reduction in tax liability. Thus, under a progressive system, a tax cut which leaves the distribution of after-tax income unchanged requires a larger percentage tax cut in lower income groups than in higher income groups.

B. Fundamental Determinants of Tax Liability—Rate Schedules, ZBA, Personal Exemptions, Two-Earner Deduction, and Earned Income Credit

Present Law and Background

Tax rates

Rate schedule classifications

Present law provides different tax rate schedules for each of four filing status classifications: (1) married individuals filing jointly and certain surviving spouses; (2) heads of household; (3) single individuals; and (4) married individuals filing separately.[6]

The term "head of household" means an unmarried individual (other than a surviving spouse) who pays more than half of the household expenses for himself or herself and a child or dependent relative who lives with the taxpayer, or for the taxpayer's dependent parents. A "surviving spouse," who may use the schedule for married individuals filing jointly, is an individual whose spouse died during one of the two immediately preceding taxable years and who maintains a household that includes a dependent child.

Computation of tax liability

Tax liability is calculated by applying the tax rate from the appropriate schedule to the individual's taxable income. Taxable income equals adjusted gross income (gross income less certain exclusions and deductions) minus personal exemptions, minus either itemized deductions or the charitable deduction for nonitemizers. Tax liability calculated from the rate schedules is reduced by applicable tax credits.

Under present law, tax rates in each schedule start at 11 percent in the first taxable income bracket above the zero bracket amount (ZBA) and rise to a maximum tax rate of 50 percent in the top bracket. Three of the schedules have 14 tax rates and brackets; the schedule for single individuals has 15 rates and brackets. Each tax rate applies only to income in that bracket. Income in excess of the amount defining the upper end of each bracket is taxed at a higher rate. Present law and proposed tax structures for 1986 and 1987 are shown in Tables 2 and 3 below.

For married individuals filing joint returns and for surviving spouses, the 11-percent bracket starts at $3,540 of taxable income, and the 50-percent bracket at $168,896; for married individuals filing separate returns, the first and last brackets begin at half these amounts, i.e., $1,770 and $84,448, respectively. Those dollar

[6] For tax purposes, an individual's marital status for a year generally is determined on the last day of the year. If, however, one spouse dies during the year, the other spouse may still be eligible to file a joint return for that year.

figures are applicable for 1985 and have been indexed to reflect approximately a four-percent inflation rate in the preceding year. For 1986 and later years, present law provides that all dollar figures defining the tax brackets for these and the other rate schedules are to be adjusted annually according to subsequent percentage changes in the consumer price index.

Unmarried individuals are taxed initially at 11 percent on the first $1,100 of taxable income over $2,390, and at 50 percent on taxable incomes in excess of $85,070. For a head of household, the 11-percent rate also begins at $2,390, and the 50-percent rate at $112,630. The tax rates applicable to a head of household are lower than those applicable to other unmarried individuals on taxable income above $3,540. Thus, a head of household in effect receives a portion of the benefits of the lower rates accorded to a married couple filing a joint return.

Schedule for married individuals

Separate rate schedules for joint returns by married couples and for single persons were enacted in 1948; prior to then, there was one schedule for both types of taxpayers, under which a married person and a single person with the same income paid the same amount of income tax. The change was made because court decisions upheld the right of each spouse in community property States to treat half his or her income as received by the other spouse, on the grounds that half of the income belonged to each taxpayer.

Rather than override community property laws, Congress decided in the context of a post-World War II tax reduction to extend the benefits of income splitting to married couples in all States. The rate schedule for a married couple filing jointly provided at that time was designed to produce the same tax liability as if each couple divided its taxable income equally and each spouse filed a return as an unmarried individual.

Thus, since 1948, a couple's tax liability generally has depended on its combined income and deductions, regardless of which spouse earned the income or incurred the deductions. A couple retains the option to file separate returns, but this usually results in an increase in combined tax liability.

Schedule for head of household

The expense of maintaining a household for dependent children or parents is cited as the chief reason for providing a separate tax rate schedule for an unmarried head of household. The provision was enacted in 1951, and it provided about one-half of the income splitting benefits given to married couples.

In the Tax Reform Act of 1969, a new rate schedule for a head of household was provided which was placed halfway between the new rate schedule for single individuals and the rate schedule for married couples. This change was, in effect, a reduction in tax rates because the tax rate schedule for single individuals was reduced, in the same Act, relative to the rates for married couples.

Zero bracket amount

The first taxable income bracket at the starting 11-percent marginal tax rate begins just above the zero bracket amount (ZBA).

The ZBA for 1985 is $3,540 for married individuals filing joint returns and for surviving spouses ($1,770 for married individuals filing separately) and $2,390 for single returns, including a head of household. Beginning in 1985, the ZBA amounts are indexed annually for inflation during the preceding year.

The ZBA has been incorporated into the tax tables and tax rate schedules as a tax bracket with a zero rate since 1977. Since the ZBA is the counterpart of the former standard deduction, nonitemizers only have to determine taxable income and use the tax table to find the tax liability. The ZBA also serves as a floor under the amount of itemized deductions. Itemizers reduce taxable income by the excess of itemized deductions over the ZBA, in order to avoid doubling the benefit of the ZBA, and then use the tax tables or tax rate schedule to find tax liability.

Personal exemption

The personal exemption for an individual, the individual's spouse, and each dependent is $1,040 for 1985. Under present law, one additional personal exemption is allowed for an individual who is age 65 or older, and for an individual who is blind.

Beginning with 1985, the amount of the personal exemption is indexed annually for inflation during the preceding year. Prior to 1985, the personal exemption amount had been $1,000 during 1979-84, $750 during 1972-78, $675 for 1971, $625 for 1970, and $600 for 1948-69.

Indexing

Provisions to index the individual income tax for inflation were enacted in 1981, but the adjustments were not made effective until calendar year 1985. The increase in the index is used to adjust the level of the personal exemption amount, the ZBA, and the minimum and maximum dollar amounts for each tax rate bracket.

Adjustments for inflation are measured by changes in the Consumer Price Index for all-urban consumers (CPI) over the 12-month period ending on September 30 of a year, over the CPI for the 12-month period ending on September 30, 1983. In effect, the annual adjustment corrects for the change in inflation during the preceding 12 months.

The first inflation adjustments under these provisions were made as of January 1, 1985, when the relevant dollar amounts were increased by approximately four percent.

Deduction for two-earner married couples

Under present law, a married couple generally is treated as one tax unit which must pay tax on the unit's total taxable income. Present law also provides different zero bracket amounts and tax rate schedules for married couples than for individuals filing as single persons or as single heads of households. One effect of these and other tax provisions has been to create a "marriage penalty" when two individuals with relatively equal incomes married each other.

In 1981, the Congress enacted a deduction for two-earner married couples. The Congress took this action because the simplest way to alleviate the marriage penalty was to allow a percentage of the earned income of the spouse with the lower earnings to be, in effect, free from income tax. This new deduction not only served to reduce the marriage penalty but also alleviated the effect of high effective marginal rates on the second earner's income.

The two-earner deduction is computed in arriving at adjusted gross income and thus is available to both nonitemizers and itemizers. The amount of the deduction equals the lesser of (1) 10 percent of the qualified earned income of the spouse with the lower qualified earned income[7] and (2) $30,000. The maximum deduction, therefore, is $3,000 (10 percent of $30,000).

The two-earner deduction was claimed on about 23 million returns for 1983. The deduction is estimated to reduce fiscal year budget receipts by $6.9 billion in 1986.

Earned income credit

Background

The earned income tax credit was enacted in 1975 as a means of targeting tax relief to working low-income taxpayers with children, providing relief from the social security payroll tax for these taxpayers, and improving incentives to work. Unlike most tax credits, the earned income credit is refundable; i.e., the amount of the credit is paid to the taxpayer to the extent it exceeds tax liability. Also, under an advance payment system, eligible taxpayers may elect to receive the benefit of the credit in their paychecks, rather than waiting to claim a refund on their return filed by April 15 of the following year.

As originally enacted, the credit equalled 10 percent of the first $4,000 of earned income (i.e., a maximum credit of $400). The credit began to be phased out for adjusted gross income (AGI) or, if greater, earned income, above $4,000 and was entirely phased out at AGI of $8,000. For 1979 through 1984, the maximum credit was increased to $500 (10 percent of the first $5,000 of earned income). Also, the income level at which the phaseout began was raised to $6,000, with a complete phaseout not occurring until an income level of $10,000.

Present law

Under the Deficit Reduction Act of 1984, the earned income credit was increased, beginning in 1985, to 11 percent of the first $5,000 of earned income. The maximum credit of $550 now begins to be reduced for income in excess of $6,500 and is zero for income equal to or in excess of $11,000. Specifically, the maximum credit is the excess (if any) of (1) $550 over (2) 12-2/9 percent of the excess of AGI (or, if greater, the earned income) of the individual for the year over $6,500. Unlike the personal exemption and the zero bracket amount, the dollar amount of the earned income credit is not indexed for inflation.

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[7] In general, qualified earned income is defined as earned income under sec. 401(c)(2) or sec. 911(d)(2) (such as wages and salaries), less certain items deductible in computing adjusted gross income and allocable to earned income, such as employee business expenses and IRA contributions. If the qualified earned income of both spouses is the same, the two-earner deduction may be computed using the qualified earned income of either spouse.

Individuals eligible for the credit are married individuals filing joint returns who are entitled to a dependency exemption for a child, surviving spouses (who, by definition, must maintain a household for a dependent child), and unmarried heads of households who maintain a household for a child. In each case, for a taxpayer to qualify for the credit, the child must reside with the taxpayer in the United States.

Historical data

Table 1 (below) shows the total amount of earned income credits received for each of the calendar years since the inception of the program, the number of recipient families, the amount of the credit that exceeds tax liability, and the average amount of the credit received per family. For 1983, approximately 45 percent of credit recipients were married couples filing joint returns and 55 percent were unmarried head of household returns.

Table 1.—Data Concerning Earned Income Credit, 1975-1986

Calendar year to which credit applies	Total amount of credit (in millions)	Number of families who received credit (in thousands)	Refunded portion of credit (in millions) [1]	Average credit per family
1975	$1,250	6,215	$900	$201
1976	1,295	6,473	890	200
1977	1,127	5,627	880	200
1978	1,048	5,192	801	202
1979	2,052	7,135	1,395	288
1980	1,986	6,954	1,370	286
1981	1,912	6,717	1,278	285
1982	1,775	6,395	1,222	278
1983 [2]	1,786	6,250	1,287	286
1984 [3]	1,643	NA	1,183	NA
1985 [3]	1,947	NA	1,460	NA
1986 [3]	1,791	NA	1,343	NA

[1] This is the portion of the credit that exceeds tax liability, it is treated as a budget outlay. All these credits were paid in the following year until 1979, when advance payments of the credit were permitted, by addition to the worker's paycheck.
[2] Preliminary.
[3] Estimated (under present law).
NA—Not available.

Administration Proposal

Tax rates

In general

The present-law tax rate structure of 14 brackets and rates for each schedule (15 for single returns) would be replaced by a structure with three taxable income brackets and tax rates—15, 25, and 35 percent. The four separate classes of filing status would be retained. They would be distinguished from each other by different zero bracket amounts and tax brackets that begin at different levels of taxable income and have different widths.

Under the Administration proposal, the new structure would not become effective until July 1, 1986, thus requiring a tax rate schedule for 1986 that blends the provisions of both the present law and proposed schedules. Similarly, withholding schedules for each filing status would change effective July 1, 1986, to reflect the new tax rates. The proposed schedule would be effective for all of 1987 and for later years. The indexing provisions of present law would be retained.

Explanation of tables

Tables 2 and 3 (below) show two sets of tax rates—the rate schedules under present law, and the rate schedules under the Administration proposal. There are separate tables for single individuals, for married individuals filing joint returns and surviving spouses, and for heads of households.

Because the proposed new tax structure would not become effective until July 1, 1986, Tables 2A, 2B, and 2C each show an estimate of a single "blended" rate structure—incorporating the two six-month rate structures—that would be applicable for calendar year 1986. The numbers in the present law column are marginal tax rates that would apply in 1986 to the taxable income brackets in the table.

Tables 3A, 3B, and 3C present taxable income and marginal tax rate structures for the present law tax structure and the Administration proposal for 1987. These rate structures for 1987 have been adjusted for an estimated 3.7 percent inflation.

Under the blended marginal tax rate structures for 1986 (Tables 2A-2C), the lowest marginal rate would be 13.0 percent and the highest rate would be 42.5 percent for each filing status. The lowest marginal tax rate for single returns begins above $2,900 taxable income, and the highest marginal tax rate would apply to taxable income above $88,910. The lowest and highest marginal rates for joint return filers begin above $4,000 and over $176,000. For heads of households, those amounts are $3,600 and $118,280, respectively.

Between successive taxable income brackets in the three filing classes, the marginal tax rates generally increase by 0.5 to 2.0 percentage points. In each structure, however, the marginal tax rates increase by 5.0 percentage points for two brackets. These larger adjustments occur at the taxable incomes that mark the borders between the tax brackets in the Administration proposal where the marginal tax rates change by 10 percentage points on a full year basis.

Tables 2A-2C and 3A-3C allow comparison of present law tax rate structures, adjusted to reflect estimated indexing effects, and the Administration-proposed three rate structures for 1986 and 1987.

Table 2A.—Comparison of Present Law Tax Rates and Blended Marginal Tax Rate Structure for 1986 (Combining Present Law and Administration Proposal)—Single Returns

Taxable income*	Marginal tax rates (%)	
	Present law	Proposal
Not over $2,900	0	0
$2,900- 4,090	11	13.0
4,090- 5,380	12	13.5
5,380- 7,450	14	14.5
7,450- 9,610	15	15.0
9,610-12,100	16	15.5
12,100-14,730	18	16.5
14,730-16,640	20	17.5
16,640-18,000	23	19.0
18,000-20,110	23	24.0
20,110-25,840	26	25.5
25,840-31,570	30	27.5
31,570-37,300	34	29.5
37,300-42,000	38	31.5
42,000-45,310	38	36.5
45,310-60,240	42	38.5
60,240-88,910	48	41.5
Over 88,910	50	42.5

* Reflects proposed increase in zero bracket amount.

Table 2B.—Comparison of Present Law Tax Rates and Blended Marginal Tax Rate Structure for 1986 (Combining Present Law and Administration Proposal)—Joint Returns

Taxable income*	Marginal tax rates (%)	
	Present law	Proposal
Not over $4,000	0	0
$4,000– 6,270	11	13.0
6,270– 8,550	12	13.5
8,550–13,200	14	14.5
13,200–17,630	16	15.5
17,630–22,180	18	16.5
22,180–26,940	22	18.5
26,940–29,000	25	20.0
29,000–32,680	25	25.0
32,680–38,410	28	26.5
38,410–49,870	33	29.0
49,870–65,230	38	31.5
65,230–70,000	42	33.5
70,000–92,940	42	38.5
92,940–118,680	45	40.0
118,690–176,020	49	42.0
Over 176,020	50	42.5

* See previous table.

Table 2C.—Comparison of Present Law Tax Rates and Blended Marginal Tax Rate Structure for 1986 (Combining Present Law and Administration Proposal)—Head of Household Returns

Taxable income*	Marginal tax rates (%) Present law	Proposal
Not over $3,600	0	0
$3,600– 5,870	11	13.0
5,870– 8,150	12	13.5
8,150–10,520	14	14.5
10,520–13,880	17	16.0
13,880–17,340	18	16.5
17,340–20,810	20	17.5
20,810–23,000	24	19.5
23,000–26,540	24	24.5
26,540–32,260	28	26.5
32,260–38,000	32	28.5
38,000–49,470	35	30.0
49,470–52,000	42	33.5
52,000–66,680	42	38.5
66,680–89,610	45	40.0
89,610–118,280	48	41.5
Over 118,280	50	42.5

* See previous table.

Table 3A.—Comparison of Marginal Tax Rates Under Present Law and Administration Proposal for 1987—Single Returns

Present Law		Administration Proposal	
Taxable income	Marginal tax rate	Marginal tax rate	Taxable income
Not over $2,590	0	0	Not over $3,030
$2,590– 3,830	11	15	$3,030–18,790
3,830– 4,960	12		
4,960– 7,320	14		
7,320– 9,580	15		
9,580–12,170	16		
12,170–14,530	18		
14,530–16,900	20		
16,900–20,510	23	25	18,790–43,840
20,510–26,480	26		
26,480–32,450	30		
32,450–38,420	34		
38,420–46,760	38	35	Over $43,840
46,760–62,310	42		
62,310–92,160	48		
Over 92,160	50		

Table 3B.—Comparison of Marginal Tax Rates Under Present Law and Administration Proposal for 1987—Joint Returns

Present Law		Administration Proposal	
Taxable income	Marginal tax rate	Marginal tax rate	Taxable income
Not over $3,830	0	0	Not over $4,180
3,830– 6,200	11	15	$4,180–30,270
6,200– 8,560	12		
8,560–13,410	14		
13,410–18,030	16		
18,030–22,760	18		
22,760–27,720	22		
27,720–33,690	25	25	30,270–73,070
33,690–39,660	28		
39,660–51,600	33		
51,600–67,600	38		
67,600–96,450	42	35	Over 73,070
96,450–123,260	45		
123,260–182,980	49		
Over 182,980	50		

Table 3C.—Comparison of Marginal Tax Rates Under Present Law and Administration Proposal for 1987—Head of Household Returns

Present Law		Administration Proposal	
Taxable income	Marginal tax rate	Marginal tax rate	Taxable income
Not over $2,590	0	0	Not over $3,760
$2,590- 4,960	11	15	$3,760-24,010
4,960- 7,320	12		
7,320- 9,800	14		
9,800-13,300	17		
13,300-16,900	18		
16,900-20,510	20		
20,510-26,480	24	25	24,010-54,280
26,480-32,450	28		
32,450-38,420	32		
38,420-50,360	35		
50,360-68,280	42	35	Over 54,280
68,280-92,160	45		
92,160-122,020	48		
Over 122,020	50		

Zero bracket amount

Under the Administration proposal, the ZBA would be increased for 1986 to $4,000 for married individuals filing joint returns and surviving spouses ($2,000 for married individuals filing separate returns), $3,600 for head of household returns, and $2,900 for single returns. Thus, unlike present law, the ZBA for a head of household would be higher than the ZBA for other unmarried individuals.

Personal exemption

The personal exemption for an individual, an individual's spouse, and each dependent would be increased from $1,080 (estimated for 1986) to $2,000 under the Administration proposal effective in 1986. The additional exemption under present law for elderly or blind individuals would be repealed.

Thus, an elderly individual or a blind individual would have the same $2,000 personal exemption as other individuals, beginning in 1986. By comparison, if present law were retained, the estimated 1986 personal exemption for an elderly or blind individual would be $2,160, or twice that of other individuals, and the exemption for an individual who is both elderly and blind would be $3,240, or three times the exemption amount. Special tax treatment for the elderly or blind would be combined in a revised tax credit for the blind, elderly, or disabled (described in Part III, below).

Indexing

The Administration proposal would not change the provisions of present law for indexing the minimum and maximum tax rate bracket amounts, the ZBA, and the personal exemption amount. The proposal would extend indexing to the earned income credit maximum amount and the AGI or earned income limit on the credit (see description below of the earned income credit).

Two-earner deduction

The Administration proposal would repeal the two-earner deduction, effective January 1, 1986.

Earned income credit

The Administration proposal would increase the maximum amount of the credit to $726 for 1986. This number represents the proposed maximum credit of $700 (14 percent of the first $5,000 of earned income), indexed for estimated inflation during fiscal year 1985.

Also, the income levels at which the credit is phased out would be raised to the $6,740 to $14,000 range. These numbers represent the proposed phaseouts of $6,500 to $13,500 after indexing for one year's inflation. Specifically, the maximum credit would be reduced by 10 percent of the excess of AGI (or earned income, if greater) over $6,740.

The effect of the expanded credit would generally be lower taxes or a larger refund than current law for individuals with less than $11,000 of AGI. Also, the expanded credit would provide tax relief for those individuals with between $11,000 and $14,000 of AGI, which is not available under the current credit.

Table 4 shows the effect on the amount of the earned income credit at various income levels of the Administration proposal, the Kemp-Kasten bill (H.R. 2222, S. 1006), and the Roth-Moore bill (S. 411, H.R. 373).

Table 4.—Amount of Earned Income Credit by Earned Income Level under Present Law and Various Proposals, 1986

Earnings	Present law	Administration proposal	Kemp-Kasten [1]	Roth-Moore
0	0	0	0	0
1,000	$110	$140	$143	$130
2,000	220	280	286	260
3,000	330	420	429	390
4,000	440	560	572	520
5,000	550	726	715	650
6,000	550	726	565	650
7,000	489	700	415	638
8,000	367	600	265	513
9,000	245	500	115	388
10,000	122	400	0	263
11,000	0	300	0	138
12,000	0	200	0	13
13,000	0	100	0	0
14,000	0	0	0	0

[1] This table assumes a two-child family; with a one-child family, the maximum credit of $644 begins to be phased out at $4,500 of AGI and is totally phased out at less than $9,000 AGI; with a three or more child family, the maximum credit of $787 begins to be phased out at $5,500 of AGI and is not totally phased out until AGI of $10,200.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

Tax rates

The Bradley-Gephardt bill would provide a three-rate tax schedule, consisting of a base tax rate of 14 percent and two surtax rates of 12 and 16 percent. The 14 percent or base tax rate would apply to taxable income, which would be defined as AGI less itemized deductions allowable under the bill, personal exemptions, charitable contributions, and child care expenses.

The two surtax rates would apply to AGI above specified levels. The 12-percent surtax would apply to AGI of $40,000 to $65,000 for a joint return, and $25,000 to $37,500 for a single return (including a head of household). The 16-percent surtax would apply to AGI over $65,000 for a joint return and $37,500 for a single return. In effect, these amounts of adjusted gross income would be taxed at marginal rates of 26 and 30 percent. Because AGI would not be reduced by itemized deductions, personal exemptions, or child care expenses, these items would reduce tax liability by 14 cents per dollar of expense at all income levels.

The indexing provision in present law that applies to the taxable income brackets would be repealed.

Zero bracket amount

In lieu of a ZBA, a standard deduction would be allowed to nonitemizers, equal to $6,000 for a joint return or a surviving spouse, or $3,000 for a single return (or a married individual filing a separate return). In this bill, indexing for inflation would not be provided for the standard deduction.

Personal exemption

The size of the personal exemption under the Bradley-Gephardt bill would be increased to $1,600 for the taxpayer and for the taxpayer's spouse, and to $1,800 for a head of household. The exemption for a dependent, and the additional exemption for the elderly or blind, would be $1,000. This amount would not be indexed for inflation.

Two-earner deduction

The Bradley-Gephardt bill would repeal the two-earner deduction.

H.R. 2222 and S. 1006 (Kemp-Kasten)

Tax rates

Under the Kemp-Kasten bill, a single tax rate of 24 percent would be applied to all taxable income. Gross income (and taxable income) would be reduced by an exclusion of 20 percent of employment income up to the maximum FICA wage base, which is estimated to be $41,400 in 1986.

Thus, a taxpayer with employment income of up to $41,400 would be able to benefit from up to an $8,280 exclusion from gross income in 1986. Under the bill, if a taxpayer had gross income in excess of $41,400, 20 percent of that excess would be added to gross income and would completely offset the exclusion at $82,800 of gross income. Under the Kemp-Kasten bill, a taxpayer with gross income in excess of $41,400 which was composed entirely of nonemployment income, for example, interest, dividends, retirement benefits, and royalties, would increase gross income by 20 percent of the excess over $41,400, up to $8,280, even though ineligible for the employment income exclusion.

Zero bracket amount

The ZBA would be increased to $3,300 in the case of a joint return or a surviving spouse ($1,750 for a married person filing separately), $3,200 for a head of household return, and $2,600 for an unmarried individual. The ZBA would be indexed for inflation.

Personal exemption

The personal exemption would be increased to $2,000 for the taxpayer and each dependent. A personal exemption no longer would be allowed for a student over 18 with $1,000 or more of gross income. The personal exemption amount would be indexed.

Two-earner deduction

The Kemp-Kasten bill would repeal the two-earner deduction.

Earned income credit

Under the Kemp-Kasten bill, the earned income credit would be computed by applying 14.3 percent to earned income, limited to a new base amount ($4,500 for a family of two, $5,000 for a family of three, and $5,500 for a family of four or more). This percentage—which is equal to the combined employer/employee social security payroll tax percentage—would be 14.3 percent for the years 1985 through 1987. This rate is scheduled to increase to 15.02 percent in 1988-1989 and would be 15.3 percent in 1990 and thereafter.

This bill also would provide for a new phaseout of the credit at a rate of 15 percent of AGI (or earned income, if greater) as exceeds the base amount.

S. 411 and H.R. 373 (Roth-Moore)

Tax rates

Under the Roth-Moore bill, a four-bracket tax rate schedule would be provided for each filing status. The tax rates—18, 26, 36, and 45 percent for 1985-1987—would apply to each rate structure, but the ZBA and the dollar amounts for the tax brackets would be different for each filing status. The tax rate schedules would be indexed for inflation beginning in 1986.

The tax rates that would apply to the taxable income brackets for each filing status schedule would be reduced in 1988, 1989 and 1990, successively. The taxable income brackets for joint returns are shown in the table below for illustrative purposes. For separate returns of married individuals, the brackets are half the amounts shown. The bracket amounts for heads of household and unmarried individuals fall between those two for married individuals. The tax rates proposed in the Roth-Moore bill for each year of change for each bracket would be as follows:

Taxable year	Taxable income brackets [1]			
	$3,550–20,000	$20,000–30,000	$30,000–60,000	Over $60,000
1985	18	26	36	45
1988	17	24	34	42
1989	14	21	31	37
1990 (and later)	12	20	30	34

[1] Brackets shown are for joint returns.

Zero bracket amount

The ZBA would be increased to $3,550 for married individuals filing joint returns and for surviving spouses ($1,775 for married individuals filing separate returns), and $2,400 for single returns (including a head of household). These levels would be indexed to reflect inflation.

Personal exemption

The personal exemption amount would be increased to $1,050 for 1985 and would be indexed for inflation in later years.

Two-earner deduction

The bill would repeal the two-earner deduction.

Earned income credit

The bill would increase the maximum earned income credit to $676, increase the phaseout point of the credit, and index the credit for inflation in future years, effective January 1, 1985.

Analysis

1. Distribution of changes in tax liability and after-tax income

This section presents data on the changes in tax liability, tax rates, and after-tax income, by income class, which are estimated to result from the adoption of the Administration proposals.

The figures shown in Tables 5 and 6 present estimates for 1987, the first year that the proposed changes in tax rates would be in effect. These figures take account of transition rules provided in the proposals; for example, it is assumed that the proposed provision for inclusion in gross income of workers' compensation applies for disabilities occurring after 1986. It should be emphasized that these figures represent only one year and that the distributional impact of the Administration proposal may shift somewhat in future years because of income growth and phase-in of various proposals.

The figures in Table 6 for specific income classes reflect the major components of the Administration proposal that specifically affect individuals, but do not reflect various proposals the net effect of which is to reduce the overall tax reduction shown in the tables by approximately 16 percent. The Appendix lists the proposals affecting individuals which are not taken into account in the distribution figures by income class. The figures in parentheses in Table 6 do take these proposals into account.

This analysis is based on tax return data and other information which provides the distribution by income class of items of income not reported on tax returns. The Appendix contains a description of the definition of income.

Table 5 shows the average tax rate (tax liability divided by income) and average tax liability, by income class under present law and the Administration proposal. (these figures take account of all individuals, including those with no tax liability.) The overall average tax rate would fall from 12.2 percent to 10.8 percent under the proposal. The overall average tax burden per tax return would fall from $3,005 to $2,677.

Table 5.—Average Tax Rates and Average Tax Liability Under Present Law and Administration Proposal, 1987

Income class (thousands of 1986 dollars)	Average tax rate (percent)		Average tax liability	
	Present law	Administration proposal	Present law	Administration proposal
Less than $10	1.5	0.3	$54	$12
10–20	5.2	4.1	792	627
20–30	7.9	7.2	2,102	1,904
30–40	10.3	9.5	3,692	3,386
40–50	11.4	10.5	5,320	4,921
50–75	13.9	13.0	8,317	7,772
75–100	17.1	15.6	14,472	13,189
100–200	20.3	18.3	27,246	24,738
200 and above	27.8	23.3	143,261	120,008
Total	12.2	10.8	3,005	2,677

Table 6.—Percentage Change in Tax Liability and in After-Tax Income Under Administration Proposal, 1987

Income class (thousands of 1986 dollars)	Percentage change—	
	In tax liability	In after-tax income
Less than $10	−77.1	1.0
$10–20	−20.8	1.2
20–30	−9.4	0.9
30–40	−8.3	1.0
40–50	−7.5	1.1
50–75	−6.6	1.1
75–100	−8.9	1.9
100–200	−9.2	2.4
200 and above	−16.2	6.0
Total	−10.9(−9.1)	1.6(1.3)

NOTE.—The figures for specific income clases do not take account of certain proposals affecting individuals; the figures in parentheses do take these proposals in account. Thus, the total tax reduction for individuals in 1987 is expected to be 9.1 percent rather than the 10.9 percent reflected in data for which distributional information is available. These proposals are listed in the Appendix.

As discussed in Part II–A–3, above, examinations of the percentage change in tax liability by income class and of the percentage change in after-tax income by income class yield different impressions of the effect of the Administration proposal. For those who wish to judge the impact of a tax change by examining changes in the relative distribution of tax liability, the percentage change in tax liabilitiy may be the most helpful measure. However, for those who wish to judge the impact of the proposal by its effect on the distribution of after-tax income, the second column is the most useful.

The income class consisting of tax returns with less than $10,000 of income would receive a tax reduction equal to 77.1 percent of their current tax liability. Because this class now has a low tax rate, however, this tax reduction leads to only a 1.0 percent increase in after-tax income. In the next higher income class, tax returns receive an average tax reduction of 20.8 percent, but this represents approximately a slightly higher percentage increase in after-tax income than for the lowest group.

For the next four income classes, returns with from $20,000 to $75,000 of income, measures of tax liability and income changes show relatively similar changes among these three classes. While the change in tax liability decreases slightly as income increases within this middle group (the tax reduction for the $20–$30 thousand class is slightly below average and the reduction for the $50–$75 thousand class is about three-fourths of the average), the change in income increases slightly. Although these groups would receive smaller percentage tax reductions than the lowest income classes, their increase in after-tax income would be approximately the same.

The next two income groups, from $75,000 to $200,000, receive percentage tax reductions which are not very different from the figures for the four groups discussed in the previous paragraph; like those groups, their percentage tax reduction is less than the average for all tax returns.

If after-tax income is used as the measure of impact, however, a different result is apparent. These two income groups receive increases in after-tax income of 1.9 and 2.5 percent, at least a 60 percent larger increase than received by the income classes below $75,000. In addition, the higher income groups receive an income increase which is greater than that for the average taxpayer.

Either measure of impact shows that the highest income group—those with incomes over $200,000—receives a relatively large benefit from the Administration proposal. The reduction in tax liability is 16.2 percent, higher than the average reduction and higher than the reduction received by all but the lowest two income classes. The increase in after-tax income received by this group, 6.0 percent, is the largest of any income class and is more than triple the average increase and five times the increases received by the income classes below $75,000.

In sum, a conclusion as to impact of the Administration proposal depends on the measure which best represents Congress' judgments about the vertical equity of tax changes. Thus, if percentage change in tax liability best corresponds to those judgments, then the lowest two income classes receive the most benefit from the proposal, and the highest income class receives a somewhat larger benefit than the remaining income classes, among which the change is roughly similar.

If, on the other hand, percentage change in after-tax income best measures those judgments because of a desire to maintain the present relative distribution of after-tax income, then a different impression results. Under this measure, the income classes below $75,000 would experience a roughly similar impact to each other;

the classes between $75,000 and $200,000 would experience a greater increase than the lower income classes; and the highest income class would have the largest benefit. If limitations on data about certain income items and certain of the proposals could be overcome, the figures would be somewhat different, but it is unlikely that the general pattern emerging from these figures would be substantially different.

If the Congress wishes to shift the distribution of tax burdens which result from the Administration proposal, many different provisions could be modified to achieve the desired result. Each change proposed by the Administration has some effect on the distribution of tax burdens, and thus each proposal could be revised accordingly. However, most of the provisions in the Administration proposal involve policy goals other than distribution by income class, such as horizontal equity or the propriety of subsidizing a particular type of expenditure.

Although one goal of tax policy is to keep tax rates as low as possible, the structure of rates may be readily modified to achieve the desired distribution pattern. Thus, the most flexible course to pursue may be to make decisions about particular base broadening items on the basis of policy goals other than distribution and then to design a rate structure to achieve the desired distribution, given those other decisions.

2. Marriage penalty and other relationships among family sizes and types

This section discusses the marriage tax penalty that would exist under the Administration tax proposal and compares it to the pattern of marriage penalties that exist under present law. Other relationships among different types of individuals also are discussed.

Table 7 presents examples of marriage tax penalties which would exist under the Administration proposal in 1987, the first year in which the proposed rate schedules would be fully effective. These calculations are made under assumptions as to the size of itemized deductions that take into account a rough estimate of the average impact of such proposed changes as repeal of the deduction for State and local taxes and the changes in the treatment of miscellaneous deductions for employee business and investment expenses. The main effect of these assumptions is to determine which taxpayers in the examples itemize deductions rather than rely on the zero bracket amount.

Table 7.—Marriage Tax Penalty for Two-Earner Couple Under Present Law and Administration Proposal, 1987

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Present law	−$5	−$45	−$133	−$453	−$2,252
Proposal	282	282	−113	−173	−2,260
$20,000					
Present law	−45	87	258	464	−851
Proposal	282	581	562	502	−715
$30,000					
Present law	−133	258	523	1,123	186
Proposal	−113	562	543	483	136
$50,000					
Present law	−453	464	1,123	2,393	2,190
Proposal	−173	502	483	1,816	1,816
$100,000					
Present law	−2,252	−851	186	2,190	3,834
Proposal	−2,260	−715	136	1,816	1,816

NOTE.—The marriage bonus or penalty is the difference between the tax liability of a married couple and the sum of the tax liabilities of the two spouses had each been taxed as a single person. Marriage bonuses are negative in the table; marriage penalties are positive. It is assumed that all income is earned, that taxpayers have no dependents, and that deductible expenses are 22 percent under present law and 13 percent under the proposals and that deductible expenses are allocated between spouses in proportion to income.

Table 7 shows that, primarily as a result of changes the Administration proposes in the zero bracket amount and tax rates and the proposed repeal of the two-earner deduction, marriage penalties generally would increase for two-earner couples with relatively low incomes and would decrease for two-earner couples with relatively high incomes.

For the very lowest income taxpayers in the table, i.e., those with combined income of $30,000 or less, the marriage tax penalty under the Administration proposal is determined largely by the fact that the proposed ZBA for married couples ($4,200 in 1987) is much less than double the ZBA for unmarried individuals (2 x $3,030 = $6,060). Thus, the amount of income excluded from taxation by the ZBA would be reduced by $1,860 when two single individuals in these income categories married. The increased taxation of this income at a 15-percent rate leads to the $282 marriage penalty shown in the table for these couples. Although such an effect exists under present law with respect to the ZBA of single and married couples, its effect is offset by the two-earner deduction.

For couples in which both spouses have incomes of $20,000 or in which one has income of $20,000 and the other $30,000, the increase in the marriage penalty is attributable to the structure of tax rates combined with the repeal of the two-earner deduction. For example, under the Administration proposal, a single individual with $20,000 of income has all taxable income (equal to $20,000 minus a personal exemption) taxed at rates of zero or 15 percent. If two such individuals marry, some of their combined income is taxed at 25 percent. In combination with the effect of the ZBA, discussed in the previous paragraph, this leads to a marriage penalty of $581. A similar effect exists under present law but is offset to a large extent by the two-earner deduction.

For couples with incomes higher than those just discussed, the effect of the repeal of the two-earner deduction is more than offset by the general reduction and flattening of marginal rates. The marriage tax penalty appears to be either approximately equal to, or less than, that under present law for couples with combined incomes of $60,000 or greater.

If a marriage penalty no greater than that under present law is desired without the retention of the two-earner deduction, then the Administration proposal can be modified in two respects. First, the ZBA for married couples can be made more nearly equal to twice that applicable to unmarried individuals. Second, the tax rate in the 25-percent bracket can be reduced. Third, the income level at which that bracket begins can be changed, by either lowering the level for unmarried individuals or increasing it for married couples, so that the ratio of the levels for married and single taxpayers is closer to 2:1. For example, the figure for married taxpayers can be increased from $30,270 to a figure closer to double the equivalent figure for single individuals (2 x $18,790 = $37,580).

Another issue involving the relationship of tax liabilities taxpayers with different types of families is the personal exemption. The increase in the personal exemption redistributes the tax burden away from larger families toward smaller families.

Some idea of the amount of redistribution involved can be obtained from Table 8, which shows the distribution of married couples and unmarried heads of households by income class and number of dependents. (Very few dependents are claimed by other unmarried taxpayers, who thus are not included in this discussion.) The table indicates that in all income classes, married couples and heads of households with no dependents or one dependent constitute more than half of all tax returns. 60.1 percent of joint returns have no or one dependent, while only 6.0 percent have four dependents. Thus, under the Administration proposal, the tax liability of this group would increase relative to the tax liability of those with two or more dependents.

Table 8.—Percentage Distribution of Taxable Returns Under Percent Low, by Number of Dependents and Income Class, for Married Couples Filing Joint Returns and Unmarried Heads of Households, 1987

Income class (thousands of 1986 dollars)	Number of dependents						
	0	1	2	3	4	5+	Total
Joint Returns							
Less than $10	80.2	15.3	3.9	0.5	0.1	0.0	100.0
$10–20	44.0	23.7	14.7	10.0	3.7	2.0	100.0
20–30	45.2	20.1	19.5	9.6	3.6	2.0	100.0
30–40	36.4	21.2	24.5	12.3	3.5	2.3	100.0
40–50	35.0	20.7	26.2	12.0	4.1	1.9	100.0
50–75	35.4	19.8	25.5	12.2	4.6	2.5	100.0
75–100	37.1	19.4	25.4	11.5	4.8	1.9	100.0
100–200	38.3	17.9	22.9	12.8	5.2	2.9	100.0
200 and above	41.4	16.0	20.2	14.0	5.6	2.8	100.0
Total	39.4	20.7	22.6	11.3	3.9	2.1	100.0
Unmarried Heads of Households							
Less than $10	18.4	48.0	24.9	7.2	1.5	0.0	100.0
$10–20	8.7	50.5	25.2	7.9	4.4	3.2	100.0
20–30	7.4	48.6	27.7	8.4	3.3	2.6	100.0
30–40	7.7	46.0	31.2	10.8	1.9	2.4	100.0
40–50	6.4	45.9	26.4	12.4	7.1	1.9	100.0
50–75	5.8	56.5	31.0	4.1	2.0	0.6	100.0
75–100	13.7	53.0	23.5	9.6	0.0	0.1	100.0
100–200	16.8	43.2	24.2	13.6	1.1	1.1	100.0
200 and above	9.3	44.9	28.7	9.8	5.3	2.1	100.0
Total	9.4	49.3	26.6	8.4	3.7	2.6	100.0

If the Congress were to view this changed distribution of tax burdens as inappropriate, or were to conclude that the $2,000 exemption is too large, the personal exemption could be set at a lower figure. The effect of such a change on tax thresholds could be offset by varying the ZBA by number of dependents. (An easier way to implement this change would be to change the ZBA into a standard deduction, which would not be built into the rate schedules. Thus, nonitemizers would claim a standard deduction which varied with the number of dependents; itemizers would claim the entire amount of their itemized deductions, not just the excess over the ZBA.) The effect of reducing the proposed personal exemption on the distribution of tax liabilities could be offset, if desired, by adjustments in the rate schedules.

Another related issue is the relationship of the tax liability of heads of household to that of other filing statuses. The Administration proposes to increase the ZBA for heads of households above the level for other unmarried individuals. it is aruged that this is appropriate in recognition that unmarried households with dependents may have extra costs not taken into account in the personal exemptions allowed for dependents. Others argue, however, that this proposal is unfair by creating a marriage tax penalty under which two unmarried individuals, each with children, would pay a substantially lower income tax than a married couple with the same number of children and the same combined income. If it is desired to focus tax reduction on low-income heads of househohld, consideration could be given to using the same rate structure for heads of household as for other unmarried individuals (i.e., using the same brackets except for differences attributable to the higher ZBA for the former).

3. Tax thresholds

The Administration proposal substantially increases tax thresholds for individuals and families of all sizes. This follows from the increases proposed in the personal exemption, the ZBA, and the earned income credit. Table 9 shows the projected tax thresholds under present law and the Administration proposal for 1987.

Table 9.—Income Tax Thresholds under Present Law and Administration Proposal, 1987

Filing status	Family size	Including earned income credit		Disregarding earned income credit		Estimated poverty level
		Present law	Admin. proposal	Present law	Admin. proposal	
Non-elderly						
Single.............	1	$3,720	$5,110	$3,720	$5,110	($5,962)
Joint...............	2	6,080	8,350	6,080	8,350	(7,637)
Head of household..	2	8,052	10,397	4,840	7,930	(7,637)
Joint...............	4	9,739	13,152	8,340	12,530	(11,990)
Head of household..	4	9,152	12,902	7,100	12,110	(11,990)
Elderly (age 65 or over)						
Single.............	1	9,540	12,110	9,540	12,110	(5,624)
Joint...............	2	14,710	18,440	14,710	18,440	(7,095)

NOTE.—These calculations are based on the following assumptions: (1) inflation is equal to the figures in the February 1985 CBO forecast, (2) families with dependents are eligible for the earned income credit, (3) for non-elderly taxpayers, all income consists of money wages and salaries, and (4) for elderly taxpayers, all income is taxable income other than wages and salaries.

The first two columns of the table show tax thresholds computed taking account of all the relevant provisions—the personal exemption, ZBA, and earned income credit. As indicated, the tax threshold for all types of taxpayers other than single taxpayers is estimated to be above the poverty line in 1987.

The last two columns in the table show what the tax theshold is estimated to be without taking the earned income credit into account. This calculation corresponds to the view that the earned income credit is intended to offset the impact of the social security payroll tax for low-income families with children and should not be seen as an offset for income taxes. Even adopting this perspective, the Administration proposal lifts the tax threshold above the poverty line for all types of taxpayers except single taxpayers.

For example, the estimated poverty level of a married couple with two children in 1987 is $11,990. Under present law, not taking into account the earned income credit, such a family has tax liability—even though its income is less than the poverty line—as soon as its income exceeds $8,340. Under the Administration proposal, this couple would start to pay taxes only after its income exceeds $12,525 (the sum of the applicable personal exemptions and ZBA).

The Administration proposal does not increase the tax threshold above the poverty line for unmarried individuals. It is argued that this is appropriate for two reasons. First, if the tax thresholds mirrored the poverty line, there would be a substantial marriage penalty created for low-income taxpayers, since the poverty line for a couple ($7,637) is considerably less than double the poverty line for single individuals (2 x $5,962 = $11,924). As discussed in the previous section, a marriage tax penalty is argued to be an undesirable feature of the tax system.

The second argument why the low tax threshold for unmarried individuals is not a serious problem relates to the fact that the income tax does not combine the income of family members (other than spouses) in computing tax liability. Since the income of children or other dependents is not added to that of their parents in computing tax liability, it is argued that tax relief to low-income unmarried individuals would in many cases go to families whose combined income is relatively high. Under this view, ability to pay taxes is best measured on the basis of combined family income, but such a measure has not been implemented for practical or other reasons (see the next section for further discussion of the treatment of dependents' income).

Information that matches the taxable income of taxpayers with that of their dependents is not available. However, information is available on the age of those who file unmarried returns.

Table 10 shows the distribution of tax returns with tax liability, for unmarried individuals, by age and income level. As the table shows, approximately 39 percent of all unmarried returns are filed by individuals under age 25, many of whom are likely to be receiving support from parents. The percentage is even higher in the lowest income groups; approximately 67 percent of individual returns with incomes less than $10,000 are filed by individuals under age 25. Thus, much of the tax relief given to low-income unmarried individuals under any tax reform proposal would be received by young individuals who may be members of higher-income families.

Table 10.—Percentage Distribution of Taxable Returns with Unmarried Filing Status, by Age and Income Class, 1987

Income class (thousands of 1986 dollars)	Age									Number of returns, all ages	
	Under 16	16–20	21–24	25–34	35–44	45–54	55–64	Over 65	Percent total	Number (thousands)	Percentage
Less than $10	4.1	35.6	27.2	15.6	6.8	3.1	5.7	3.3	100.0	12,710	37.8
$10–20	0.3	7.2	25.5	28.0	8.6	6.0	8.7	15.9	100.0	11,952	35.6
20–30	0.3	1.8	7.9	33.2	12.6	8.1	11.1	25.0	100.0	4,065	12.1
30–40	0.1	0.5	6.6	33.6	17.4	11.9	12.1	17.8	100.0	2,843	8.5
40–50	0.0	0.3	2.7	32.1	20.5	12.3	14.0	18.1	100.0	893	2.6
50–75	1.4	0.0	1.2	13.8	21.2	14.6	15.9	32.0	100.0	751	2.2
75–100	0.0	0.0	0.5	14.4	20.5	14.0	15.4	35.1	100.0	194	0.6
100–200	0.0	0.0	2.2	10.8	17.0	12.5	18.7	38.8	100.0	128	0.4
200 and above	0.0	0.4	1.4	11.6	10.5	13.2	21.8	41.0	100.0	62	0.2
Total	1.8	16.3	21.0	24.0	9.8	6.1	8.6	13.0	100.0	33,592	100.0

Another argument made to alleviate concern with the tax threshold for unmarried individuals is that many unmarried individuals live with other persons and realize economies in household expenses that are not taken into account by the tax system. Data collected by the Bureau of the Census indicate that approximately 74 percent of unmarried individuals in the 25 to 44 age group live with other persons, and 56 percent of those in the 45 to 64 age group live with other persons. Although these figures are not directly comparable with the unmarried filing status used in the income tax (because some unmarried individuals may be classified as heads of households), it appears that the majority of non-elderly unmarried individuals live with other individuals and thus are not incurring the entire expense of maintaining a household by themselves. (The tax treatment of taxpayers age 65 or over is discussed in Part III, below.)

Although much of the tax relief for low-income unmarried individuals would go to those who are under age 25 or living alone, some argue that the tax threshold for unmarried taxpayers, like others, should be brought up the poverty line. Many low-income single persons are over 25 and not living with other persons. It is argued that it is unfair to this group to impose too high a tax burden on them for the sake of avoiding the marriage penalty, or because some other group of single persons may pay too low a tax liability relative to a theoretical concept of measuring taxable income on a family or household basis. Thus, it is contended that the ZBA which the Administration proposes should be increased at least to the level proposed for unmarried heads of households in order to alleviate the tax burden of these individuals.

For the elderly, the Administration proposal substantially increases the tax threshold, even though the threshold is well above the poverty line under present law.

4. Lowering and flattening of marginal rate structure

As is apparent from examining Table 3, marginal tax rates generally are reduced under the Administration proposal. At any given taxable income level, marginal rates usually would be lower under the proposal than under present law. Although many taxpayers would have taxable income somewhat higher under the proposal than under present law—because the effect of such items as the partial taxation of employer-provided health benefits and reduced itemized deductions more than offsets the reduction resulting from the increased personal exemptions—it is likely that the overwhelming majority of taxpayers would have a lower marginal tax rate.

The actual marginal tax rate under the income tax does not depend solely on the statutory marginal tax rate in the taxpayer's particular income bracket. Also important are the exclusions and deductions applicable to various forms of income (such as fringe benefits and capital gains), as well as floors or phaseout provisions which reduce the benefit of a deduction, credit, or exclusion as income rises (such as the medical expense deduction, the child care credit, or the exclusion for social security benefits).

In order to gain a more comprehensive picture of the marginal tax rate under the present tax system and under the Administration proposal, an average marginal tax rate was calculated by examining the tax liability increase which results if all items of income increase by a small, uniform percentage on all tax returns. In addition, it was assumed for purposes of this calculation that State and local income taxes increase by the same percentage. Calculation of the increase in tax liability resulting from this income increase and dividing this amount by the income increase produces an effective marginal tax rate which takes account of the provisions listed above.

Table 11 represents the results of these calculations. They show substantial marginal rate reductions in all income classes. The rate reductions in the income classes above $30,000 appear to be particularly sizable. Overall, the aggregate marginal rates for all taxpayers are reduced by approximately 15 percent, from 22.2 percent to 18.8 percent.

It should be noted that these calculations may overstate the effect of the Administration proposal by not taking into account the tendency under present law that additional income leads to additional deductions as individuals spend this additional income on certain items. For example, under present law, additional income may lead to additional sales tax deductions and property tax deductions as individuals respond to their increased income by increasing purchases of housing and other goods. This effect is not taken into account in these calculations.

Table 11.—Average Marginal Tax Rates Under Present Law and Administration Proposal, 1987

Income class (thousands of 1986 dollars)	Percent	
	Present law	Administration proposal
Less than $10	6.0	4.9
$10–20	11.9	11.3
20–30	16.5	15.1
30–40	20.9	17.1
40–50	23.6	20.5
50–75	27.5	22.7
75–100	31.5	25.3
100–200	33.5	28.5
200 and above	33.3	27.3
Total	22.2	18.8

NOTE.—See text for explanation of calculations.

The Administration proposal reduces the number of brackets, so that a substantial portion of taxpayers would be in the 15-percent bracket. There are several advantages to a flat or flattened rate schedule. For example, if taxpayers are more likely to be in the same tax bracket over a period of years, tax considerations would be less likely to influence the timing of transactions. This would reduce one of the sources of inefficiency of a progressive rate schedule.

If most individuals faced the same tax rate, there would be less incentive to shift income to low-bracket family members, which may improve the perception of equity in the system. The marriage penalty would be reduced since, in a system in which married couples may pool their income and file a joint return, this penalty arises from the fact that the amount of income taxed at each rate depends on marital status. Finally, a flatter schedule of tax rates could allow a closer correspondence between amounts withheld and tax liability.

On the other hand, the Administration proposal has 10-percentage point differences between the tax rates in different brackets, a higher difference than the maximum six-point gap found in present-law rate schedules. An increase in this difference would create an increased incentive, for taxpayers near the bracket dividing points, to shift income and deductions from one year to another in order to minimize the tax on a particular item of income or maximize the benefit of a deduction.

5. Withholding rules and transitional issues

The effective date for a large number of the Administration's base broadening proposals (e.g., the repeals of the deduction for State and local taxes and of income averaging) would be January 1, 1986, while the effective date for the revised rate schedules would be July 1, 1986. As a result, a higher number of taxpayers would receive a tax increase during 1986 than during 1987 and following years, when the rate reductions would be fully effective.

It appears that the staggering of effective dates in the Administration proposal is attributable to revenue considerations. Revenue estimates reflect the assumption that repeal of various itemized deductions and exclusions are not immedately reflected in increased withholding, while rate reductions are immediately reflected in reduced withholding. Thus, if the rate reductions had been proposed to be in effect on January 1, 1986, there would have been a projection of a large reduction in revenue received through the withholding system during the first nine months of calendar year 1986, and thus a substantial revenue loss for fiscal year 1986.

The assumption as to the reflection of itemized deductions in withholding rests on observations that itemizers often do not reflect the full value of itemized deductions in extra withholding allowances and, thus, reduced withholding. This may occur because many itemizers may not be aware of the exact amount of their deductions until the end of the year. It is likely that a significant portion of the approximately $63 billion of tax refunds paid in 1983 was attributable to this source. Thus, under a system with lower rates and fewer itemized deductions, this assumption implies a smaller gap between income tax withholding and actual tax liability attributable to this factor.

The Administration proposal would make up for this gap by delaying the benefit of the rate reduction for six months. If the Congress wishes to avoid this delay, it could consider other measures to preserve the current relationship between withholding and income tax liability. For example, income tax withholding rates could be set above the statutory rates in recognition of the fact that many taxpayers have sources of income (such as dividends and interest) in addition to wages. Further, the withholding schedules could be extended to withhold from high wage earners at the top statutory rate (under present law, the highest withholding rate of 37 percent is less than the maximum tax rate of 50 percent). Finally, the rules for payment of estimated tax could be tightened to reduce the amount of underwithholding.[8]

6. Earned income credit issues

Several issues arise in connection with the earned income credit and the treatment of earned income generally. These include the desired rate of the credit, whether the credit should vary by family size, and whether there should be a reduced tax rate on earned income generally.

Rate of credit

The earned income credit has been viewed in large part as an offset to social security payroll taxes for low-income working families with children. Thus, it has been refundable since its inception to take account of the fact that many such families do not have sufficient income tax liability to take full advantage of the credit.

In this context, the Administration proposal would increase the rate of the credit to more nearly equal the sum of the employer and employee tax rates. The Kemp-Kasten bill explicitly ties the credit rate to the combined social security tax rates, which will be 14.3 percent in 1986 and are scheduled to rise to 15.3 percent by 1990. These proposals accept the theory, with which many economists agree, that the employer's share of social security taxes also is borne by employees, in the form of reduced wages. Thus, a total offset of the effect of these payroll taxes on low-income workers would require an earned income credit equal to the combined social security tax rates.

The Administration proposal also provides for indexing of the credit. Although the credit was increased in the Deficit Reduction Act of 1984, the increase generally left the credit below what it would have been if it had been indexed after the previous change in 1979. If indexing had been effective in 1980, the credit in 1986 would be approximately 10 percent of the first $8,180, for a maximum credit of $818, phased out for income between $9,820 and $16,360. Although this indexed credit would have been less generous to families with incomes below $5,500, it would have been considerably more generous for eligible families with incomes above that level.

Effect of family size

A second issue is whether the maximum amount of the credit should vary according to the number of dependents, as proposed in the Kemp-Kasten bill. Although there may be theoretical arguments why the amount of relief from payroll taxes should vary by family size, others contend that such a modification would make

[8] For further discussion of this option, see Joint Committee on Taxation, *Tax Reform Proposals: Compliance and Tax Administration* (JCS-32-85), July 30, 1985.

the credit more of a welfare-type program and less of a way of alleviating the burden of the payroll tax on low-income families and increasing work incentives for such individuals.

In addition, varying the credit by family size would entail practical problems related to eligiblity of unmarried heads of households for the credit. Specifically, unmarried heads of households are not, under present law, required to claim a dependency exemption in order to be eligible for the credit; the only requirement is that they maintain a household for a child which is the child's principal place of abode. This rule reflects the fact that a significant number of unmarried heads of households have assigned their dependency exemption to non-custodial spouses. Thus, in order to be consistent with present law rules for credit eligibility, any family size variation in the credit would have to depend on a family size definition not presently in the law.

Impact of social security taxes

A third issue is whether the impact of social security taxes should be taken into account in the income tax calculation for all taxpayers, rather than just low-income taxpayers. The Kemp-Kasten bill contains an earned income allowance which has the effect of offsetting a portion of the impact of the employee share of social security taxes for taxpayers with earned income. This raises the issue of whether ability to pay taxes is best measured by ignoring these taxes, as under present law, or by taking them into account.

Proponents of such a proposal argue that, by recognizing that earned income is taxed under the social security tax as well as the income tax, it makes more nearly equal the overall marginal tax rates on earned and unearned income. Opponents of such a proposal, however, believe that this view ignores the fact that additional social security taxes lead to significant additional benefit payments. It is argued that the overall marginal tax on earned income therefore is not increased significantly by employee social security taxes, and that an earned income allowance thus would discriminate against taxpayers who had other forms of income.

Appendix: Concepts Used in Distributional Analysis

Definition of income

The income concept used to place tax returns into income classes and to analyze changes in the distribution of after-tax income is adjusted gross income plus (1) tax exempt interest, (2) employer contributions for health plans and life insurance, (3) inside build-up on life insurance, (4) workers' compensation, (5) nontaxable unemployment compensation and social security benefits, (6) contributions to individual retirement accounts, (7) the deduction for two-earner married couples, (8) the minimum tax preferences, and (9) net losses, in excess of minimum tax preferences, from rental and royalty activities, subchapter S corporations, and limited partnership interests.

This definition of income represents an attempt to include items which clearly increase the ability to pay taxes, but which are not included in the present-law definition of adjusted gross income. The adjustment for losses from certain passive investment activities takes into account that investments in such activities may result in losses for tax purposes that do not represent real economic losses.

This income definition is subject to various limitations. First, it omits certain items which clearly affect ability to consume goods and services, including accrual of pension benefits, other fringe benefits (such as military benefits, veterans benefits, and parsonage allowances), means-tested transfer payments (such as Aid to Families with Dependent Children, Supplemental Security Income, food stamps, housing subsidies, and general assistance), and imputed rent on owner-occupied homes. Second, it reflects the accounting rules in effect in 1981 (e.g., depreciation allowances, rules governing use of accrual accounting, and realization taxation of gain).

After-tax income, as used in tables in this section, equals income minus Federal, State, and local income taxes and social security taxes paid by employees and self-employed individuals.

All income and deduction items and tax parameters are projected to 1987 levels based on economic assumptions consistent with the February 1985 forecast of the Congressional Budget Office.

The tax return is the unit of analysis in all tables, so that each income class consists of tax returns with the stated amount of income.

Unless specifically indicated, all distributional tables exclude taxpayers under age 16. This reflects the view that income of children under 16, who tend to have relatively low incomes, should, if possible, be added to that of their parents in order to achieve a more accurate measure of the distributional impact of tax change.

Proposals not taken into account

Distributional tables reflect the major components of the Administration tax proposal. However, the distributional impact of the following items is not taken into account because of a lack of adequate information on the income levels of taxpayers affected by them:

(1) taxation of employer-provided death benefits;
(2) taxation of prizes and employee awards;
(3) limitation of the exclusion of student fellowships and scholarships;
(4) extension of the exclusion for employer-provided legal services;
(5) extension of the exclusion for employer-provided educational assistance;
(6) discrimination rules for nonretirement employee benefits;
(7) limitations on business meals and entertainment expenses;
(8) revisions of taxation of trusts and estates;
(9) taxation of certain unearned income of children under age 14 at the parents' rates;
(10) changes in depreciation and amortization schedules;
(11) limitation of expensing to first $5,000 of depreciable business property;
(12) indexation of FIFO inventory accounting;
(13) recapture of rate differential on accelerated depreciation;
(14) increase in allowable contribution for spousal IRA;
(15) taxation of pre-retirement distributions;
(16) repeal of ten-year averaging of lump-sum distributions;
(17) repeal of three-year recovery rule for contributory pension plans;
(18) repeal of combined plan limit for non-top heavy pension plans;
(19) modifications of cash and deferred arrangements;
(20) 10-percent dividends paid deduction;
(21) accounting changes;
(22) repeal or alteration of certain energy provisions other than percentage depletion;
(23) disallowance of interest incurred to carry tax-exempt bonds;
(24) change in rules for deduction of insured losses;
(25) tax-exempt bond provisions; and
(26) repeal of expensing of conservation, fertilizer, and field clearing expenditures.

C. Tax Treatment of Income of Minor Children

Present Law

Taxation of a minor child

The Federal income tax liability of a minor child having gross income generally is computed in the same manner as for an adult. Thus; a minor child with income is allowed a personal exemption ($1,040 for 1985) and the applicable zero bracket amount (ZBA) ($2,390 for a single person for 1985).

In general, a person with gross income in excess of the personal exemption allowance ($1,040 for 1985) may not be claimed as a dependent on another taxpayer's return, even though the taxpayer satisfies the general support requirement by furnishing over half of the dependent's support for the year. However, parents may claim a dependency exemption for their dependent child with income in excess of that limit,[9] if (1) the child is under age 19, or (2) is a full-time student. Thus, two personal exemptions are available with respect to a minor child—one on the parents' return and one on the child's return.

Special rules apply for calculating the ZBA of a child eligible to be claimed as a dependent on the parents' return. Although both the parents and the child are entitled to claim a full personal exemption for the child, the child may apply the ZBA only against earned income, if any. Thus, in effect, a child's unearned income (such as dividends and interest) in excess of the personal exemption is fully taxable to the child at the child's marginal tax rate.

Property transferred to a minor child

Under present law, if income-producing assets are transferred to a child, the income generally is taxed to the child, even if the transferor retains significant current control over the assets or the right to recover the assets after a stipulated period.

Under the Uniform Gift to Minors Act (UGMA), for example, a transferor may transfer assets to a custodian (who may be the transferor) for the child. Legal title to the property is held by the child but the assets need not be placed in trust and, during minority, the custodian has broad powers to dispose of the property, and to distribute or accumulate income. Thus, under the UGMA, a transferor may shift income to the minor child while retaining significant control of the property.

Another method for shifting income for a limited period of time while retaining a reversionary interest in the assets is the so-called Clifford trust. Under present law, if assets are placed in a qualify-

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[9] For simplicity of explanation, the family unit discussed herein is assumed to consist of two parents and a child or children; hence, the text refers to the parents' return, the parents' marginal tax rate, etc.

ing Clifford trust, income will not be taxed to the grantor, even though the trust will ultimately terminate by reversion to the grantor. To qualify, the trust must preclude the reversion for a minimum period of 10 years and must require the current distribution of annual income.

Administration Proposal

Overview

To reduce the present Federal income tax advantage of transferring income-producing assets to a minor child, the Administration proposal generally would tax the unearned income of a child under 14 years of age at the parents' marginal tax rate, to the extent such income was attributable to property received from the parents. Earned income and unearned income derived from other assets would be taxed at the child's marginal rate.

Unearned income

To the extent unearned income derived from property transferred from the parents exceeds the amount of the child's personal exemption allocated to such income ($2,000 under the proposal), such income would be taxed at the parents' marginal tax rate. The child's tax liability would be equal to the tax that his or her parents would owe if the income were added to the parents' taxable income and reported on their return. In calculating tax liability, unearned income could be reduced by any deductible expenses properly attributable to such income, but could not be offset by the child's otherwise applicable ZBA.

The proposal makes no distinction between property held by the child outright or property held in trust. Thus, for example, any income derived from assets transferred from the parents, including assets held in UGMA custodianship or a Clifford trust, would be taxed to the child at the parents' marginal rate.

All unearned income of a child would be treated as derived from property transferred from the parents unless the income were derived from a qualified segregated account. Property eligible to be placed in a qualified segregated account would include earned income, money or property received from someone other than a parent, and property received by reason of the death of a parent. No other amounts received directly or indirectly from a parent could be placed into the account.

Earned income; qualified segregated account income

Earned income and unearned income attributable to property held in a qualified segregated account would be taxed to the child at the child's marginal tax rate. In calculating tax liability, the amount of the child's personal exemption ($2,000) allocated to such income and the applicable ZBA would be allowed in full.

Other Proposals

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the special rule allowing parents to claim a dependency exemption for a child who is a full-time student, regardless of age, if the support test is met. Accordingly, no child who had attained age 19 could be claimed as a dependent on the parents' return if the child's income exceeded the personal exemption allowance (estimated to be $1,080 for 1986 under present law, $2,000 under the Administration proposal and $2,000 under the Kemp-Kasten bill).

Other proposals

Reduced exemption

It has also been suggested that it may be inappropriate to permit a full exemption allowance ($2,000 under the Administration proposal) to certain children whose income consists solely of unearned income. One proposal would limit the sum of the ZBA and the personal exemption to the amount of earned income (if any) plus $1,000.

Qualified segregated asset account

It has also been suggested that it is inappropriate and administratively difficult to apply different rules to unearned income derived from different sources. One proposal would disregard the existence of a qualified segregated account and tax all unearned income of certain children at the parents' marginal rate regardless of the source of the income-producing assets. Another proposal would tax income attributable to assets held in a qualified segregated account at the child's marginal rate but would not permit use of the ZBA to offset tax liability on this income.

Analysis

Taxation of the family unit

The proposal to tax certain unearned income of a child at the parent's marginal rate raises several issues relating to tax policy goals of equity and progressivity including: (1) the scope of family attribution; (2) the appropriate rate of tax; (3) the appropriateness of providing duplicate exemptions; (4) the appropriate application of the ZBA; and (5) the definition of a minor.

Scope of attribution

The scope of family attribution may be determined by examination of the underlying tax policy goals. Some who believe that it is appropriate to tax the family as an economic unit argue that it is appropriate to attribute all income of the child to the parents. Some who believe that attribution should merely preclude tax-favored intra-family transfers argue that a more limited attribution rule is appropriate. However, others question whether it is appropriate to aggregate any income of a child with that of the child's parents, effectively taxing the family as an economic unit.

The Administration proposal addresses the issue of aggregation in a limited fashion. Under the proposal, only unearned income derived from income-producing assets received from the parents is taxed at the parents' marginal rate.

Some argue that it is more appropriate to tax the family as a unit, without regard to the source or character of the income. Because all income of any family member is available to discharge expenses that would otherwise be borne by the parents, there is no policy reason that any such income be free of tax or subject to tax at lower rates. Thus, it is argued that it would be more appropriate to aggregate all earned and unearned income of dependent children with that of the parents, impose a single tax, and make each family member jointly and severally liable for payment of the tax.

This approach, it is argued, would protect the integrity of a progressive system by eliminating tax incentives to shift income-producing assets among family members. Aggregation of family income also would correct the present-law inequity between families deriving their income largely from wages—which cannot be shifted to another family member and taxed at lower brackets—and those deriving substantial income from investment property—which can be transferred.

Others question whether the scope of the aggregation should be determined by the character of the child's income—earned or unearned. If the tax policy underlying aggregation is taxation of the family as a unit, it may be appropriate to aggregate all income of a child, regardless of its character. Alternatively, some argue that it is appropriate to aggregate only the unearned income of a dependent child which often is attributable to income-producing property received from parents or other family members. Under this view, any earned income should be taxed separately to the child, at the child's marginal rate. This would remove the tax incentive for intra-family shifts of income-producing assets while providing an incentive for a child to work. Still others argue, however, that if it is appropriate to tax the child's earned income at the child's rate, it may also be appropriate to tax unearned income attributable to accumulations of the child's earnings at the child's marginal rate.

Qualified segregated account

An issue related to the scope of attribution is the appropriateness of the qualified segregated account. Proponents of the Administration proposal argue that it is appropriate to require family attribution only in very limited circumstances. They believe that the primary tax policy goal of family attribution is to preclude parents from nominally transferring income-producing assets to their children to gain tax advantages, while retaining substantial control over the assets. Accordingly, because they argue that it is unnecessary to aggregate assets received from other sources, they support the use of a qualified segregated account.

Others question why it is appropriate to limit the attribution rules to parent-child transfers. They believe a broader tax policy goal is to preclude any bracket shifting through transfers of income-producing assets to minors. Moreover, they point out that one problem with the Administration proposal is the difficulty of identifying all assets transferred directly or indirectly from the parents. They argue that the availability of the qualified segregated account exemption encourages step or sham transactions.

Accordingly, they question whether it is feasible to assume compliance with the source rules. They note, for example, that parents desiring to avoid family attribution could transfer income-producing assets to their children indirectly. For example, parents could first transfer assets to grandparents, who would then retransfer the assets to the children. Because the grandparents in this example would be the nominal transferors, they argue, the assets could be placed in the qualified segregated account and income could be taxed to the child at the child's marginal rate.

Others suggest that, even in nonabusive cases, the availability of the qualified segregated account would undermine the effectiveness of the family attribution rules because gift patterns would change over time. They believe that individuals accustomed to making transfers to their children would merely redirect those gifts to grandchildren. Proponents of the Administration proposal argue that, because this was an indirect transfer from the parents, the assets could not be placed in the qualified segregated asset account. Opponents question whether there would be adequate enforcement to preclude such transactions.

Still others who agree that it may be appropriate to permit use of a qualified segregated asset account, question whether the ZBA should be available to offset the income derived from the account. Although it may be appropriate to tax certain unearned income at the child's marginal rate, they argue it is inappropriate to expand present law by permitting use of the ZBA. See the discussion of zero bracket amount, below.

Many European countries have adopted some form of aggregation or family attribution, each using different age thresholds, and different distinctions between the source and character of the income. Where attribution is required, it is most frequently applied only with respect to unearned income. For example, many systems attribute unearned income directly to the parent only if the parent retains significant control over the income-producing assets, or only if the transfer is revocable. Others require aggregation of all unearned income. Still others consider aggregation beyond the family unit and attribute income to any transferor if the transferor retains certain controls over the property.

Imposition of tax

If some aggregation is considered appropriate, additional issues involve the imposition and collection of the aggregate tax. It could be argued that it is most appropriate to aggregate all family income, making each family member jointly and severally liable for the taxes. Of course, if aggregation is to be required one must first define the family. Some would suggest that a family should encompass only the nuclear family unit. Others question whether it is appropriate to aggregate several generations. Additional issues arise in the case of divorce or separation.

To avoid these definitional difficulties and narrow the scope of aggregation, some argue that it may be more appropriate to use a system of parent-child attribution. Thus, a child's income could be directly attributed to the parents, taxed as the parents' income, with the parents being fully liable for the tax. Alternatively, if all unearned income derived from previously transferred assets is attributed to any transferor (regardless of relationship), such transferor could be directly taxed. This may, however, impose an unfair tax burden on the parents (or transferor) who would then be liable for the tax, without having access to the child's income to defray that liability.

To avoid this problem while deterring tax-motivated transfers, it may be more appropriate to hold the child liable, while calculating the tax using the parents' (or other transferor's) marginal tax rate. However, some argue that this solution, reflected in the Administration proposal, would necessarily require fairly complicated disclosure and coordination rules to accurately calculate tax liability. Although disclosure arguably may pose no insurmountable difficulties as between a parent and a minor child, it may be difficult to mandate such disclosure as between a child and other relatives or unrelated transferors.

Proponents of the proposal to use the parents' marginal tax rate suggest, however, that the disclosure difficulties may be minimal because, in most instances, the parent is already subjected to tax at the maximum marginal rate. In addition, they would argue that, absent disclosure by the parent sufficient to precisely calculate tax liability, it is appropriate to tax the child at the maximum marginal rate.

Alternatively, some suggest that disclosure problems could be minimized by permitting the parents to irrevocably assign tax brackets without disclosing other return information. Under this proposal, parents whose marginal rate was less than the maximum rate could irrevocably assign that otherwise unused bracket amount to the child. Under this proposal, the child's tax liability could be calculated without requiring the parents to disclose total income. In addition, the child's tax liability would be fixed. Because the transfer is irrevocable, any subsequent charge attributable to recalculation of the parents' liability would not affect the child's liability.

Duplicate exemptions

Whether or not a decision is made to aggregate family income, one issue is whether, or under what circumstances, it is appropriate to permit duplication of an exemption allowance for a minor child. In general, no taxpayer may claim a dependency exemption for a person with income in excess of the currently applicable exemption amount (estimated to be $1,080 under present law for 1986; $2,000 under the Administration proposal). However, parents who provide over half the support of a child under age 19 or a full-time student may claim a dependency exemption, regardless of the amount of the child's income. The child also is entitled to claim a personal exemption against his or her income.

When the Code was amended in 1954 to permit parents to claim a dependency exemption for a minor child or full-time student, regardless of the child's income level, the stated intent was to provide relief for students helping to pay their way through school. Denying the exemption to parents who otherwise provided most of the support was considered a hardship to the parents and an inappropriate inducement for the child to stop work just before earnings reached the threshold.

Some would question whether it is appropriate to provide an exemption for a child age 19 or older, merely because the child is a full-time student. Even if duplicate exemptions are otherwise permitted for younger children, it is argued that an individual age 19 or older is more likely to be employed and, thus, separately subject to tax.

Others would contend that even if relief is appropriate to encourage student employment (and thus mitigation of the family burden to provide education), similar treatment may not be required with respect to unearned income. Thus, it may be appropriate to permit duplicate exemptions only with respect to earned income. Indeed, some argue that parents who support a minor child or full-time student should be the only taxpayers entitled to claim a personal exemption with respect to the child. They believe that some separately determined means should be used to encourage student employment and ensure that those with de minimis earnings are excluded from the tax filing system.

With respect to a minor child or full-time student receiving only unearned income, different issues arise. If only one exemption is to be permitted, the interests of parents who provide most of the child's support must be compared with those of the child who, at least at some de minimis level, arguably should be excluded from the tax filing system.

Some argue that the parents should be entitled to the dependency exemption if they provide half the child's support, and that all unearned income of the child (or all unearned income in excess of some newly defined threshold) should be taxed to the child. Others give preference to the child, arguing that each taxpayer should be entitled to a personal exemption. Still others argue that the two exemptions should be coordinated on the basis of some sliding scale where, for example, the parents' dependency exemption would be reduced by each dollar of the child's income.

Also to be considered is whether providing duplicate exemptions for a minor child provides inappropriate tax benefits to the family unit by encouraging tax-motivated transfers of income-producing assets to the child. Even if the child were in the same marginal tax bracket as the parent (negating any tax savings otherwise attributable to bracket shifting), use of the duplicate personal exemption inappropriately shields income equal to the exemption amount from tax, lowering the aggregate tax liability imposed on the family unit.

If these benefits are considered inappropriate under present law—where the child's tax liability with respect to unearned income is calculated without regard to the ZBA and taking into account a personal exemption of $1,080 for 1986—it is argued that the Administration proposal—which would increase the personal exemption to $2,000 and permit an increased ZBA to offset certain unearned income—would provide even greater benefits for engaging in these tax-motivated transfers.

Others would argue that the personal exemption creates a threshold designed to exclude persons with de minimis income from the impact of the tax filing system. Permitting a minor child to claim an exemption even though supported by his or her parents and claimed as a dependent on their return is necessary to exclude the child from the tax system. Thus, in effect, they would sanction a de minimis threshold of $1,080 under present law, and $2,000 under the Administration proposal. Those who oppose duplication of exemptions claim that it would be more appropriate to address separately the creation of a de minimis threshold, perhaps at a level much lower than the $2,000 personal exemption suggested by the Administration proposal. Some suggest that the appropriate threshold may be the $100 figure currently applicable to trusts.

Zero bracket amount

Another issue is raised by the proposal to increase the zero bracket amount (ZBA) and permit use of the increased ZBA to offset unearned income attributable to a qualified segregated account.

With respect to unearned income, present law denies the availability of the ZBA for certain children eligible to be claimed as dependents of another taxpayer. Thus, in effect, a child's unearned income in excess of the personal exemption is subject to tax. Under the Administration proposal, a child's tax liability for unearned income attributable to a qualified asset account would be calculated taking into account a personal exemption and a ZBA. Thus, the amount of unearned income excluded from the tax base would increase from $1,080 (the amount of the present-law personal exemption) to $4,900 (the proposed $2,000 personal exemption, plus a ZBA of $2,900), provided the unearned income is derived from a qualified asset account.

Expansion of the ZBA generally is designed to target tax relief for low-income individuals. Those favoring expanded availability of the ZBA argue that a child should be entitled to the same ZBA as any other low-income taxpayer. Because the ZBA generally is available to offset unearned income, it is inappropriate to restrict its availability for a child merely because a parent is eligible to claim a dependency exemption. To the extent the restriction is intended to discourage intrafamily transfers of investment property, they argue that it is more important to target denial of the ZBA to income derived from assets transferred from the parents.

Because the Administration proposal would make the ZBA inapplicable to offset income derived from assets transferred (directly or indirectly) from parents, it is argued, tax advantages for transfers between the parents and a child would not be increased. With respect to other income-producing assets, they argue that it is appropriate to make the ZBA available, even though the parents had claimed a duplicate exemption. Of course, the proposal to permit use of the ZBA to offset income derived from assets received from transferors other than the parents, would provide greater tax benefits than existing law.

Those opposing expanded availability of the ZBA argue that it is important to permit the ZBA to offset earned income to avoid discouraging a child from working. However, they argue that no similar incentive is needed with respect to unearned income derived from income-producing assets whether received from parents, relatives, or unrelated third parties. The ZBA is really a standard deduction, available in lieu of itemized deductions for such expenses as medical and certain housing costs typically borne by the parents or other individuals providing more than half of the dependent's support. Thus, it is argued, expanding the availability of the ZBA to dependents is inappropriate. Opponents conclude that if the ZBA is intended to provide tax relief targeted at truly low-income taxpayers, it is inappropriate to provide such relief for a minor child receiving substantial amounts of unearned income.

Definition of a minor

Under present law, duplicate personal exemptions may be claimed for a child younger than age 19 or for any child, regardless of age, who is a full-time student, if the support test is met. Regardless of the duplication, the child's income in excess of the personal exemption is taxed at the child's marginal tax rate.

Under the Administration proposal, the new rules taxing certain unearned income to the child at the parents' marginal rate would apply only to a child under 14 years of age. All income of an older child or full-time student would be separately taxed at the child's marginal tax rate as under present law. In calculating tax liability, a full personal exemption would be taken into account, and the ZBA could be used only to offset earned income, without regard to the existence of qualified segregated accounts.

Utilization of a different age threshold for these new rules raises several issues. Those supporting the different age threshold argue that children age 14 and older often are eligible to work. The increased likelihood of a child's having earned income would create undue complexity, requiring maintenance of segregated accounts and complicated tax return preparation. They also note that the tax motivation for shifting investment income into a child's bracket is strongest in the case of a younger child who often secures no control over the transferred property. Others suggest, however, that disclosure problems could be minimized by permitting the transferor to irrevocably assign unused tax brackets. Thus, the tax liability of a minor could be calculated without requiring full disclosure of the parents' return.

Those opposing introduction of an additional age threshold question the need for separate rules. If no distinction is made between a child less than 14 years of age and an older child with respect to the availability of the dependency exemptions, it seems inappropriate to use that age threshold to provide different rules with respect to calculation of tax liability. Moreover, if the new rules are intended to prevent the inappropriate tax savings generated by shifting income from investment assets to a child's bracket and to ensure the integrity of the progressive tax rate structure, there is no reason to permit those tax savings once a child attains age 14.

D. Child and Dependent Care Expenses

Present Law and Background

Prior law

Prior to 1976, individuals who itemized deductions could deduct a limited amount of employment-related child and dependent care expenses. Eligible expenditures were limited to $400 per month (in the case of out-of-home care, $200 per month for one child and $300 per month for two or more children). Also, the amount of eligible expenses was reduced by one-half of adjusted gross income (AGI) in excess of $35,000 a year.

In the Tax Reform Act of 1976, the Congress replaced the deduction with a credit, on the ground that availability of the deduction was unduly restricted by its classification as an itemized deduction and by its complexity. Treating child care expenses as an itemized deduction denied any tax benefits for such expenses to taxpayers who did not itemize. Also, deductions favor taxpayers in the higher marginal tax brackets, while the benefit of tax credits can be structured independently of the tax rate schedule.

Present law

General rules

A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses (sec. 21). The credit may be claimed by an individual who maintains a household that includes one or more qualifying individuals. A qualifying individual is a child or other dependent who is under the age of 15, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse.[10]

Employment-related expenses are expenses for the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. For example, amounts paid for services of a housekeeper, maid, or cook usually qualify if such services are performed at least partly for the benefit of the child or other qualifying individual; amounts paid for a chauffeur or gardener do not qualify.

The full costs of a day care center or nursery school for a child (other than transportation costs) count as eligible expenses. If the taxpayer's job can be performed only if his or her child is sent to a boarding school, only the part of the school's fees allocable to care of the child is eligible for the credit; the costs allocable to education cannot qualify.

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[10] For convenience, the discussion below generally refers to child care, but the credit also applies to qualified expenses of care for other qualifying individuals.

Limitations

The amount of employment-related expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. (This limitation does not apply in the case of a spouse who is a full-time student or who is incapable of caring for himself or herself.) Thus, if one spouse is not working no credit is generally allowed.

Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual, and $4,800 if there are two or more qualifying individuals.

The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income (AGI) above $10,000. Because married couples must file a joint return to claim the credit, a married couple's combined AGI is used for purposes of this computation. Individuals with more than $28,000 of AGI are entitled to a credit equal to 20 percent of allowable employment-related expenses.

Data on credit

Although thought of in part as a credit to assist low-income persons, few such individuals use the credit. It is estimated that in 1983, only one percent of married couples who claimed the earned income credit also claimed the child care credit. This result probably occurs because married couples with income low enough to be eligible for the earned income credit are predominantly one-earner couples, who are not eligible for the child care credit. Even among working unmarried low-income persons with children, however, use of the child care credit is low; fewer than six percent of unmarried heads of households who claimed the earned income credit also claimed the child care credit.

Precise information is not available to account for the low use of the child care credit by the earned income credit population. However, a Bureau of the Census study of 1982 child care arrangements[11] used by mothers for their youngest child under age five may provide some indication. For those with family income under $15,000, only about 36 percent used child care arrangements for which cash payments are most common—care in a home by a nonrelative or care in a nursery school or day care center. The remainder of arrangements (other than the five percent not classified or reported) consisted of care by relatives. In addition, families whose oldest child is age five or older may be less likely than the other category to require child care arrangements because of time spent in primary school.

Child care credits totaling $2.1 billion were claimed on approximately 6.4 million returns in 1983.

Administration Proposal

Under the Administration proposal, the credit for employment-related dependent care expenses would be replaced by an above-

[11] U.S. Department of Commerce, Bureau of the Census, *Child Care Arrangements of Working Mothers: June 1982* (Series P-23, No. 129), 1983.

the-line deduction (allowable in computing (AGI), for taxable years beginning on or after January 1, 1986. The $2,400/$4,800 limitation on credit-eligible expenses and the earned income limitation applicable under present law would continue to apply.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill (S. 409; H.R. 800) would convert the credit for dependent care expenses to a deduction, which would be allowed in addition to the standard deduction. The deduction would be allowed in computing taxable income, which would be taxed at a 14-percent rate for all taxpayers, but would not be allowed in computing AGI, which would be subject to a surtax for high-income taxpayers.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill (H.R. 2222, S. 1006) would repeal the credit.

Analysis

General considerations

In general, deductions for personal, family, or living expenses are expressly disallowed by statute (sec. 262). On the other hand, deductions generally are allowed for all trade or business expenses, and various expenses incurred by employees in earning wages (e.g., union dues) may be claimed as itemized deductions.

Certain expenses may be viewed as having both business elements as well as personal elements (e.g., business meals). In the absence of a controlling test for distinguishing deductible business expenses from nondeductible personal expenses, the Congress, in specific instances, has allowed the deduction of some mixed-use expenses in whole or in part (e.g., for the business use of a portion of a taxpayer's principal residence). The Administration proposal treats child and dependent care expenses as falling within the category of mixed-use expenses for which a deduction should be allowed.

As indicated above, certain expenses incident to earning wages are not deductible. For example, taxpayers are not permitted to deduct the cost of commuting to and from home (although the costs of traveling from one place of employment to another are deductible). Some argue that child and dependent care expenses are like disallowed commuting costs, which are incident to but not necessary expenses of employment; i.e., they are viewed as attributable to voluntary choices by taxpayers of how far they live from work and how they commute. Given this analogy, it is contended that child and dependent care expenses should not be taken into account in determining tax liability, since they represent a voluntary choice as to method of child care chosen by individuals and, in some cases, would be incurred whether or not the individual works.

Opponents of recognizing child and dependent care expenses as deductible or creditable costs also point out that allowing a tax benefit for every incremental cost of being employed would be tantamount to an across-the-board reduction in tax rates. Thus, it is argued that a substantial rate reduction would compensate taxpayers who incur such expenses, with commensurate simplification of the tax law. On the other hand, lowering the tax rate would benefit all taxpayers and would give no special effect to the additional costs incurred by those who incur child and dependent care expenses.

Another suggested dividing line between nondeductible personal expenses and deductible mixed-use expenses is the distinction between expenses like commuting costs that are universally incurred, and other expenses such as child and dependent care costs that are special to certain employed persons (i.e., necessary to employment but not generally incurred). Although it would be impractical to impose burdensome record-keeping requirements on tens of millions of taxpayers to keep track of every cost that is directly attributable to being employed (apart from basic living expenses), employment-related child and dependent care expenses represent costs that can generally be identified without extensive records.

The Administration proposal recognizes that some portion of child and dependent care expenses should be viewed as purely personal. Thus, the Administration proposal places a dollar limitation on the amount allowed as a deduction. This mechanism for determining the deductible business element of a mixed-use expense is consistent with the treatment accorded to other such expenses (e.g., business meals) elsewhere in the Administration proposal.

Structure of tax benefit

Opponents of converting the credit for dependent care expenses to a deduction argue that the credit now is structured not for income measurement, but rather to subsidize the cost of child care. The higher credit rate for lower-income taxpayers reflects a judgment that a high subsidy is necessary to mitigate the burden of the child care expense, which, for these taxpayers, is a serious impediment to work.

The credit rate for higher-income taxpayers is lower than the marginal tax rate applicable to these taxpayers, which is equivalent only to partial deductibility. This treatment reflects the view that a considerable portion of household care expenses for these taxpayers would have been incurred regardless of whether the second spouse worked.

Those who favor converting the credit to a deduction argue that relief for low-income taxpayers is best provided through substantial adjustments in the personal exemption, ZBA, and earned income credit, as the Administration proposes. This generally increases work incentives, rather than subsidizing particular expenditures of low-income persons.

Under present law, the subsidy provided by the credit increases with the amount paid for child care. Because the credit rate is higher than the rate at which income is taxed, a low-income taxpayer with, for example, income and child care expense which are each $1,000 higher than a second taxpayer identical in other respects actually has a lower income tax liability than the second taxpayer. This appears to presume that paid arrangements are better than unpaid arrangements, even though many parents choose unpaid or very low cost arrangements for child care. Further, if subsidies are deemed desirable, it is argued that it is far preferable to rely on outlay programs (such as Title XX of the Social Security Act) which are designed to respond individually to the particular needs of various types of families.

Alternative approaches

The Bradley-Gephardt bill represents, in some respects, a compromise among these points of view. For low -and middle-income taxpayers, child care expenses would be deductible under the bill at the same rate at which income is taxed, so that the deductible amount is treated like an expense of earning income. For high-income taxpayers subject to the surtax, however, the amount would be deductible at a lower rate than that applicable to additional income, presumably on the grounds that taxpayers in this income class would have incurred a portion of these expenses regardless of their earnings.

A result similar to the Bradley-Gephardt bill could be obtained by a child care credit with a rate equal to the lowest tax rate (15 percent in the case of the Administration proposal).

E. Income Averaging

Present Law and Background

In general

An individual whose income fluctuates sharply from year to year, or whose income increases rapidly over a short period, may have a greater aggregate income tax liability over a period of years than another individual, earning the same total amount, who has relatively constant earnings on an annual basis. This result derives from two aspects of the income tax—the annual accounting period and the progressive rate schedule.

The rules for income averaging address this disparity by permitting individuals with fluctuating annual incomes partially to avoid the effects of rate progressivity in high-income years. Under these rules, eligible individuals may reduce their tax liabilities during a year for which their income is at least 40 percent greater than the average income for the immediately preceding three years (the "base years"). In such a case, the income averaging provision reduces tax liability by applying to a portion of the current year's income a lower marginal rate than would be used under the regular tax system.

In order to be eligible to use income averaging, an individual (1) must meet one of several alternative standards generally intended to restrict the availability of income averaging to individuals who were self-supporting during the base years, and (2) must have been a United States citizen or resident during the taxable year and the three base years.

Computation

In effect, the liability of an individual eligible to use income averaging for a year is calculated in three steps:

—First, the taxpayer determines tax liability as if the current year's taxable income equaled a lower amount, i.e., 140 percent of the average income during the base years; this portion of income for the current year is taxed at the rates that would have applied if it had constituted all of the taxpayer's income for the year.

—Second, the individual computes the increase in tax liability over the amount determined according to the first step which would result if 25 percent of the remaining income (i.e., total income less 140 percent of average base period income) were added to the portion of income described in the first step.

—Third, this increase is multiplied by four and added to the tax liability calculated in the first step in order to determine the individual's tax liability for the current year.[12]

Each of these tax liability computations is performed using the current year's rate schedules.

Data

For 1982, 5.5 million individuals filed returns using income averaging (computed under the rules in effect prior to restrictions imposed by the Deficit Reduction Act of 1984); these returns represent 6.2 percent of returns filed that year. Total income involved in income averaging was $226 billion, or 12.1 percent of the total income reported on all 1982 returns with a tax computation. Tax savings of $2.7 billion were realized as a result of using income averaging in 1982.

Administration Proposal

Income averaging would be repealed, effective for taxable years beginning on or after January 1, 1986.

Other Proposals

Congressional bills

Income averaging also would be repealed under the Bradley-Gephardt bill (S. 409; H.R. 800), the Kemp-Kasten bill (H.R. 2222; S. 1006), and the Roth-Moore bill (S. 411; H.R. 373).

1984 Treasury Report

Under the 1984 Treasury report, income averaging would be retained, but with a modification denying its benefits to any individual who was a full-time student during any of the three base years.

Analysis

The proposals to repeal income averaging raise issues related to the tax policy goals of simplicity and equity, as well as to the degree of rate progressivity that is retained in the tax system.

Fairness issues

It is generally agreed that the disparity which income averaging seeks to address—higher taxes for individuals with fluctuating, as opposed to stable, yearly taxable incomes—is a byproduct of the tax system's use of annual reporting periods and progressive rates. Thus, it has been argued that income averaging should be a part of any steeply progressive system of income taxation, unless its benefits are outweighed by undue complexity, administrative difficulty, or over-breadth (i.e., application to individuals who are not meant to be benefited).

The main ground advanced for repealing income averaging is that there is less need for it under a broad-based tax system with

[12] For example, if 140 percent of the average income in the base years equals $40,000, and the taxable income for the current year equals $80,000, then the portion of the income between $40,000 and $80,000 is all taxed at the marginal rate applying under the regular rate schedules between $40,000 and $50,000.

fewer rates, wider tax brackets, and a flatter rate structure, since income averaging benefits only those taxpayers whose current year income puts them in a different rate bracket than if their taxable income were 140 percent of base period income. Under the rate structures proposed by the Administration, as well as in various Congressional tax reform bills, fluctuations in annual income would not change the taxpayer's marginal tax rate as frequently as under present law.[13]

Advocates of retaining income averaging respond by noting that the Administration proposal would not eliminate the progressivity of the tax system. Thus, some individuals with sharp income fluctuations could still have a greater aggregate tax liability over a period of years than other individuals with level annual earnings.

Indeed, in some cases the benefit of income averaging, if retained, could be greater under the rate structure proposed by the Administration than under present law. In large part, this is because under the Administration proposal, the difference between the marginal rates applying to adjacent brackets would be greater than under present law. That is, marginal rates would increase by 10 percentage points, from 15 to 25 percent and then to 35 percent, whereas under present law the difference between the marginal rates applying to adjacent brackets, disregarding the zero bracket amount, is always less than 10 percentage points.[14]

For example, a married couple (filing a joint return) who averaged slightly over $40,000 of taxable income over three consecutive years and then earned $100,000 in the fourth year would save about $3,000 through income averaging in the fourth year under the rate structure proposed by the Administration, as compared with less than $500 under present law. In general, under the Administration's proposed rate structure, the repeal of income averaging would have a greater negative impact on lower- and middle-income taxpayers, whose taxable incomes might be at or near the upper bounds of tax brackets, than on higher-income taxpayers, whose incomes regularly would reach the maximum 35 percent bracket.

Simplification issues

A second issue raised by advocates of repealing income averaging is that of simplicity. The rules for income averaging are highly complex, largely due to the goal of providing it only for individuals whose income has truly been fluctuating, while denying its benefits to those who experience a one-time increase in annual income as new entrants into the work force.

Individuals in the latter category are difficult to identify precisely or simply, but they are considered inappropriate beneficiaries from income averaging since they are likely to experience a sustained increase in income, rather than ongoing fluctuations. (For example, it is expected that the income of college students will rise

[13] The repeal of income averaging would be effective January 1, 1986, although full rate reductions would not become effective until 1987. A blended rate schedule, giving only one-half the benefits of the new rates, would be in effect for 1986.

[14] Under present law, only two marginal tax rate changes exceed five percentage points. Both such changes occur at marginal rates above 35 percent and affect taxpayers with taxable incomes above $35,000.

rapidly after graduation, but special tax computations are not provided for them.) The rules for income averaging are particularly complex for an individual whose marital status has changed during the current year or during one of the three base years.

In addition, advocates of repeal assert that, even with the complexities of present law, some unintended beneficiaries continue to qualify for income averaging. In the absence of any simple or straightforward means of disqualifying these individuals, the advocates conclude that income averaging should be repealed.

In response to the complexity and abuse arguments, advocates of retaining income averaging note that the change proposed in the 1984 Treasury report (denying income averaging to any individual who was a full-time student during any of the three base years) would decrease unintended use of the provision without significantly further complicating the tax system. Thus, they argue that the complexity and abuse problems caused by the provision are not so great as to outweigh the increase in fairness to taxpayers who utilize it. Moreover, they argue that income averaging does not in practice impose significant complexity on taxpayers whose marital status has not changed recently, since the tax form that is used to calculate its effects simply requires the taxpayer to complete the computational steps.

Summary

In large part, the determination as to whether income averaging should be retained may depend upon the degree of rate progressivity that is retained in the tax system. To the extent that progressivity is reduced but not eliminated, the merits of retaining income averaging are influenced by the relative weight that one assigns to the conflicting goals of simplicity and equity.

III. TAX TREATMENT OF THE ELDERLY AND DISABLED

Present Law and Background

Overview

Present law includes a number of provisions that have the effect of reducing or eliminating the burden of Federal income tax on individuals who are elderly, disabled, or unable to work on account of injury or layoff. Some of these special provisions are targeted to lower-income taxpayers; others reduce taxes for all taxpayers.

Partly as a result of these provisions, the majority of elderly individuals do not have any income tax liability under present law. In 1982, the U.S. population age 65 or over was 26.8 million. However, the number of individuals in this age group represented on tax returns filed in that year was 14.0 million. Only 11.4 million of these individuals had any tax liability. Thus, in 1982, about 48 percent of the elderly did not file a tax return, and 57 percent of the elderly had no income tax liability.

Personal exemptions

Present law provides an additional personal exemption ($1,040 for 1985) for an individual who is age 65 or older, or who is blind. An individual who is both age 65 or over and blind is entitled to claim two additional personal exemptions. For a general description of the personal exemptions, see the discussion above in Part II.

Credit for the elderly and certain disabled individuals

In general

Present law provides a nonrefundable income tax credit (sec. 22) for individuals who are age 65 or over, or who have retired on permanent and total disability. For this purpose, an individual is considered permanently and totally disabled ("disabled") if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than 12 months. The individual must furnish proof of disability to the IRS.

This credit is designed to provide tax benefits to individuals who receive only taxable retirement or disability income, or who receive a combination of taxable retirement or disability income plus social security benefits, that are generally comparable to the tax benefits provided to individuals who receive only social security benefits (including social security disability benefits). As explained below, social security benefits are tax-exempt unless the individual's AGI (with certain modifications) exceeds $25,000 ($32,000, in the case of a joint return).

Computation of credit

The credit equals 15 percent of an amount which equals an initial base amount, as specified in the statute, that is then reduced by the amount of certain tax-free income received by the taxpayer and by one-half of the taxpayer's AGI exceeding a specified threshold.

The statute specifies the initial base amount to be $5,000, in the case of an unmarried elderly or disabled individual or in the case of a married couple filing a joint return if only one spouse is eligible for the credit; $7,500, in the case of a married couple filing a joint return with both spouses eligible for the credit; or $3,750, in the case of a married couple filing separate returns. For a disabled individual who is under age 65, however, the initial base amount is the lesser of the applicable specified amount or the individual's disability income for the year. Consequently, the maximum credit available is $750 (15 percent x $5,000), $1,125 (15 percent x $7,500), or $562.50 (15 percent x $3,750), depending on the initial base amount applicable to the taxpayer.

The initial base amount is reduced by the amount of certain nontaxable income of the taxpayer, such as nontaxable pension and annuity income or nontaxable social security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the initial base amount is reduced by one-half of the taxpayer's AGI in excess of $7,500, in the case of a single individual; $10,000, in the case of married taxpayers filing a joint return; or $5,000, in the case of married taxpayers filing separate returns.

Impact on tax threshold

As a result of the credit and the additional personal exemption for the elderly, the tax threshold for elderly individuals exceeds the poverty level under present law. For a single elderly taxpayer, none of whose income consists of tax-free social security benefits, the tax threshold for 1986 is estimated to be $9,383; for an elderly couple, the threshold is estimated to be $14,450. These amounts are well above the estimated poverty levels for such individuals of $5,450 and $6,860, respectively.

Tax treatment of social security benefits

Under present law (sec. 86), a portion of social security benefits and railroad retirement tier 1 benefits, including disability benefits,[15] is included in gross income if the sum of the individual's AGI (increased by the amount of any interest on tax-exempt bonds) plus one-half of the taxpayer's benefits exceeds a base amount. The base amount is $25,000 for an unmarried individual, $32,000 for a married couple filing a joint return, and zero for married couples filing separate returns. If the base amount is not exceeded by the sum of modified AGI plus one-half of benefits, the benefits are wholly excluded from income.

If any portion of such benefits is taxable, the amount of benefits includible in income is limited to the lesser of (1) one-half of the

[15] Also, any workers' compensation benefit the receipt of which caused a reduction in disability benefits is subject to these section 86 rules.

benefits or (2) one-half of the excess of the taxpayer's combined income (modified AGI plus one-half of benefits) over the base amount.

A special rule is provided under present law to limit the amount of social security or railroad retirement tier 1 benefits includible in income in the case of a taxpayer who receives a lump-sum payment. Under this rule, if any portion of a lump-sum payment of such benefits is attributable to years prior to receipt of the payment, the taxpayer may elect to include in income the amount that would have been included if the benefits had been taken into account in the years to which they are attributable (sec. 86(e)).

Revenues from the partial taxation of social security and railroad retirement benefits, as estimated by the Treasury Department, are transferred to the appropriate trust funds at the beginning of each fiscal quarter. It is estimated that approximately 10 percent of social security and railroad retirement recipients (or three million returns) include a portion of benefits in income. The estimated amount to be transferred in 1985 is $2.9 billion.

Wage replacement benefits

Overview

Gross income means all income from whatever source derived, including compensation for services. However, under present law, certain amounts received to replace lost wages for individuals who cannot work on account of layoff or injury are partially or totally excluded from gross income.

Unemployment compensation

Present law provides a limited exclusion from income for unemployment compensation benefits received under a Federal or State program. Generally, unemployment compensation programs are those designed to protect taxpayers against the loss of income caused by involuntary layoff.

Treasury regulations provide that this exclusion also applies to cash disability payments made pursuant to a governmental program as a substitute for cash unemployment payments to a taxpayer who is ineligible for unemployment compensation benefits solely because of the disability. Amounts received under workers' compensation acts as compensation for personal injuries or sickness are not treated as unemployment compensation (Treas. Reg. sec. 1.85-1(b)), but may be excludable under section 104(a)(1), as described below.

Under present law, if the sum of the taxpayer's unemployment compensation benefits and AGI does not exceed a base amount, then the entire benefit is excluded from income. (For this purpose, AGI is computed without regard to unemployment compensation benefits, social security benefits, and the deduction for two-earner married couples.) The base amount is $12,000, in the case of an unmarried individual; $18,000, in the case of a married couple filing a joint return; and zero, in the case of a married couple filing separate returns.

If the base amount is exceeded by the figure computed as described below, then the amount of unemployment compensation benefits that is includible in income is equal to the lesser of (1) one-half of the excess of the taxpayer's combined income (modified AGI plus benefits) over the base amount, or (2) the amount of the unemployment compensation.

Workers' compensation disability benefits

Present law (sec. 104(a)(1)) provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness. This exclusion also applies to benefits paid under a workers' compensation act to a survivor of a deceased employee.

The exclusion does not apply to amounts attributable to (and not in excess of) itemized deductions allowed for medical expenses for any prior taxable year. Under Treasury regulations, the exclusion does not apply to a retirement benefit or annuity to the extent it is determined by reference to the employee's age or length of service, or to the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Further, the exclusion for workers' compensation benefits does not apply to amounts received as compensation for a nonoccupational injury or sickness or to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workers' compensation law (Treas. Reg. sec. 1.104-1(b)).

Black lung disability payments

Under present law, black lung disability benefits paid for claims by coal miners are excludable from gross income as workers' compensation benefits (Rev. Rul. 72-400, 1972-2 C.B. 75).

Amounts received under accident and health plans

Under present law, gross income does not include amounts received under an employer-provided accident and health plan to the extent the amounts (1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the employee (or the employee's spouse or dependent), and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work (sec. 105(c)).

Administration Proposal

Additional personal exemption for the elderly and blind

The Administration proposal would repeal the additional personal exemption for an individual age 65 or over, and would repeal the additional personal exemption for an individual who is blind.

The personal exemption for 1986, after indexing, is estimated to be $1,080. Inasmuch as the Administration proposal also would increase the general personal exemption amount for 1986 to $2,000 (to be indexed after 1986), an elderly person or a blind person would receive approximately the same total dollar amount of exemption as under present law. The total exemption amount would be lower than under present law for an individual who is both blind and age 65 or over.

Credit for the elderly, blind, and disabled

Under the Administration proposal, the tax credit for the elderly and disabled would be expanded and modified as follows:

(1) The class of taxpayers eligible for the credit would be expanded to include taxpayers under age 65 who (1) are blind, or (2) receive workers' compensation or black lung disability benefits.

(2) The initial base amount on which the credit is calculated would be increased to $7,000, in the case of an eligible single individual or a married couple filing a joint return with only one spouse eligible for the expanded credit; $9,250, in the case of a head of household; and $11,500, in the case of a married couple filing a joint return where both spouses are eligible for the credit ($5,750, in the case of such a married couple filing separate returns). In addition, the initial base amount for an individual who is both elderly and blind would be increased by $1,500,[16] reflecting the fact that, under present law, such an individual would have a total of three personal exemptions.

(3) The AGI level at which the initial base amount begins to be reduced would be increased to $11,000, in the case of an unmarried individual; $12,500, in the case of a head of household; and $14,000, in the case of a married couple filing a joint return ($7,000, in the case of a married couple filing separate returns). As under present law, the initial base amount of the credit would be reduced by one-half of the taxpayer's AGI in excess of these amounts.

(4) All dollar amounts used in determining the amount of the credit would be indexed for inflation in future years.

(5) For those taxpayers with workers' compensation and black lung disability benefits, the initial base amount would be the sum of (a) the amount of such benefits received, and (b) any initial base amount for which they would otherwise qualify.[17] Under the proposal, other disability income eligible for the credit would be restricted to disability payments from a "qualified plan."

Taxation of social security benefits

The Administration proposal does not contain any provision that would directly alter the present-law tax treatment of retirement, survivor, and disability benefits under the social security and railroad retirement systems. However, the tax rate reductions proposed by the Administration are expected to reduce the amount of revenue collected from the partial taxation of such benefits and hence to reduce the amounts transferred to the social security and railroad retirement trust funds.

Wage replacement benefits

Unemployment compensation.—Under the Administration proposal, all unemployment compensation would be includible in gross income.

Workers' compensation, and black lung disability payments.—Under the Administration proposal, all cash payments for disabil-

[16] This provision is a clarification of the Administration proposal that was not expressly reflected in the description of the proposed credit in the May 1985 Administration report.

[17] This provision is a clarification of the Administration proposal that was not expressly reflected in the description of the proposed credit in the May 1985 Administration report.

ity from workers' compensation and black lung would be includible in gross income, except for payments for medical services (unless previously deducted), payments for physical and vocational rehabilitation, and payments for burial expenses.

Amounts received under accident and health plans.—The Administration proposal would not modify the exclusion for certain amounts received under an employer-provided accident and health plan for permanent loss or loss of use of a body function.

Effective dates

Under the Administration proposal, the repeal of the exclusion for workers' compensation benefits would apply to benefits attributable to disabilities occurring on or after January 1, 1987.

The Administration proposal relating to the credit for the elderly and disabled generally would be effective for taxable years beginning after December 31, 1985. However, the provision that would make workers' compensation and black lung disability benefits eligible for the credit would be effective for taxable years beginning after December 31, 1986, to correspond with the effective date of the provision that would repeal the exclusion for those benefits.

Finally, the repeal of the exclusion for unemployment compensation would apply for taxable years beginning after December 31, 1986.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

Credit for the elderly and disabled.—Under the Bradley-Gephardt bill, the credit for the elderly and disabled would be repealed.

Unemployment compensation.—The Bradley-Gephardt bill would repeal the exclusion for unemployment compensation.

H.R. 2222 and S. 1006 (Kemp-Kasten)

Credit for the elderly and disabled.—The Kemp-Kasten bill would repeal the tax credit for the elderly and disabled.

Unemployment compensation.—The Kemp-Kasten bill would repeal the exclusion for unemployment compensation.

Social security benefits.—Under the bill, the amount of social security disability benefits included in income would equal the lesser of one-fourth of the benefits received or one-fourth of the excess of the combined income (modified AGI plus one-half of the benefits received) over the base amount. The base amount would be the same as under present law.

Workers' compensation and black lung benefits.—The Kemp-Kasten bill would repeal the exclusion from gross income for cash payments from workers' compensation and black lung disability programs.

S. 411 and H.R. 373 (Roth-Moore)

Credit for the elderly and disabled.—The Roth-Moore bill would repeal the credit for the elderly and disabled. In addition, the bill would repeal the extra personal exemption for taxpayers who are age 65 or over.

Unemployment compensation.—Under the Roth-Moore bill, the exclusion from gross income for unemployment compensation would be repealed.

Analysis

Taxation of wage replacement benefits

The proposals to repeal the exclusions for certain wage replacement benefits have been justified on several bases. Similar arguments led Congress in 1983 to tax social security disability and retirement benefits for high-income taxpayers.

One theory is that the current exclusion for wage replacement payments causes unfairness among taxpayers because the net (after-tax) wage replacement rate varies depending on whether the individual receiving the payments is single or married, has other dependents, or has other sources of income. Those who make this argument point out that the value of net wage replacement payments is least for those individuals who have other dependents and no other sources of income. This, they argue, is the group of taxpayers for whom net wage replacement payments should be the largest rather than the smallest. To the extent that a taxpayer's physical condition actually affects ability to pay taxes, this would be reflected much more accurately through such provisions as the medical expense deduction and present-law rules allowing penalty-free withdrawals from employer pension plans, individual retirement arrangements (IRAs), and annuities than through the exclusion.

A second reason asserted by those who support the inclusion in income of wage replacement payments is that high net wage replacement rates can have the effect of encouraging individuals to prolong their absences from work. Because an employer cannot determine whether a specific individual will have other income or dependents and, thus, a high or low net replacement rate, it is difficult to develop a wage replacement program that will not, under certain circumstances, create a disincentive to return to work.

Finally, it has been suggested that the exclusion of wage replacement payments results in a tax subsidy for industries with high injury or layoff rates. This occurs because employers or States or municipalities generally take account of the income exclusion in structuring their wage replacement programs so that the actual costs of the programs are reduced.

On the other hand, others argue that the present-law treatment of wage replacement payments is appropriate, because it recognizes the fact that many who receive such payments need the full amount of the payments, unreduced by taxes, to maintain a subsistence standard of living. For example, in 1984, the average amount of monthly black lung disability benefits received was \$376.40 (\$4,516.80 a year). Those who support the current tax treatment point out that such individuals at all income levels have special hardships and costs and need the full amount of the wage replacement payment for living expenses, rather than the payment reduced by taxes.

In addition, some argue that eliminating the exclusions for wage replacement payments would require employers and State and local governments to alter their wage replacement programs to take account of the loss of exclusion. This, they point out, may increase unduly the overall expenditures required to maintain these programs. Thus, the net effect may be a reduction in benefits, because the costs of maintaining the programs may prove to be too burdensome.

Further, with respect to workers' compensation, it is argued that it is inequitable to tax these payments, which are in lieu of damages under State tort law, while continuing to exclude from tax actual damage payments on account of personal injuries or sickness (sec. 104(a)(2)).

Finally, the exclusion from income for amounts received under an employer-provided accident and health plan for permanent loss or loss of use of a body function could also be evaluated in considering the appropriate tax treatment of wage replacement payments. Some argue that it is possible to structure an accident and health plan that essentially provides wage replacement payments, yet which qualifies for exclusion under section 105(c). However, many of the payments made under other programs, such as social security disability or workers' compensation, are paid on account of permanent injuries and yet do not (or would not under the proposal) benefit from a similar exclusion. Continuing the exclusion under section 105(c), while repealing all other wage replacement exclusions, could create disparate tax treatment among taxpayers depending on the nature of their disability.

Some have proposed an alternative to repealing the section 105(c) exclusion under which the exclusion would apply only if the benefits provided are unrelated to wage levels. In other words, a payment of $10,000 for loss of a finger would continue to be excluded from gross income if all workers would receive the same benefit regardless of their wage levels. Those who oppose this approach argue that it would be difficult to monitor compliance with such a provision.

Impact on tax threshold

Despite the repeal of the additional personal exemptions for the elderly and blind, the Administration proposal would increase the tax threshold for these groups. For a single elderly taxpayer, none of whose income consists of tax-free social security benefits, the tax threshold for 1986 is estimated to be $11,600; for an elderly couple, the threshold is estimated to be $17,667. Those who are blind (or both elderly and blind) also would have higher tax thresholds; i.e., more income would be nontaxable.

The credit also would increase the tax-free level of income for those with black lung disability income and for those receiving substantial amounts of workers' compensation.

Credit for the elderly and disabled

The Administration argues that a more rational system for tax treatment of the elderly and disabled would be accomplished under proposals (1) to repeal the additional personal exemptions for the elderly and blind, (2) to repeal the exclusions for workers' compensation and black lung disability benefits, and (3) to replace these provisions with an expanded and increased credit for the elderly, blind, and disabled. This approach would continue to recognize, through tax benefits, the special costs and hardships of being elderly or disabled, while targeting these tax benefits only to the class of lower-income individuals who need them most.

Those who support this view point out that the additional personal exemptions and income exclusions under present law provide the greatest tax benefit to individuals in the highest tax brackets. For example, the $1,040 additional personal exemption (for 1985) provides $520 of tax benefit to a taxpayer in a 50 percent tax bracket, but only $228.80 of benefit to a taxpayer in a 22 percent tax bracket. By expanding and increasing the credit for the elderly and disabled, which provides the greatest tax benefits to taxpayers who have the lowest income, it is argued that the Administration proposal more appropriately targets tax benefits to those taxpayers who have the greatest need.

It is also argued that the Administration proposal, by making workers' compensation and black lung disability benefits eligible for the expanded credit for the elderly and disabled, eliminates a disparity of present law under which certain types of disability income are treated more favorably than others.

Some who support the theory of the Administration proposal to limit the tax benefits provided to higher-income taxpayers who are elderly or disabled nonetheless would assert that the expanded and increased credit for the elderly and disabled is inconsistent with recent Congressional policy concerning the treatment of social security benefits received by these groups.

Under this view, the Administration proposal is inconsistent with decisions the Congress made in the Social Security Amendments of 1983, which provided for the taxation of social security benefits and extensively revised the credit for the elderly and disabled. In that Act, the income thresholds determining the levels at which taxpayers become subject to social security benefit taxation were not indexed, so that, eventually, all taxpayers may be subject to that provision.

In addition, the levels of the credit were set to provide tax relief only to those elderly and disabled taxpayers who were not receiving appreciable social security benefits and whose incomes were sufficiently low that these benefits would have been tax free had they been received. Further, the credit levels were not indexed, so that under present law the credit will diminish in importance as more taxpayers are subject to taxation of benefits. Thus, under the policy established in 1983, the credit is, in effect, a temporary provision which provides tax relief only to the narrow group of taxpayers not receiving tax-exempt social security benefits and which will ultimately disappear as full tax exemption of these benefits becomes less common.

The Administration proposal, it is argued, would reverse this policy. Because of indexing, the credit would be made into a permanent provision providing to a substantial portion of elderly taxpayers tax benefits considerably larger than the present extra personal exemption. In the near future, many taxpayers would both pay tax on their social security benefits and receive the credit, which in effect would offset part of this taxation. Thus, it is argued that the proposed credit would lack a coherent rationale, other than a permanent expansion of tax relief to the elderly.

Further, it is argued that the proposed credit would be unfair to many social security disability beneficiaries for two reasons. First, because of offset provisions in the Social Security Act, some States reduce workers' compensation by the amount of social security benefits. Yet any remaining workers' compensation benefits may not be eligible for the tax credit, which is reduced on account of social security benefits. Thus, recipients in those States may be taxed more than recipients in other States whose social security benefits are reduced on account of workers' compensation and whose remaining workers' compensation benefits would be fully eligible for the tax credit. Second, social security disability benefits, although taxable, would not be eligible for the proposed credit as would other disability benefits. These beneficiaries thus would continue to be more heavily taxed than, for example, recipients of workers' compensation, even though the disabilities of the latter could be much less severe than those of the social security beneficiaries.

Proponents of this view also point out that the Administration proposal increases the complexity of calculating the credit by changing the initial base amount of the credit depending on whether the individual is both elderly and blind or on whether the individual has workers' compensation or black lung disability benefits. They point out that many lower-income taxpayers do not have access to qualified tax return preparers to help them calculate the amount of the credit that they are entitled to claim. Accordingly, some believe that many taxpayers who would be eligible for the expanded credit for the elderly, blind, and disabled would not claim the credit on their tax returns.

In effect, it is argued, the proposal employs a very complicated way of, first, taxing certain disability benefits, and then undoing the effects of this taxation for lower-income taxpayers. Thus, it is suggested that some complexity could be eliminated by making the tax treatment of workers' compensation more similar to the tax treatment of social security benefits. For example, workers' compensation could be partially or fully included in income to the extent that an individual's AGI, including the workers' compensation, exceeds a base amount. This base amount could be the same base amount used for purposes of determining whether social security benefits are taxable, or could be the base amount used under present law as a threshold for the taxation of unemployment compensation. If such a proposal were adopted, the credit for the elderly and disabled generally could be retained with few or no changes.

On the other hand, those who support the Administration proposal argue that the expanded credit for the elderly, blind, and disabled is not significantly complex. They point that a much larger proportion of taxpayers would become eligible for the expanded credit and argue, therefore, that the chances of a taxpayer failing to claim the credit may decrease because of greater awareness of it. Further, they assert that the IRS could easily compute the credit a taxpayer is entitled to claim as long as the IRS receives social security information.

Those who support the proposal also argue that any complexity in the expanded credit for the elderly, blind, and disabled occurs primarily because of the reduction in the base amount for one-half of the amount by which AGI exceeds a specified amount. They point out that this approach is currently used in determining the taxation of social security and unemployment compensation. Such a calculation could be avoided if the credit did not phase out gradually as income rises.

Taxation of social security benefits

It has been suggested that, in considering comprehensive tax reform, it is necessary to consider the effect of any proposal on the continued solvency of the social security and railroad retirement systems.

The Congress enacted the partial taxation of social security and railroad retirement tier 1 benefits in 1983. At that time, the Congress articulated its belief that social security benefits are in the nature of benefits received under other retirement systems, which are subject to taxation to the extent they exceed a worker's after-tax contributions, and that taxing a portion of social security benefits would improve tax equity by treating more nearly equally all forms of retirement and other income that are designed to replace lost wages (for example, unemployment compensation and sick pay). Furthermore, by taxing social security revenues and appropriating these benefits to the appropriate trust funds, the Congress concluded that the financial solvency of the social security trust funds would be strengthened.

It is estimated that the Administration proposal would reduce the tax liability attributable to the taxation of social security and tier 1 railroad retirement benefits and, therefore, the amounts transferred to social security and railroad retirement trust funds, by $4.1 billion during the period 1986-1990. A significant revenue loss could be expected under any proposal that substantially reduces marginal tax rates.

Consequently, some argue that it may be appropriate to alter the tax treatment of social security and railroad retirement benefits to generate the additional revenue that otherwise would be lost under the tax reform proposals. This could be accomplished either by reducing the base amounts at which the benefits become taxable or by increasing the percentage of benefits that are taxable (e.g., from one-half to three-fourths). Either change would make the taxation of these benefits more similar to the taxation of other employment-related retirement or disability benefits, which are taxed in full, to the extent in excess of employee contributions at all income levels.

On the other hand, repealing certain exclusions would increase the amount of wages subject to employment taxes and, thus, would increase fiscal year receipts for the social security trust funds.

IV. EXCLUSIONS FOR FRINGE BENEFITS, SCHOLARSHIPS, AND PRIZES

A. Fringe Benefits

1. Introduction

Gross income, for income tax purposes, includes "all income from whatever source derived" (Code sec. 61(a)). The Supreme Court has stated that this provision "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."[18]

The social security and unemployment insurance payroll taxes (FICA and FUTA, respectively) and income tax withholding apply to "wages," defined by statute as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash (secs. 3121(a), 3306(b), and 3401(a)). The railroad retirement tax (RRTA) applies to any form of money remuneration (sec. 3231(e)). Regulations applicable to these provisions specify that the value of any noncash item is to be determined by the excess of its fair market value over any amount paid by the recipient for the item (see, e.g., Reg. sec. 31.3121(a)-1(e)).

Thus, an individual must include in gross income all forms of compensation, whether or not received in cash. The Deficit Reduction Act of 1984 clarified this longstanding rule by modifying Code section 61(a) to include fringe benefits among the items specifically listed in that provision as included in gross income, and made similar statutory modifications to the definition of wages or compensation for purposes of FICA, FUTA, and RRTA taxes and withholding. Accordingly, any fringe benefit that does not qualify for exclusion under a specific statutory benefit provision is includible in gross income for income tax purposes, and subject to income tax withholding and employment taxes, at the excess of its fair market value over any amount paid by the employee for the benefit.

2. Statutory Fringe Benefit Provisions

Present Law

In general

As a general rule, if an employer-provided fringe benefit program qualifies under a specific statutory provision of Federal

[18] *Comm'r* v. *Smith*, 324 U.S. 177, 181 (1945); see also, *Comm'r* v. *Kowalski*, 434 U.S. 77 (1977). Similarly, the Court has stated: "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted" (*Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955)).

income tax law, then the benefits provided under the program are excludable (generally, subject to dollar or other limitations) from the employee's gross income for income tax purposes. Similar exclusions also generally apply for employment tax purposes. The costs of benefits that are excluded from the employee's income nonetheless are deductible by the employer, provided they constitute ordinary and necessary business expenses (sec. 162).

The Internal Revenue Code provides specific income tax exclusions, among others, with respect to the following benefits provided by an employer to employees:

(1) the cost of up to $50,000 of group-term life insurance (sec. 79);

(2) up to $5,000 of death benefits (sec. 101(b));

(3) accident or health benefits (secs. 105 and 106);

(4) housing allowances or homes provided as compensation to ministers (sec. 107);

(5) employer-provided meals and lodging (sec. 119);

(6) benefits under prepaid legal services plans (sec. 120);

(7) commuting through use of a van pool (sec. 124);

(8) up to $5,000 annually of employee educational assistance (sec. 127);

(9) dependent care assistance (sec. 129); and

(10) employee discounts and other miscellaneous fringe benefits (sec. 132).[19]

These fringe benefits have commonly been referred to as statutory fringe benefits. In addition, certain benefits provided to members of the Armed Forces are excluded from gross income.

Under present law, the exclusions for prepaid legal services, van pooling, and employee educational assistance are scheduled to expire after 1985.

Nondiscrimination rules

Under present law, exclusions for most of the statutory fringe benefits are conditioned on compliance with rules prohibiting discrimination in favor of employees who are officers, owners, or highly compensated. There is no nondiscrimination rule for benefits provided by an employer under an insured health plan or for the exclusion of up to $5,000 of death benefits paid by an employer.

These nondiscrimination rules generally prohibit discrimination as to eligibility to participate. A plan or program is required to meet the eligibility requirement by covering a reasonable classification of employees in a manner determined by the Internal Revenue Service not to result in prohibited discrimination. A self-insured medical reimbursement plan or group-term life insurance plan may also satisfy the requirement by covering a stated percentage of the employer's employees.[20]

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[19] For a more complete description of these exclusions under present law, see Joint Committee on Taxation, *Overview of Tax Treatment of Fringe Benefits* (JCS-33-84), September 14, 1984.

[20] A group term life insurance plan is considered nondiscriminatory if the plan benefits 70 percent of all employees (other than excludable employees) or if at least 85 percent of all employees who are participants in the plan are not key employees. A self-insured medical reimbursement plan is considered nondiscriminatory if the plan benefits (1) 70 percent of all employees (other than excludable employees), or (2) 80 percent or more of eligible employees if at least 70 percent of all employees (other than excludable employees) are eligible.

Employees who are covered by a collective bargaining agreement and who are not covered by a fringe benefit plan or program generally are excluded from consideration in applying the nondiscrimination rules as long as the benefits provided by the plan or program are the subject of good faith bargaining between the employer and employee representatives. The eligibility rules for self-insured medical reimbursement plans also provide that employees need not be taken into account if they have not completed three years of service, have not attained age 25, or are part-time or seasonal employees.

The present-law nondiscrimination rules applicable to certain types of fringe benefit plans and programs also prohibit discrimination as to contributions or benefits provided under a plan. Under present law, all benefits provided under a self-insured medical reimbursement plan to the five highest-paid officers, 10-percent shareholders, or the 25-percent highest-paid employees must also be provided to all other plan participants.

In addition, an exclusion is not available unless the following concentration tests are satisfied:

(1) in the case of prepaid legal services, no more than 25 percent of the amounts contributed for a plan year are provided to five-percent owners (or their spouses or dependents) of the employer;

(2) in the case of employee educational assistance, no more than five percent of the amounts paid or incurred by the employer during a plan year are provided to five-percent owners (or their spouses or dependents) of the employer; or

(3) in the case of dependent care assistance, no more than 25 percent of the amounts paid or incurred by the employer during a plan year are provided to five-percent owners (or their spouses or dependents) of the employer.

Under present law, if a plan is found to discriminate in favor of employees who are officers, owners, or highly compensated, the otherwise applicable income exclusion generally is denied for all benefits provided under the plan, including those benefits provided for rank-and-file employees. However, under a discriminatory self-insured medical reimbursement plan or group-term life insurance plan, or in the case of certain miscellaneous fringe benefits, including qualified tuition reduction (secs. 117(d) and 132), only those employees with respect to whom discrimination is prohibited are required to include amounts in gross income; other employees retain the benefit of the income exclusion.

Benefits provided under a cafeteria plan

Individuals generally are taxed on income that is made available (constructively received) in addition to income actually received. Under a cafeteria plan, a participant is offered a choice between cash and one or more fringe benefits. If ceratin requirements are met (sec. 125), then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes. Thus, a participant in such a cafeteria plan is required to include in gross income only those taxable benefits actually received.

The cafeteria plan rules generally do not affect whether any particular benefit offered under the plan is a taxable or nontaxable benefit. A benefit that is excludable under the Code when offered separately is an excludable benefit under a cafeteria plan only if the rules providing for the exclusion of the benefit from gross income continue to be satisfied when the benefit is provided under the cafeteria plan.

A highly compensated participant is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits and contributions. In addition, if more than 25 percent of the total excludable benefits for a plan year are provided to employees who are key employees (certain officers and owners) with respect to the plan for such year, then the key employees will be taxed as though they received all available taxable benefits under the plan. Generally, in determining the portion of the total excludable benefits that is provided to key employees, the value of coverage provided under a plan and not actual expense reimbursements are to be counted.

Meals and lodging for the employer's convenience

Present law excludes from gross income the value of certain meals or lodging furnished to an employee (or to the employee's spouse or dependents) by or on behalf of the employer for the convenience of the employer (sec. 119).

The exclusion for meals is available only if the meals are furnished (1) on the employer's business premises and (2) for the convenience of the employer. The exclusion for lodging is available only if (1) the lodging is furnished on the employer's business premises, (2) the lodging is furnished for the convenience of the employer, and (3) the employee is required, as a condition of employment, to accept such lodging.

Benefits provided to members of the Armed Forces

Present law permits military personnel to exclude a variety of in-kind benefits and cash payments from gross income. Specific exclusions apply to certain disability pensions (sec. 104(a)(4)); qualifying combat pay (sec. 112); mustering-out payments (sec. 113); and subsistence, housing, and uniform allowances, as well as the value of quarters or subsistence provided in kind (Treas. Reg. sec. 1.61-1(b)). A similar exclusion is provided for FICA (sec. 3121(i)(2)).

In addition, present law generally provides that the gross income of a member of the Armed Forces does not include compensation received for active service for any month during any part of which the member is in missing status during the Vietnam conflict, as a result of that conflict (sec. 112(d)). No exclusion is provided, however, for a period with respect to which it is officially determined that the member is officially absent from a post of duty without authority. A similar exclusion is provided for certain missing Federal civilian employees.

The Code provides an exclusion from gross income for mustering-out payments (sec. 113).

Data relating to fringe benefits

Table 12 presents data summarizing the growth over four decades of employer contributions to group health insurance and group life insurance. These benefits, the two largest generally available statutory fringe benefits, are indicative of the considerable growth in recent years in employer-provided benefits. There is currently no tax on the value of employer-provided group health insurance coverage. By contrast, the tax exclusion for life insurance coverage is limited to $50,000.

The table provides actual historical information for selected years from 1955 to 1983, as well as projected figures for 1985 and 1990, on the amount of employer contributions, the percent that amount is of total wages, and the decreased Federal tax liabilities due to excluding these contributions from taxation. Contributions to group health, second only to qualified pension plans in overall magnitude of employer-provided benefits, are expected to more than triple during the period 1980-1990, reaching an annual figure of $140.2 billion by 1990.

The table also shows the rates at which the benefits have grown compared to total wages and salaries. Group health insurance grew from 0.8 percent of wages in 1955 to 4.7 percent of wages in 1983. Group health insurance has grown at a much faster rate than group life insurance, which has been approximately the same percentage of wages since 1965.

Table 12.—Employer Contributors for Group Health Insurance and Group Life Insurance

[Billions of dollars]

Item	Actual							Projected	
	1955	1960	1965	1970	1975	1980	1983	1985	1990
Group health insurance:									
Amount [1]	1.7	3.4	5.9	12.1	21.3	45.4	77.2	90.4	140.2
Percent of wages	0.8	1.2	1.6	2.2	2.6	3.3	4.7	4.7	5.1
Individual income tax liability effect	−0.4	−0.7	−1.1	−2.5	−4.9	−12.2	−19.6	−22.0	−36.2
Group life insurance:									
Amount	0.6	1.1	1.7	2.9	4.4	6.3	7.6	8.5	11.5
Percent of wages	0.3	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Individual income tax liability effect	−0.1	−0.2	−0.3	−0.6	−1.1	−1.8	−2.0	−2.2	−3.0

[1] Amounts are based on Department of Commerce reported data and include employer contributions for short- and long-term disability insurance covering private employees and their dependents for 1955–1970. Actual amounts shown for 1975–1983 and Department of Health and Human Service projections for 1985–1989 do not include disability insurance.

A second table (Table 13) shows another way of examining the growth in employer contributions to health and life insurance during this period. These figures compare the increases in wages to the increases in those fringe benefits during this period.

Between 1950 and 1955, for example, health contributions increased 1.5 cents for every dollar of increase in aggregate wages. During the 1970's, health benefit contributions increased approximately 4.5 cents for each dollar of increase in wages. There has been a significant acceleration in the growth of health benefits relative to wages over the 1980 to 1983 period.

In contrast, increases in group-term life insurance as a percentage of wage increases declined over the 1950-1983 period. During the first five years, group-term life insurance contributions increased 0.5 cents for every dollar of wage increase. This figure reached a peak during the last part of the 1950s. Since that time, however, the increase in life insurance as a percentage of wage increases declined, so that by 1983 these contributions increased by only 0.4 cents for every dollar of wage increases.

Table 13.—Increase in Total Employer Insurance Contributions as Percentage of Total Increase in Wages, United States, 1950–1983

[In percent]

	Group health	Group life
1950–55	1.5	0.5
1955–60	2.8	0.9
1960–65	2.7	0.6
1965–70	3.3	0.7
1970–75	4.7	0.6
1975–80	4.4	0.4
1980–83	10.5	0.4

Source: Computed from U.S. Department of Commerce data.

Administration Proposal

In general

The Administration proposal would make the following changes in the tax treatment of employer-provided fringe benefits, generally effective January 1, 1986:

(1) employer contributions to a health plan would be partially includible in income up to $10 or $25 a month;

(2) the exclusion for up to $5,000 of death benefits would be repealed;

(3) the exclusion for van pooling would be allowed to expire after 1985;

(4) the exclusions for employee educational assistance and group legal services would be made permanent and the $5,000 annual cap on excludable employee educational assistance would be repealed; and

(5) uniform nondiscrimination rules would be established for all statutory fringe benefits and miscellaneous fringe benefits.

Employer-provided health benefits

Under the Administration proposal, employer contributions on behalf of an employee to a health plan would be partially includible in the employee's gross income for income tax purposes.[21] The includible amount would be $10 per month for individual coverage and $25 per month for family coverage; thus, the maximum includible amount in any year would be $120 for individual coverage and $300 for family coverage. For a taxpayer with the highest proposed marginal tax rate of 35 percent, the maximum amount of increased income tax for a year would be $42 for individual coverage and $105 for family coverage.

The proposal provides that employer contributions on behalf of an employee would be measured by the annual cost of coverage of the employee under the plan, reduced by any employee contributions to the plan. In most cases, it would not be necessary to measure employer contributions on behalf of an employee because the cost of coverage would clearly exceed the floor on includible amounts.

The annual cost of coverage of an employee would be calculated by dividing the aggregate cost of providing coverage to all employees with the same type of coverage (i.e., individual or family) and in the same plan by the number of employees eligible for that type of coverage and plan. The aggregate cost of providing coverage for any year would depend on whether the plan was insured or self-insured. A plan would be treated as self-insured only to the extent that the risk of loss is not shifted from the employer to an unrelated third party.

In the case of an insured plan, the aggregate cost of coverage would be the net premium charged by the insurer for the coverage. In the case of a self-insured plan, the total costs incurred in providing the coverage, including administrative expenses, would be considered the aggregate cost of coverage for any year. The proposal would provide a safe harbor so that an employer would not be required to quantify actual administrative expenses for a self-insured plan. Under this safe harbor, an amount equal to seven percent of the total costs incurred for benefits under the plan could be used for the cost of administrative expenses.

Finally, the proposal would impose nondiscrimination requirements on insured and self-insured employer-provided accident and health plans (see uniform nondiscrimination rules, below).

The Administration proposal would be effective for employer contributions received in taxable years beginning after December 31, 1985.

Repeal of exclusion for employer-provided death benefits

The Administration proposal would repeal the $5,000 exclusion for employer-provided death benefits (sec. 101(b)). Thus, the amount paid to the estate or a beneficiary of an employee by an employer

[21] It is unclear under the Administration proposal whether employer contributions would also be partially includible in wages for employment tax purposes.

on account of the employee's death would be included in the gross income of the recipient, effective for taxable years after 1985. The Administration proposal would also preclude the characterization of an employer-provided death benefit as a gift from the employer to the beneficiary.

Expiration of van pooling exclusion

In addition, the Administration proposal would allow the exclusion for employer-provided transportation (van pooling) to expire on December 31, 1985, as scheduled under present law.

Employee educational assistance and group legal services

Under the Administration proposal, the exclusion for income and employment tax purposes of employee educational assistance (sec. 127) and group legal services (sec. 120) would be made permanent. The exclusion for a group legal services plan would be available only to the extent that employer contributions to the plan are fixed before the beginning of the year for which benefits are provided. Also, the annual cap on the educational assistance exclusion of $5,000 during a year for an employee would be repealed, effective for taxable years after 1985.

Uniform nondiscrimination rules

In general.—The Administration proposal would establish uniform nondiscrimination rules applicable to employer-provided group-term life insurance, accident and health plans (whether or not insured), group legal services plans, employee educational assistance, dependent care assistance, cafeteria plans, miscellaneous fringe benefits, qualified tuition reductions, and welfare benefit funds.

Prohibited group.—The proposal would define the employees (highly compensated employees) in whose favor discrimination is prohibited. Such an employee would include (1) an owner of at least one percent of the employer (determined with attribution), (2) an employee whose annual compensation is at least $50,000, (3) an employee with annual compensation of at least $20,000 who is within the top 10 percent of all employees by compensation or is among the highest-paid three employees, and (4) any family member of an employee described in (1), (2), or (3). An employee would be treated as an employee described in the preceding sentence if the employee was such an employee at any time during the three-year period ending on the last day of the plan year. In addition, a former employee who was an employee in whose favor discrimination is prohibited at the time of separation from service with the employer or in the preceding year would continue permanently to be considered a highly compensated employee.

Certain mechanical adjustments would be made to the top 10-percent and highest-paid three employees tests to take into account an employer's salary structure. Similarly, adjustments would be provided to the three-year lookback rule to reflect significant fluctuations in an employer's workforce.

Nondiscriminatory coverage.—The proposal provides that the exclusion from gross income would be available only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the Internal Revenue Service could waive the 125 percent test in favor of a more liberal test.

Under the Administration proposal, a plan would not be considered nondiscriminatory even if it satisfied the 125-percent test if, on its face, the classification of employees eligible to participate (e.g., a classification that excluded the lowest-paid 20 percent of employees) in the plan or a condition of benefit receipt was not nondiscriminatory.

Certain classes of employees would be disregarded in applying the 125-percent test. Thus, under the proposal, the following employees need not be taken into account in testing whether a plan provides nondiscriminatory coverage: (1) if the plan so provides, employees with less than one year of service (30 or 90 days, in the case of an employer-maintained health plan), (2) if the plan so provides, part-time and seasonal employees, (3) employees covered by certain collective bargaining agreements, and (4) nonresident aliens who have no U.S. earned income.

Nondiscriminatory availability.—Under the Administration proposal, all types and levels of benefits available to any highly compensated participant must also be available to all nonhighly compensated participants. Similarly, any condition for receipt of a benefit would be required to be applied in a nondiscriminatory manner.

Insurance-type benefits.—The proposal would apply a nondiscriminatory benefits test to group-term life insurance, health benefits, and group legal benefits provided under a permanent and enforceable plan. This test would apply whether or not the benefit was provided through insurance or self-insured by an employer. Certain benefits would be permitted to vary by compensation level.

Noninsurance-type benefits.—Under the proposal, employee educational assistance benefits, dependent care assistance, miscellaneous fringe benefits, and qualified tuition reductions would also be subject to a nondiscriminatory benefits test under which the average amount of benefits provided to highly compensated employees could not exceed 125 percent of the average amount of benefits provided to other employees. In the case of educational assistance benefits, only amounts expended for degree programs would be required to be tested under this nondiscrimination rule.

Concentration test.—The Administration proposal would modify the utilization test of present law applicable to group legal services, cafeteria plans, employee educational assistance, and dependent care assistance. Under the modification, the contributions provided to the top 20 highly compensated employees by compensation could not exceed 25 percent of the total contributions provided under the plan for any year. This rule would apply to each fringe benefit otherwise excludable from gross income.

Sanctions for discrimination.—Under the Administration proposal, if a plan is found to be discriminatory in coverage, benefits, or utilization, the benefits provided to highly compensated employees would not be eligible for exclusion from gross income. The amount to be included in gross income in the case of insurance-type benefits would be the value of the coverage provided to a highly compensated employee and not reimbursements received under the plan for expenses. Under the proposal, benefits provided to non-highly compensated employees would continue to be excludable from gross income even though the plan under which the benefits are provided is discriminatory.

Cafeteria plans.—Under the proposal, the nondiscrimination tests applicable to any particular type of benefit would continue to apply even though the benefit is provided under a cafeteria plan. In addition, the proposal would apply a separate coverage and availability test to each benefit provided under a cafeteria plan.

In applying the coverage and availability tests to each benefit offered under a cafeteria plan, the proposal would apply a special rule to reimbursements of medical, legal, or dependent care expenses under a reimbursement account. Under this rule, the reimbursements would be deemed to be nondiscriminatory if the average reimbursements for highly compensated employees does not exceed 125 percent of the average reimbursements for all other participants in the cafeteria plan. Under the proposal, reimbursement of insurance premiums would not be permitted from a reimbursement account, and the present-law rules would continue to apply to those insurance premiums.

Welfare benefit plans.—The nondiscrimination rules of the Administration proposal would also apply to benefits provided under a tax-exempt voluntary employees' beneficiary association (sec. 501(c)(9)), suppplemental unemployment compensation benefit trust (sec. 501(c)(17)), or group legal services organization (sec. 501(c)(20)).

Effective date.—The Administration proposal relating to uniform nondiscrimination rules generally would be effective for plan years beginning after December 31, 1985, except that, in the case of a health plan, the proposal would be effective for plan years beginning after December 31, 1986. The proposal would provide a delayed effective date for collectively bargained plans.

Cafeteria plans

Under the Administration proposal, reimbursements of insurance premiums generally would not be permitted from a cafeteria plan reimbursement account, and the present-law rules would continue to apply to those insurance premiums.

Other Proposals

1984 Treasury Report

Repeal of fringe benefit exclusions.—In addition to repeal of the exclusions for van pooling and employer-provided death benefits, the 1984 Treasury report proposed repeal of the following fringe benefit exclusions: (1) employer-provided group-term life insurance, (2) group legal services, (3) dependent care assistance, and (4) employee educational assistance. In addition, the proposal would have repealed the special treatment of cafeteria plans. The proposal would have repealed the exclusions for military allowances and parsonage allowances.

Limit on exclusion for employer-provided health insurance.—The 1984 Treasury report would have provided for a cap on the amount of benefits that could be excluded from gross income under an employer-provided health plan. This proposal was similar to a proposal contained in the Administration's 1985 budget proposals.

Under the proposal, employer contributions on behalf of an employee to health plan would be included in an employee's gross income to the extent they exceed $70 per month ($840 per year) for individual coverage or $175 per month ($2,100 per year) for family coverage. The cap would have been indexed annually to take account of increases in the Consumer Price Index.

Nondiscrimination rules.—The 1984 Treasury report proposed nondiscrimination requirements on employer-provided accident and health plans. No detail was provided in the report for these nondiscrimination requirements.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the following fringe benefit exclusions: (1) group-term life insurance, (2) dependent care assistance, (3) group legal services, (4) employee educational assistance, (5) employer-provided commuting, and (6) coverage under a health plan. In addition, the proposal would repeal the special treatment of cafeteria plans.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the exclusion for group legal services and employer-provided commuting.

S. 411 and H.R. 373 (Roth-Moore)

The Roth-Moore bill would repeal the following fringe benefit exclusions: (1) group-term life insurance to the extent that employer-paid premiums exceed employee-paid premiums, (2) $5,000 of employer-provided death benefits, (3) dependent care assistance, (4) group legal services, (5) employee educational assistance, (6) employer-provided commuting, and (7) coverage under a health plan. In addition, the proposal would repeal the special treatment of cafeteria plans.

H.R. 2424 (Russo-Schumer)

Under the Russo-Schumer minimum tax bill, the fair market value of excludable fringe benefits would be included in the base amount subject to the alternative minimum tax on individuals.

H.R. 2914 (Rangel)

In general.—H.R. 2914 would provide uniform nondiscrimination rules for coverage and benefits under certain statutory fringe benefit programs. The statutory fringe benefit programs to which the bill would apply are (1) health plans, (2) group legal services plans, (3) group-term life insurance plans, (4) van pooling plans, (5) educational assistance programs, and (6) dependent care assistance programs. Under the bill, a highly compensated employee participating in a discriminatory fringe benefit plan would be required to include in gross income for any taxable year the amount of the employee's employer-provided benefit. Other employees would continue to be eligible for the exclusion from gross income.

Employer-provided benefit.—Under the bill, an employee's employer-provided benefit would be either the value of coverage or the value of benefits provided to the employee that is attributable to employer contributions. The value of coverage would be the appropriate measure of employer-provided benefits in the case of a health plan, group-term life insurance plan, or group legal services plan. The value of benefits provided would be used in the case of any other statutory fringe benefit program to which the rules apply.

Discriminatory fringe benefit plans.—The bill provides that a statutory fringe benefit program is discriminatory unless (1) the plan does not discriminate in favor of highly compensated employees as to eligibility to participate, and (2) the type and amount of benefits available under the plan do not discriminate in favor of participants who are highly compensated employees.

A fringe benefit plan would not satisfy the nondiscriminatory eligibility requirement unless (1) in the case of a health plan, the plan benefits 100 percent of all employees, or (2) in the case of any other plan, the plan benefits at least 85 percent of all employees. For purposes of testing nondiscrimination in eligibility, the following employees would be excluded from consideration: (1) employees who have not completed one year of service (90 days, in the case of a health plan), provided no such employee benefits under the plan, (2) seasonal or less than half-time employees, provided no such employee benefits under the plan, (3) collective bargaining unit employees not included in the plan, and (4) nonresident aliens with no U.S. earned income.

The bill provides that a fringe benefit plan would not be considered nondiscriminatory unless all benefits available to any highly compensated participant are available under the same terms and conditions to all participants who are not highly compensated employees.

Highly compensated employee.—Under the bill, a highly compensated employee would include any employee who is (1) among the 15 percent highest paid employees, or (2) a five percent owner of the employer. A former employee would be considered highly compensated if the employee was highly compensated at any time during the five plan years ending with the plan year in which the employee separated from service with the employer.

Reporting requirements.—The bill would require an employer maintaining a statutory fringe benefit plan to report to an employee the amount of any fringe benefit that is taxable. In addition, the bill would amend the information reporting requirement applicable to certain fringe benefits (sec. 6039D) to apply to any statutory fringe benefit plan.

Application of certain present law tests.—The bill would not repeal the provisions of present law relating to the maximum amount of benefits all five-percent owners are entitled to receive under a group legal services plan, educational assistance program, or dependent care assistance program.

Effective date.—The bill would be effective for plan years beginning after December 31, 1985.

Analysis

In general

Historically, the tax law has been structured to give incentives to employers (through statutory exclusions from gross income for employees) to provide certain benefits to their employees. In addition, favorable tax treatment has been provided to programs under which employees are permitted to reduce their salaries by electing the amount and type of fringe benefits to be received during a taxable year (i.e., cafeteria plans). It is estimated that, for 1986, the value of employer-provided fringe benefits excluded from income will be approximately $100 billion. This amount is expected to rise to over $150 billion by 1990.

These tax incentives have been justified as a means to ensure broad-based coverage of workers under certain programs that have been determined to be socially desirable. Nondiscrimination requirements have been imposed to guarantee that fringe benefit programs benefit significant numbers of low-paid employees. It is argued that availability of these benefits results in less worker absenteeism and creates a more stable and productive workforce.
ductive workforce.

Generally, tax incentives are said to provide an efficient means by which the Federal Government can encourage employers to provide employees with benefits at lower cost than if the benefits were purchased separately by individual workers. Similarly, some contend that the cost to the Federal Government of providing tax incentives for fringe benefits is significantly lower than the expense and administrative regulation that would be required for the Federal Government to provide the same benefits through a spending program.

For example, it has been estimated that it would cost $100 billion annually if the Federal Government adopted a health insurance program that provided coverage to workers at the same levels that employers provide under present law. This analysis assumes that, in the absence of tax incentives for employer-maintained fringe benefit programs, there would be sufficient political demand that the Federal Government would be required to provide the benefit through a spending program.

On the other hand, some suggest that elimination of tax incentives for fringe benefit programs would not lead to their elimination because employee demand for these benefits is not based primarily on tax incentives. They argue that employer plans provide economies of scale that would be a sufficient incentive for employees to negotiate for benefits on a group basis without regard to the tax incentives.

Further, it is argued that any elimination of fringe benefit programs by employers as a result of elimination of a tax incentive to provide the benefit would not necessarily cause the Federal Government to adopt a spending program to replace the eliminated benefit. Although adequate health care may be a sufficiently important national objective that the Federal Government might guarantee health insurance coverage to all workers, other fringe benefits may not be considered worth what some perceive to be the substantial cost of lost revenues and the inequitable tax burden. For example, it is suggested that it is unlikely that the Federal Government would be compelled to compensate workers for the loss of the exclusion for a no-additional-cost service by providing free air travel to airline employees. Similarly, it is argued that the Federal Government would not, in the absence of statutory exclusions, provide all workers with free life insurance coverage, legal services, van pools, or education not related to employment. Moreover, some argue that Federal spending programs would be more efficient than tax incentives because, under such programs, the benefits are more likely to be targeted to the group of individuals (such as low-income people whether or not employed) who need them most.

Some contend that tax incentives provided for certain fringe benefits are an inefficient means of accomplishing the goal of broad-based worker coverage. For example, some argue that decisions to offer employees fringe benefits are often motivated by tax preferences, rather than the marketplace, and may lead to excessive utilization of unneeded benefits. Further, the existence of tax preferences for certain fringe benefits causes the overall income tax burden on individuals to be shifted to individuals whose employers do not offer such tax-favored benefits.

On the other hand, those favoring the present-law tax treatment for employer-provided fringe benefits argue that employers and employee bargaining units are better equipped than the Federal Government to determine the kinds of social assistance employees need, thereby ensuring a more efficient means of delivering this social assistance to all employees. Further, they argue that, as innovative employers adopt fringe benefit plans and begin to attract employees at lower costs because of these fringe benefits, other employers are encouraged to follow suit. Finally, they point out that, as tax rates are lowered, the exclusions for employer-provided fringe benefits become less important to employees.

Some of the issues on which the discussions of the tax treatment of fringe benefits have focused generally include the following: (1) whether the exclusion from income of certain fringe benefits unfairly shifts tax burdens to taxpayers who do not receive such benefits, (2) whether taxing fringe benefits creates unreasonably burdensome valuation problems for employers, and (3) whether the present law nondiscrimination rules adequately insure that favorable tax treatment will result in fringe benefit programs that cover broad classes of employees. In addition, certain issues have been raised relating to specific fringe benefits. For example, one issue is whether measures to encourage cost savings in health care spending are appropriately dealt with through the tax system.

Equity

In general.—Those who favor including employer-provided fringe benefits in gross income argue that employees whose employers do not or cannot offer tax-free fringe benefits in effect "subsidize" (through higher marginal tax rates) those taxpayers whose employers pay them a portion of their compensation in the form of excludable fringe benefits. For example, if an employer offers tax-free group-term life insurance benefits to its employees, the cost of those benefits is partially borne by employees of other employers who do not bargain for the benefit, because, it is argued, income and employment tax rates could be lowered if the income and wage bases included employer-provided fringe benefits. Thus, it has been suggested that any tax reform proposal in which a primary goal is fairness among taxpayers should evaluate the present law exclusions for employer-provided fringe benefits.

Counter to this view is the notion that it is possible to have an equitable Federal income tax system without altering the tax-free character of certain fringe benefits. Proponents of this view point out that coverage under such programs as group health and group-term life insurance are currently broad-based. For example, it is estimated that approximately 67.2 percent of the civilian nonagricultural workforce in the United States is covered under an employer-provided health insurance program. Coverage tends to vary according to the size of the employer, with companies with 1-24 workers covering about 39 percent of their workforce while firms employing over 500 workers cover, on average, 86 percent of the workforce. It is estimated that approximately 60 percent of the civilian nonagricultural workforce receives group-term life insurance coverage. Coverage under other fringe benefit programs, such as dependent care assistance or group legal services, generally is estimated to represent a small percentage of the workforce.

Others argue that even benefits, such as group health, that are provided to a large percentage of the workforce are not necessarily provided on a nondiscriminatory basis. They suggest that present law permits an employer to determine whether or not to cover the low- and middle-income employees. Further, employers can choose the level of coverage to be provided to different groups of employees. For example, an employer could provide minimal health coverage to low-paid employees, while providing highly compensated employees with much greater health coverage. Similarly, an employer could require low-paid employees to meet deductible and copayment requirements, while providing health coverage to highly compensated employees with no deductible and copayment requirements.

It is argued that equity would be better achieved by increasing the incentives for employers to provide tax-free fringe benefits to the relatively small percentage of the workforce that is not currently covered, rather than increasing the costs of, or possibly eliminating, programs for all other workers by subjecting the value of the benefits to taxation. This rationale assumes that employees faced with the choice between cash compensation and taxable fringe benefits will negotiate for more cash compensation with which they will purchase the benefit if they can afford it and think they need it. In the case of employer-provided health benefits, many feel that lower-paid employees particularly would elect to receive more cash compensation, with a corresponding reduction in their protection against catastrophic losses (such as substantial medical expenses).

Some dispute the theory that employers would actually discontinue their fringe benefit programs if the benefits become taxable to their employees. This group argues that employers do not establish fringe benefit programs, such as health insurance coverage, solely on account of the tax benefits and that, in fact, employers have an interest in providing such benefits because availability of the benefits helps ensure that their workforces are stable and productive. Moreover, it is argued that employer plans provide economies of scale that would be a sufficient incentive for employees to negotiate for benefits on a group basis without regard to the tax incentives.

Caps on exclusions.—Another equity issue concerns placing a cap on the amount of fringe benefits that can be excluded annually from income. For example, the 1984 Treasury report proposed that annual caps should be imposed on excludable health insurance benefits. This approach is also proposed in S.1211, introduced by Senator Durenberger. Some have argued that a cap on excludable benefits has the effect of penalizing workers who live in high cost parts of the country to the benefit of workers living in low cost areas. Furthermore, it is argued that a cap on excludable benefits would disproportionately affect the elderly, whose health insurance costs are significantly higher than the costs for younger workers.

Some believe that the experience with group-term life insurance demonstrates that a cap on exclusion has the effect of controlling the growth in utilization of a fringe benefit. They point out that, from 1964 (when the $50,000 cap was first imposed on excludable group-term life insurance) to 1983, employer contributions for group life insurance decreased as a percentage of wages from 0.6 percent to 0.4 percent. On the other hand, employer contributions for health plans, which are not subject to a cap on exclusion, increased significantly as a percentage of wages during the same period from 2.7 percent to 10.5 percent.

Others believe that the differences in growth rates of these two fringe benefits are attributable to the nature of the benefits provided. Health insurance costs have substantially increased in the United States in recent years, which would also increase the costs of these benefits as a percentage of wages. On the other hand, group-term life insurance costs have remained fairly constant as a percentage of wages because the costs of coverage have remained constant or even decreased slightly. Also, life insurance coverage is often provided to replace lost wages and generally is calculated as a percentage of wages, which would tend to keep the costs constant as a percentage of wages.

Some believe that the structure of the Federal tax system should not be governed by the problems of taxpayers who live in high cost areas. Further, some argue that concern over the impact on the elderly of eliminating a fringe benefit exclusion should be considered in the context of discussions of the overall tax burden imposed on the elderly, rather than as a separate issue (see the discussion above relating to the credit for the elderly). It is argued that it is unfair to the average taxpayer to provide an unlimited exclusion that provides the most tax benefits to those with the best health coverage.

Floor on inclusion.—Some believe that the Administration proposal to include in income $10 or $25 per month for health coverage will result in inequitable treatment of taxpayers. Those who support this view argue that the floor approach to inclusion is regressive in that its effect is more significant on low-income taxpayers with relatively modest health benefits than on high-income taxpayers who have more generous health benefits.

On the other hand, some argue that the floor approach is more equitable than a cap on exclusion because it does not disproportionately impact on employees in high cost areas and guarantees that all employees will pay tax on some portion of their health benefits.

Proportional inclusion.—Another proposal suggested to address the issue of greater equity among similarly situated taxpayers, while reducing the disproportionate effect of income inclusion on employees who are older or who live in higher cost areas, is to include a percentage of the value of a fringe benefit in gross income. For example, 25 percent of the value of a fringe benefit provided by an employer could be included in employees' income and wages.

If such a proposal were largely motivated by a desire to increase employee awareness of health plan costs, it could be structured explicitly to encourage employee contributions by providing, for example, that there would be an inclusion in income only to the extent that 25 percent of the cost of coverage exceeds the employee contribution.

This proposal could be viewed as a compromise between the proponents of the floor and the proponents of the cap. On the one hand, such a proposal does not impose any fixed limitation on the favorable tax treatment for employer health plans, as proponents of the floor prefer. On the other hand, it does address the equity and efficiency concerns of cap proponents by providing that employees with relatively expensive health plans generally would have a higher tax liability than similarly situated individuals with less expensive (or no) health plans.

Incentives for individuals.—Some argue that certain fringe benefits, such as health care coverage, are so important to productivity and the general economic well-being of people in the United States that the tax system should encourage all taxpayers to maintain adequate health insurance coverage. They suggest that equity is better achieved by extending the tax incentives for health insurance coverage by (1) making self-employed individuals eligible for the exclusion from income, or (2) giving individuals a deduction or credit for health insurance that is not provided by an employer.

Some suggest that expanding the tax incentives for individuals or permitting a continuing exclusion for employer-provided health insurance is justified only if minimum standards are adopted for health insurance eligible for the tax incentives. They argue that the present-law incentives do not operate to ensure that all individuals have adequate health insurance coverage because no minimum standards are provided. They contend that minimum standards would guarantee that the tax incentives achieve the desired social goals.

Others counter that it would be extremely difficult to enact administrable standards that would be required for tax incentives for health insurance. They argue that such minimum standards also may not take account of the special needs of some individuals.

Similar arguments are made with respect to other excludable fringe benefits. For example, some suggest that, if it is desirable to encourage individuals to use an energy-efficient means of transportation for commuting, the statutory fringe benefit exclusion for van pooling should be extended to provide a similar tax incentive, through a deduction or credit, to individuals whose employer does not offer the benefit. Those who support this view point to the present-law treatment of child care expenses under which the tax incentives provided to high-income taxpayers through the statutory fringe benefit exclusion are more generous than the tax incentives provided through the individual income tax credit, the rate of which are deliberately set at a relatively low level for this group of taxpayers.

On the other hand, some argue that the reason that tax incentives have been provided for fringe benefits provided through plans maintained by employers is the concern that low-paid individuals will not utilize tax incentives provided to individuals. They assert that tax incentives provided to individuals either through deductions or credits do not address the primary problem of low-income taxpayers, that is, the lack of discretionary income.

Further, it is argued that extending tax incentives, such as a van pooling or health insurance deduction or credit, would have the effect of providing tax breaks to expenditures that have historically been considered nondeductible personal expenses (see the discussion in Part II. D, above, relating to the child care credit). Some suggest that these individual tax incentives are inappropriate absent a compelling reason, such as the goal of the child care credit to remove barriers to employment for the poor who have dependent children. Many believe, however, that the need to ensure adequate health care coverage for all Americans is one of the most compelling reasons for increasing tax incentives, particularly fringe benefit exclusions.

Valuation

Generally, compensation received in noncash forms (such as property) is includible in an employee's gross income and wages at its fair market value. Although in theory an all-inclusion rule for fringe benefits would be simpler because employers would treat all noncash compensation similarly, in practice significant administrative complexity may be added if employers are required to attribute fair market value to particular types of fringe benefits.

The fair market value of a benefit provided generally would be the amount an employee would have to pay to purchase the benefit individually. For insurance-type benefits, such as health and life, this value could vary significantly from employee to employee for the same benefit if factors such as insurability, geographic locale, health, age, etc., are taken into consideration. Attributing value to certain employer-provided fringe benefits can become complicated if true fair market value is used as the measure. In addition, the fair market value of benefits provided to an employee will almost always exceed the employer's cost of providing the benefits at group rates.

In order to avoid these complexities, some proposals would use employer cost as a measure of income for employees. For example, the 1984 Treasury report on employer-provided health insurance would permit employers to use, as a measure of value in an insured plan, the per-capita cost of insurance determined by dividing total premiums paid by the number of employees covered. Although such an approach may appear to be an arbitrary measure of value that fails to reflect an individual employee's circumstances, it reflects the realities of the marketplace for group insurance. Many individuals purchase group insurance through employers (by employee contributions) or associations, and the price paid commonly reflects the group's experience.

The determination of fair market value is most problematic with respect to employee coverage under an employer accident and health plan, whether or not insured. In the case of other employer-provided fringe benefits (e.g., child care, other than child care provided on the employer's premises, or educational assistance), the calculation of fair market value generally may not be difficult, because fewer factors are relevant and it is relatively easy to attach a price based on comparable services provided in an open market. The calculation may be somewhat more complicated if the employer directly provides the benefit (e.g., in-house educational training).

Some argue that the Administration proposals on fringe benefits have essentially solved valuation difficulties. First, the proposal would retain the exclusion for most employer-provided fringe benefits, thereby making valuation irrelevant. In addition, the proposal to tax the first $10 or $25 per month of health insurance coverage generally makes valuation unnecessary, because almost all employer health plans provide coverage at least equal to the floor on inclusion. However, for example, some collectively bargained health plans would not exceed the floor on inclusion, and valuation issues would become important under these plans.

Another way in which the problems of valuation of insurance-type fringe benefits, particularly health insurance, could be addressed would be to tax the benefits received rather than the value of the coverage provided. It is argued that such an approach would treat individuals with taxable fringe benefits the same as taxpayers whose employers do not provide them the fringe benefit and who are forced to pay for such benefits out of after-tax dollars because they do not purchase insurance. Specifically, it is pointed out that, under such an approach, an individual with extraordinary medical expenses during a year that become taxable would be entitled to a medical expense deduction (sec. 213) just as any other taxpayer.

Issues relating to specific fringe benefit exclusions

Dependent care assistance.—Several issues are presented by the existence of both an exclusion for employer-provided dependent care assistance and a child care credit for individuals. Some have questioned whether limits should be imposed on the dependent care exclusion to coordinate generally the tax incentives provided under the exclusion with the tax incentives provided to individuals through the credit. It is argued that the present-law treatment of dependent care assistance provided by an employer is more valuable to higher income taxpayers than the child care credit due to the progressivity of the income tax system and that, therefore, higher income taxpayers are disproportionately benefited by the exclusion. Moreover, it is argued that it is inequitable to provide an unlimited exclusion to individuals whose employers provide dependent care assistance while providing a limited tax credit to individuals who are required to pay their own child care expenses.

One way of addressing these issues would be to place a dollar limit on the exclusion for dependent care assistance. An alternative, which would provide treatment more similar to the credit available to individuals, would be to place a dollar limit on the exclusion for dependent care assistance that decreases as the income of the employee increases. Finally, some propose repealing the exclusion for dependent care assistance on the theory that the exclusion is unnecessary if individuals are given a credit for their child care expenses. Others propose limiting the exclusion to child care provided on an employer's premises.

Those who support the exclusion for dependent care assistance argue that it is appropriate to have this disparity of treatment because the reason for providing the dependent care assistance exclusion was not the same as the reason for providing a credit to individuals for child care expenses. They argue that the dependent care assistance exclusion was designed to encourage employers to provide adequate child care for their employees and, particularly, to provide day care on the employer's premises. They point out that it would be difficult to determine a value for child care provided on an employer's premises.

Others point out that the child care credit provides individual taxpayers with choices (more similar to personal expenses) of child care providers and the manner in which child care should be provided.

Educational assistance benefits.—The exclusion for educational assistance benefits was originally enacted because Congress was concerned about the inequity of providing a deduction for educational expenses only to taxpayers who could demonstrate that their expenses were job-related. Some suggest that the prior-law treatment had the effect of primarily benefiting higher income employees who generally found it easier to satisfy a job-relatedness test. In addition, employers who provided education benefits to their employees generally were forced to make a determination of whether the benefit would be a job-related expense for a particular employee in order to determine whether or not the benefit was includible in the employee's income.

Some oppose the Administration proposal to repeal the $5,000 annual cap on educational assistance benefits. They argue that individuals whose employers do not offer the benefit will perceive the tax system to be less equitable if the cap is removed. Further, they argue that the cap should be lowered because one of the original justifications for the exclusion (i.e., to avoid requiring employers and employees to make job-relatedness determinations) should only apply to de minimis levels of benefits.

On the other hand, others argue that the nondiscrimination rules proposed by the Administration would make an annual cap on excludable education benefits unnecessary. They believe that employers will be required to impose caps on benefits at relatively low levels to ensure compliance with the nondiscrimination requirements.

Some believe that the exclusion for employee educational assistance should be repealed. They argue that employees whose employes do not provide this benefit are treated unfairly because they must pay for education with after-tax dollars. They further argue that retaining the exclusion is particularly inequitable in light of the Administration proposal to repeal the exclusion for scholarships and fellowships.

Those who oppose repeal of the exclusion for employee educational assistance contend that the exclusion primarily benefits low-income employees who cannot meet a job-relatedness test. They believe that the tax incentive is an efficient way to encourage upward mobility of workers.

Others who support the Administration proposal note that it would not require in-house training to be tested for nondiscriminatory utilization because of the difficulty of attaching a value to such training.

Health insurance.—A study conducted by the Rand Corporation in 1981 concluded that health care utilization tends to rise if individuals are required to pay little or no money out of pocket for the care.[22] For example, because many employer-provided health plans require no copayments or low deductibles to be met by an employee, it is argued that employees covered by such plans will be unconcerned about the amount of their health care utilization.

Further, some believe that the present-law tax incentives for employer-provided health coverage exacerbates this utilization because a dollar of health coverage, which is not taxable, is more valuable to an employee than a dollar of cash compensation, which is taxable. They argue that employees will want more generous health care coverage because the value of the coverage is greater to the employee than an equivalent amount of cash compensation.

Proponents of this theory suggest that including all or a part of employer-provided health coverage in income will tend to make employees more cost-conscious consumers of health care because the value of the fringe benefit will not be greater to the employee than the value of equivalent cash compensation. Thus, it has been suggested that, by capping the exclusion for health benefits, the 1984 Treasury Department proposal would help control the rapid acceleration of health care utilization. It is argued that utilization control would be promoted with a cap on excludable health benefits because employers would be encouraged, in order to continue to provide tax-free health benefits to employees, to make use of more efficient health care providers or to introduce or increase required copayments and deductibles. It is also argued that preventive health care would thereby become more commonplace as a way to reduce utilization.

Further, it is argued that employers will generally attempt to keep the value of health coverage below the cap because they will be concerned about employee morale and about the administrative burden of valuing and withholding on fringe benefits.

Those who oppose elimination of all or part of the exclusion for employer-provided health benefits suggest two primary reasons why the exclusion should be continued.

First, it is argued that eliminating the tax preference for health care will create adverse selection, in which younger and lower-paid

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[22] Newhouse, Joweph P., Ph.D., et. al., "Some Interim Results from a Controlled Trial of Cost Sharing in Health Insurance," *New England Journal of Medicine,* Vol. 305, No. 25, Dec. 17, 1981.

workers will opt out of health coverage entirely in return for increased cash compensation. This will tend to drive up the costs of coverage for the remaining employees, because an insurer will be covering the group of greatest health care utilization, causing more and more employees to opt out. As lower-paid employees opt out of the system, increased pressure will be placed on Federal, State, and local governments to provide at least minimal level of coverage to all workers to protect against catastrophic losses. According to this theory, as employer costs for covered employees become prohibitively high through this adverse selection, employers will drop health care programs entirely and will shift the burden even more significantly to governmental programs.

In addition, it is argued that eliminating or limiting the exclusion for health care may cause employers to continue to provide traditional health insurance coverage and to eliminate preventive health programs. This, it is argued, will have the effect of continuing the rapid growth of health care costs, because employees will not agree to cost-saving programs which will increase their taxable income. Finally, it is argued that employers have responded to the rising cost of health care by employing more programs to require employee recognition of costs, such as copayments and deductibles. Some believe that cafeteria plans or a wide variety of health care options contribute to this trend.

It is suggested that the Administration proposal would cause neither the elimination of preventive health programs nor adverse selections by younger and lower-paid employees. Because the proposal would tax at most $10 or $25 per month of coverage at relatively low marginal rates, it can be argued that employers will not be discouraged from continuing current insurance coverage. Similarly, because the addition of preventive medicine programs generally would not create a greater income inclusion under the Administration proposal, it can be argued that the health floor will not have a deleterious effect on employers' cost-containment efforts.

Nondiscrimination rules

In general.—The Administration proposal would impose uniform nondiscrimination rules applicable to all excludable fringe benefits. The present-law nondiscrimination rules generally applicable to fringe benefits have developed over time and different rules apply to each type of fringe benefit. Because the nondiscrimination rules are designed to guarantee that an exclusion is not available unless coverage is broad based among all income classes of employees, it is suggested that, if the current exclusions from income of certain statutory fringe benefits are continued, then it is important to provide nondiscrimination rules that are effective in ensuring broad-based coverage and that can be administered both by employers and by the Internal Revenue Service.

In addition, the Administration proposal would extend uniform nondiscrimination rules to insured health plans, which have not previously been subject to nondiscrimination requirements.

Some believe that nondiscrimination rules should not be extended to insured health plans, because coverage under such plans is currently very high. It is estimated that 67.2 percent of the civilian nonagricultural workforce is currently receiving health care under an employer health plan. Critics point out that the imposition of nondiscrimination rules would merely increase the administrative expense to employers by requiring that they maintain adequate records to demonstrate that their plans are nondiscriminatory. It may also limit the ability or willingness of an employer to provide a variety of health care options to meet the diverse needs of employees.

On the other hand, some believe that the statistics on health coverage in the United States do not demonstrate that coverage is provided by employers on a nondiscriminatory basis. Those who support this view argue that employers are permitted under present law to decide whether or not to provide coverage to low- and middle-income employees and whether or not to provide more generous coverage to highly compensated employees than the coverage that is provided to low- and middle-income employees.

Others believe that the administrative expense associated with demonstrating compliance with nondiscrimination requirements will be negligible and that this expense is far outweighed by the benefit gained by increasing coverage to an even larger percentage of the workforce.

Highly compensated employees.—Under the present law, nondiscrimination rules, an employee who is an officer, shareholder, or highly compensated is considered a highly compensated individual in whose favor discrimination is prohibited. Many argue that these terms generally lack clear definition and, therefore, create standards that are imprecise and inadministrable. For example, they point to the term "officer." To determine whether an employee is an officer requires a subjective evaluation of each potential officer's status (both in name and in authority), including the source of the officer's authority, the term of office, and the nature of the officer's duties.

While determining the status of an employee as a shareholder generally is easier, some question whether it is appropriate to treat all shareholders as highly compensated, regardless of their level of ownership or level of compensation.

With respect to the definition of an employee as highly compensated, they point out that judicial and administrative precedent provides that the compensation level that makes an employee "highly compensated" depends on the facts and circumstances of each situation. An employee whose compensation is high, relative to the compensation of other employees of the employer, is considered highly compensated. This result occurs regardless of the actual dollar level of compensation and regardless of whether that compensation would otherwise be considered high in another industry or area.

Considering all of these ambiguities in present law, many support, in concept, a proposal to develop a uniform, more mechanical definition of a highly compensated individual. Under the Administration proposal, an employee is considered highly compensated if the employee (1) owns an interest of at least one percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) is earning at least $20,000 in compensation and is among (a) the top 10 percent of employees by compensation, or (b) the top three employees by compensation; or (4) is a family member of another prohibited group member for such year.

Those who support the proposal argue that it more narrowly defines the group of highly compensated employees. They also argue that the new definition is objective, providing precise, easily administrable guidance. Some also argue that adoption of a mechanical test may permit the development of a generally applied sanction for failing to satisfy the nondiscrimination requirements under which only the highly compensated employees are required to include the value of benefits in income.

Definition of owner.—Others, who argue that a more objective definition is appropriate, question certain aspects of the Administration proposal. They question, for example, why the proposal includes a new definition of owner. If uniformity is a desirable goal, they suggest it may be more appropriate to conform the ownership definition used for testing nondiscrimination with that already used for group-term life insurance. Under this approach, five-percent owners, certain one-percent owners earning more than $150,000, and the top ten employee owners would be considered highly compensated by virtue of their ownership interest.

Some suggest that an owner should be considered a highly compensated employee only if the owner is an employee who participates in the fringe benefit plan.

Employees earning more than $50,000.—Some question whether application of a dollar threshold is appropriate to identify those individuals in whose favor discrimination is prohibited. They suggest that individuals with high salary levels may not control the employer or have any influence over the plan. Some also argue that the existence of a dollar threshold adds unnecessary complexity.

Others argue, however, that tax incentives are prohibited for fringe benefits to encourage employers to provide retirement benefits for low- and middle-income employees. Accordingly, the definition of individuals in whose favor discrimination is prohibited serves to identify not only those employees who control the employer, but also those employees who are perceived to be the employees in whose favor an employer is more likely to seek to discriminate. Consistent with this goal, it is argued that a compensation threshold is necessary and that no fringe benefit plan should be permitted to discriminate in favor of those earning more than that dollar amount. Those who support this view argue that this not only helps to focus the tax incentives toward low- and middle-income employees, but also prevents a perception of unfairness. If fringe benefits are provided to individuals who are perceived to be highly compensated (even if they do not control the employer) without providing the same benefits to low-paid employees, it is argued that low-paid employees will view present law as unfair.

Some who favor use of a dollar threshold question whether an individual earning $50,000 is, in reality, highly compensated in all circumstances. In certain businesses, such as law firms, medical practices, and certain high-technology electronic industries, some employees (or associates) start at or near the $50,000 threshold. In some cases, a majority of employees would be considered highly compensated using the $50,000 threshold. Some question why it is appropriate to include the majority of employees in the highly compensated group.

Those supporting broader coverage also point out that, if these individuals are considered highly compensated, it may be very easy to manipulate the proposed nondiscrimination tests. For example, if all associates of a law firm were considered highly compensated, the firm could cover all the partners and, by excluding the highly compensated associates, could reduce the number of other employees required to be covered. This group suggests that, in some instances, the compensation threshold used to determine highly compensated status should be increased. For example, if more than thirty percent of the work force earn more than $50,000, it may be appropriate to provide that only those individuals earning more than some higher amount (e.g., $75,000) would automatically be considered highly compensated.

Top-ten percent.—Some are also concerned about the proposal to treat as highly compensated an individual earning at least $20,000, provided the individual is among the top-ten percent by compensation of employees or the top-three employees. Proponents argue that this test is needed to ensure that there is always some individual who is highly compensated relative to other employees. They point out that in some areas or industries, no employee earns as much as $50,000. They argue that the Administration proposal to treat the top-ten percent or the top-three employees as highly compensated is appropriate.

Others argue that a test based on the top percentage of employees by compensation is too difficult to administer, especially because it is necessary to determine this status for the current year and two preceding years. As any employee enters or leaves the work force, it would affect the calculation, possibly changing the employees included in the top-ten percent. These problems would be exacerbated for larger employers with employees at many locations and on multiple payrolls. Others argue that $20,000 may not represent a high level of compensation, even within a given industry. They suggest that it may be appropriate to develop an additional rule excluding certain employees from the highly compensated group if, for example, they earned less than $35,000 and were not among the top-five percent employees.

Others argue that application of the top-three employee test creates difficulties, especially in the context of a small work force. Some suggest that it would be more appropriate to require that a plan cover the lesser of a specified number of employees who are not excludable by reason of age, service, etc. or all employees.

Family members.—Some question whether family members of every highly compensated employee should be considered highly compensated. They point out that, in a large corporation or a controlled group with many diversified businesses, employers would be forced to determine whether a family member of any highly compensated employee is also an employee of the employer. They suggest that the recordkeeping burden would be extremely difficult. They also point out that family members of owners generally would be included through the attribution rules, so they question why this separate test is necessary.

Some who favor the proposed coverage test also suggest that, if all family members are considered highly compensated, it may be very easy to manipulate the test. For example, an owner could add family members to the payroll, exclude them from participation, and reduce the number of other employees required to be covered. This group would suggest that family members be considered highly compensated only if they are participants in the plan or are otherwise separately determined to be highly compensated (e.g., because their compensation exceeds $50,000, or because they are owners of the employer). Still others suggest that it may be appropriate to count family members only of the top-20 highly compensated employees.

Lookback period.—Under the Administration proposal, an individual's status as a highly compensated employee is determined by examining his ownership and compensation levels during a three-plan year period. An individual will be treated as a highly compensated employee with respect to a plan year if the individual was a highly compensated individual at any time during the three-plan year period ending on the last day of the plan year for which nondiscrimination is being tested.

Those favoring the extended testing period argue that status determinations based only upon one year may cause significant fluctuations in the composition of the highly compensated group. They also believe a single year test could be easily manipulated to the advantage of certain highly compensated employees.

Others argue, however, that it is inappropriate to include the year for which the test is applied in the testing period. They suggest that a test including the current year makes it difficult to finally identify the highly compensated group before the last day of the year, thus making it difficult to determine coverage for the year. They suggest that it may be more appropriate to use a lookback period that ignores the current year and ends instead on the last day of the preceding plan year. This would fix the highly compensated group at the beginning of the year, making it easier to comply with the nondiscrimination requirements without requiring employers to monitor employee changes within the current year.

Proponents of the Administration proposal argue, however, that it is important to match the identification of highly compensated employees with the current work force. They believe it is appropriate to require consideration of the current year. They also point out that use of a 125-percent rather than a 100-percent ratio for coverage requirements provides some flexibility to compensate for current year changes in the work force.

They also point out that if the current year is ignored, a newly hired employee who otherwise would be considered highly compensated could receive very large benefits in that first year. Including the employee in the highly compensated group in the second year would not correct this discrimination.

Percentage tests.—With respect to the present-law percentage tests that apply to test coverage under certain types of fringe benefits, those seeking to require expanded coverage argue (1) that the present-law percentage tests do not assure coverage of a broad cross-section of low- and middle-income employees, and (2) that the percentage tests inappropriately measure coverage by determining a percentage of the total work force rather than comparing coverage of the prohibited and nonprohibited groups. They assert that the employees most likely to be omitted from coverage are the low- or middle-income workers.

Those who favor broader coverage suggest that the percentage limits could be increased. For example, the Rangel bill would require coverage of 85 percent of all employees (100 percent in the case of health insurance). Some argue that an employer should be required to cover 100 percent of the employees who satisfy the minimum age and service requirements for purposes of all fringe benefits. They point out that minimum age and service requirements may be appropriate to exclude very young or short-service employees, but they question why an employer should also be permitted to arbitrarily exclude an additional percentage of employees who meet these age and service requirements. They note that any percentage might still work to the disadvantage of low- or middle-income workers.

Proponents of the Administration proposal argue that elimination of the percentage tests would tend to promote better coverage of low- and middle-income employees. They suggest that it is more appropriate to test coverage by comparing the coverage percentage of highly compensated employees with that of other employees. They note that, under the present-law percentage tests, an employer with 100 employees, consisting of 20 highly compensated employees and 80 other employees, would satisfy the 70-percent test by covering 70 employees, consisting of all of the highly compensated employees (100 percent) and only 50 of the 80 other employees (62.5 percent).

Alternatively, the employer could satisfy the 70/80-percent test by covering 56 employees, consisting of all of the highly compensated employees (100 percent) and as few as 36 of the other employees (45 percent), provided at least 50 of the other employees are eligible to participate. Consequently, some argue that tests which permit an employer to benefit 100 percent of the highly compensated group while benefiting a much lower percentage of nonhighly compensated employees cannot be expected to encourage nondiscriminatory coverage.

Those opposing expansion of the present-law coverage requirements believe that the Code is designed to provide incentives for employers to provide fringe benefits, rather than to compel mandatory benefits. They point out that plans are required to provide benefits for a "significant percentage of employees," not "all employees." In a system in which the employer's decision to adopt or maintain a plan is voluntary, they are concerned that imposing broader coverage rules may cause plan termination because benefits might otherwise be prospectively reduced to de minimis levels if coverage is expanded and costs are held constant. On the other hand, proponents of broader coverage argue that the cost of providing certain fringe benefits for the lower-paid employees who generally are younger may be very small. They also argue that the cost of broader coverage could be recovered through future reductions in excessive benefits for highly compensated employees.

Fair cross-section test.—With respect to the fair cross-section tests, those who support the Administration proposal to repeal such tests and who seek to require expanded coverage argue that the subjectivity of the present-law test creates anomalous results. Aggressive taxpayers willing to risk being audited may be unduly advantaged while more conservative taxpayers may be hampered in their compliance efforts by the lack of any mathematically precise guidelines. They would support a more objective, mechanical test.

Proponents of the Administration proposal also note that the present-law subjective test also may permit an employer to benefit 100 percent of the highly compensated employees while benefiting a much lower percentage of nonhighly compensated employees.

Opponents of the Administration proposal argue that the retention of a more subjective fair cross-section test is necessary because there are many instances in which an employer plan may cover a significant number of employees, even though it does not benefit 70 percent or more of employees. They emphasize that compliance with the requirements of the Administration proposal may be particularly difficult for a large employer with diversified lines of business, both in an ongoing business situation and in the context of mergers and acquisitions. Such an employer may have separate plans for each line of business and some of its plans may differ according to the geographic area in which employees work. Each plan of such an employer may be designed to provide a level of benefits considered appropriate for that line of business or geographic locale. Often, the plans compare with the plans of other employers who compete for the same work force either in the same industry or the same geographic locale.

Because the plans for the rank-and-file employees in each line of business may be designed to provide benefits at competitive levels for that line of business, plans in different lines of business may provide benefits that are not comparable. Under present law, provided each plan covers a nondiscriminatory fair cross-section of employees, the plans need not be aggregated.

Under the Administration proposal, however, any plan that does not, standing alone, meet the new coverage requirements would not be considered nondiscriminatory unless that plan could be aggregated with other plans, thereby satisfying the coverage requirements on an aggregate basis. However, only plans that provide the same coverage could be aggregated. Thus, the employer could be required to provide the same benefits to employees in different geographic areas or different lines of business, whether or not those benefits were economically necessary from a business point of view, and regardless of whether those benefit levels were customary or appropriate for that industry. Opponents of the Administration proposal argue that this would artificially distort business decisions and compensation practices, especially in situations involving mergers and acquisitions. Some also argue that employers should not be required to provide the same coverage to employees in more than one plan, but should be permitted to compare employer costs under more than one plan as a measure of whether the plans provide comparable benefits.

Some proponents of the Administration proposal agree that application of any coverage rules, including the present-law rules, on a controlled group basis necessarily involves certain administrative problems. They note that the Administration proposal deals with these concerns and concerns about necessary flexibility by permitting some disparity in the percentage of highly compensated participants covered by the plan versus nonhighly compensated participants covered by the plan. Absent the problems faced in the controlled group context, they suggest that the proposal should have required that the highly compensated employees' percentage not exceed 100 percent of the nonhighly compensated employees' percentage. In fact, some argue that employers should be required to cover all employees, other than excludable employees.

Though sensitive to the impact of coverage rules on a diversified business, some question whether distinctions based on another standard, such as a "line of business" or "geographic locale" test is administratively feasible. Development and enforcement of a line of business test would require detailed economic analysis of the business enterprise. They question whether those distinctions should reflect different product lines, different job duties, or disparate skill levels and how such distinctions could be developed and administered in an objective fashion. Other problems would arise in developing a geographic locale rule. Determining the situs of an employee could be complicated, as would dividing an employer with operations throughout a region.

In addition, some suggest that it may be difficult to coordinate line of business or geographic locale rules with nondiscrimination requirements. They note that Congress originally applied controlled group rules to prevent an employer from avoiding the nondiscrimination rules by operating through separate corporations instead of separate divisions. New distinctions based on job duties, they argue, might permit distinctions based on management duties, thereby permitting an employer to cover management personnel without covering rank-and-file employees. Similarly, distinctions based on geographic locale might permit an employer to provide benefits for home office employees who are often highly compensated without covering lower-paid employees of operating companies. Also, these new distinctions might result in the exclusion of assembly-line workers who are creating one product, while other assembly-line workers with similar job functions would be covered if they were creating a "different" product or working in a different geographic locale.

Some assert that the line of business approach, which was recently applied to certain statutory fringe benefits, has already proven difficult to administer with respect to employee discounts. For example, some are concerned that, for fringe benefit purposes, employees of organizations providing catering services, hotel accommodations, or rental cars as an adjunct to air travel, may be considered separate lines of business. Historically, fringe benefits have been available to all such employees as though employed in a single line of business. However, because it may be difficult to demonstrate that pension benefits provided to catering employees or hotel personnel are "comparable" to those afforded pilots and flight attendants, some claim that each of those functions represents a different line of business for pension purposes. Some suggest that it is inappropriate to develop two different and opposite standards—one for fringe benefits and the other for pension benefits.

Nevertheless, because some are sensitive to the assertion that a conglomerate business entity needs flexibility to provide different benefits for bona fide separate operations (especially in the case of new acquisitions), it has been suggested that other exceptions to the Administration's proposed coverage test might be developed. However, because pension benefits are based upon compensation and compensation is already adjusted to reflect lines of business and geographic locale, others argue that no further adjustment in the coverage test is needed.

On the other hand, some argue that the variations noted in different lines of business or geographic locales are caused not only by fluctuations in the total amount of compensation but also by variations in the mix of current and deferred compensation. They believe that it is unnecessary to impose artificial restraints on the relative allocation of current and deferred compensation through expanded coverage rules. Thus, they believe further adjustments are appropriate to reflect these problems.

Others question whether it is appropriate to permit unlimited flexibility to tailor different compensation packages for different employees within a controlled group. They believe that it is unappropriate to encourage the provision of inadequate benefits for employees in certain industries. Some argue that, consistent with the tax policy goal of permitting tax benefits only to those plans that provide benefits for low- and middle-income employees, the coverage rules should preclude the provision of lower benefits for certain employees based on their line of business or geographic locale. They further point out that some employers that acquire additional subsidiaries or lines of businesses require the newly acquired entities to adopt the employer's plan with in a certain period of time. This, they argue, undermines the argument that business reasons, rather than corporate custom, underlie the decisions by other employers not to have a uniform plan throughout their controlled group.

Excludable employees.—Proponents of the Administration proposal argue that it is appropriate to narrow the class of excluded employees. In determining whether a plan covers a significant percentage of employees, they argue that, in situations other than those involving legitimate collective bargaining agreements or nonresident aliens, it is appropriate to consider at least those employees who have attained age 21 and completed one year of service. In applying the exclusion for collective bargaining, however, some argue that it is inappropriate to exclude employees merely because the employer has negotiated in some fashion with a tax-exempt labor organization. They emphasize the importance of ensuring that fringe benefits were the subject of good faith collective bargaining.

In addition, some argue that it is also appropriate to require coverage of those employees who work on a part-time or seasonal basis. They believe that such employees also have fringe benefit needs and expectations.

Utilization test.—The Administration proposal requires that both the utilization and the availability of fringe benefits be nondiscriminatory. It is argued that it is necessary to test nondiscrimination in the actual use of fringe benefits because, if the tax incentives are justified only if, in fact, fringe benefits are provided on a broad basis to employees generally, then it is important to consider the actual delivery of benefits and not just the availability of benefits.

Further, those who support the Administration proposal argue that, if availability of fringe benefits were sufficient to guarantee nondiscrimination and broad-based coverage, then it would not be necessary to provide tax incentives through employer plans and that individual tax incentives, such as deductions or credits, would be adequate. Moreover, they argue that the reason for providing tax incentives for employer-maintained fringe benefit programs is to provide an incentive for an employer to force participation in the programs by low-paid employees. They assert that such an approach is the only way to ensure that low-paid employees have the protection (such as health insurance) that Congress considers important.

Those who oppose the Administration proposal to modify the concentration test applicable to group legal services, cafeteria plans, educational assistance, and dependent care assistance argue that the proposal may have the effect of eliminating these programs for small employers. For example, if an employer has three employees, one of whom is a highly compensated employee, the employer could not maintain a cafeteria plan that provided equal benefits to all employees. This occurs because the highly compensated employee would receive benefits equal to 33⅓ percent of the benefits provided under the plan and the test is violated if the top-20 highly compensated employees receive more than 25 percent of the benefits.

Those who support the Administration proposal argue that this result is appropriate because they believe that the tax incentives for employer-provided fringe benefits should not be available unless the plan provides significant amounts of beneifts to nonhighly compensated employees. They further note that the employer can satisfy the concentration test by reducing the benefits provided for the top-20 highly compensated employees.

Opponents of this approach point out that a test based on utilization of benefits is particularly difficult to administer and that the Administration proposal is unduly complicated. They suggest that strict utilization tests will limit flexibility. They suggest that, as long as all employees have equal access to benefits, it is inappropriate to require that utilization of the benefits also be nondiscriminatory. It is suggested that, if a utilization test must be met annually, then benefits may be considered discriminatory over such a short period of time irregardless of a good-faith attempt to design a plan that delivers benefits in a nondiscriminatory manner.

Some have argued that, in order to provide effective nondiscrimination rules, it is appropriate to take into consideration only compensation up to a specified level. They suggest that only compensation up to $100,000 should be taken into account for purposes of testing whether fringe benefits that are related to compensation, such as disability or life insurance, are provided on a nondiscriminatory basis.

Cafeteria plans

It is necessary to examine the impact of cafeteria plans (and, more specifically, flexible spending accounts) when examining arguments concerning the role the Federal tax system should play in controlling health care spending. Cafeteria plans allow employees to choose whether to take compensation in the form of tax-free fringe benefits or cash. By structuring a cafeteria plan with a salary reduction mechanism, employees can effectively convert after-tax dollars spent on fringe benefits (such as health care) into pre-tax dollars.

Those who favor cafeteria plans argue that the plans give employers more flexibility to deal with the rapidly changing socioeconomic and demographic composition of their workforces (e.g., the recent emergence of two-earner households). Such an approach permits each employee to structure his or her own fringe benefit program to fit changing needs.

For example, a cafeteria plan could offer employees a choice among cash, group-term life insurance, low and high-option health insurance, and child care. A married employee with minor children may elect child care, high-option health insurance, and low levels of group-term life insurance. A married employee without children, whose spouse has family health coverage, may elect cash only. Thus, the cafeteria plan provides a tailor-made fringe benefit program for each employee.

Proponents of continuing favorable tax treatment for fringe benefits provided under a cafeteria plan maintain that the plans offer an effective means for employers to reduce health care expenditures. They point to surveys recently conducted by a number of organizations, which show that some employers have, in fact, experienced success in lowering their health care costs in conjunction with the use of cafeteria plans (particularly, flexible spending accounts).

Others point out that any evidence of reduced health costs coincident with the establishment of cafeteria plans may be attributable to shifts to greater employee cost sharing, which have been adopted at the same time. Thus, it is not clear from these surveys that cafeteria plans promote lesser health care expenditures by employees. Some argue that cafeteria plans may increase total health care spending. This will occur when employees are permitted, through establishment of a cafeteria plan, to convert after-tax cost sharing into pre-tax cost sharing. Such a conversion, in effect, provides a means of avoiding the five-percent floor on the medical expense deduction, reduces the cost to the employee of the health care expenditure on account of the tax subsidies, and may operate as an incentive to employees for greater health care utilization.

A recent study published by the Department of Health and Human Services evaluated the present-law rules for flexible spending accounts under cafeteria plans. Under a flexible spending account, an employee has an account balance from which certain of the employee's personal expenses, such as medical expenses, are reimbursed. Any unused balance at the end of a year is required to be forfeited.

The HHS study concluded that allowing flexible spending accounts to develop under present law would undermine efforts to control health care utilization and substantially increase revenue losses. The Department estimated that the revenue losses associated from flexible spending accounts would grow to $12 billion annually over the next few years ($5 billion of which is attributable to reimbursement of employee premium contributions and $7 billion of which is attributable to the sheltering of employee out-of-pocket health spending). The study pointed out that the amount of revenue loss could be lower to the extent that some employers use flexible spending accounts to increase employee cost sharing.

Finally, the study concluded that eliminating the forfeitability requirement for flexible spending accounts under present law would increase the revenue loss attributable to flexible spending accounts even more.

Military benefits

The existence of a specific tax subsidy (such as an exclusion from gross income of certain military benefits) generally affects the level at which the benefits are provided. Thus, for example, if a military disability benefit was required to be included in gross income, it could be anticipated that the level of benefits paid would be increased to compensate for the taxes owed on the benefits.

Some argue that such a result would cause the total costs of providing military benefits to be calculated accurately and would improve decision making in the military budget process.

On the other hand, it is suggested that eliminating the exclusion of certain military benefits merely alters the way in which the costs of these benefits are accounted with no true substantive effect on the amount of the costs. Thus, it is argued that a change in the historical manner in which the costs of military benefits are accounted should not be accepted without a thorough review of any potential impact on military strength and national defense.

Another issue that has been raised with respect to taxing military benefits is whether the rules of current law result in fact, as in theory, in a higher benefit for higher income individuals. Some argue that the exclusions under present law should be repealed and that military compensation and benefits should be taxed in the same manner as compensation and benefits for nonmilitary workers. Such a system would eliminate the inherent bias toward higher-income individuals that occurs under present law. Finally, some suggest that taxing military compensation and benefits would reduce the perception that the tax system unfairly favors some classes of taxpayers over others.

Parsonage allowances

Some argue that the present-law exclusion for housing allowances provided to ministers is inappropriate and should be repealed.[23] They support the 1984 Treasury report proposal to repeal the exclusion because they believe that present law is unfair in

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[23] Another issue that arises in the context of the exclusion for parsonage allowances is whether it is appropriate to provide an interest deduction for home mortgage payments when a minister is also entitled to a tax-free housing allowance. In Rev. Rul. 83-3, 1983-1 C.B. 72, the IRS held that a minister may not deduct interest and property taxes that are allocable to an allowance excludible under sec. 107 because sec. 265 (1) provides that no deduction is allowed for any amount that is otherwise deductible but that is allocable to one or more classes of income (other than interest) wholly exempt from income tax. The IRS has announced, in Rev. Rul. 85-96, 1985-29 IRB 7, that the deduction disallowance provided in Rev. Rul. 83-3 will not be applied to costs paid or incurred before January 1, 1987, where the minister owned the home before January 3, 1983.

that it treats ministers more favorably under the tax laws than other taxpayers with equal income.

Those who oppose repealing the exclusion for parsonage allowances argue that the present-law treatment of ministers reflects the special needs of the clergy. They believe that the exclusion recognizes that ministers may not be able to satisfy the requirements of the general exclusion for meals and lodging provided for an employer's convenience. They also point out that repealing the exclusion would require ministers to value the housing provided, which may be difficult.

B. Scholarships and Fellowships

Present Law and Background

General rules

Degree candidates.—As a general rule, an individual who is a degree candidate at a college, university, or other educational institution may exclude from gross income amounts received as a scholarship or fellowship grant (Code sec. 117).[1] This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. Under present law, there is no dollar cap on the amount that may be excluded from income as a scholarship or fellowship grant in the case of a degree candidate.

Other recipients.—For individuals who are not degree candidates, the exclusion is available only for scholarships or fellowship grants made by tax-exempt educational, charitable, etc., organizations, foreign governments, certain international organizations, or Federal, State or local government agencies. Also, the exclusion for a nondegree candidate in any one year cannot exceed $300 times the number of months for which the recipient received scholarship or fellowship grant amounts, and no further exclusion is allowed after the nondegree candidate has claimed exclusions for a total of 36 months (i.e., a maximum exclusion of $10,800). However, this dollar limitation does not apply to that portion of scholarships or fellowship grants received by the nondegree candidate for travel, research, clerical help, or equipment.

Definitions; compensation rules

The terms "scholarship" and "fellowship grant" are not defined in the statute. Treasury regulations define scholarship as an amount paid or allowed to, or for the benefit of, a student to aid in pursuing studies; similarly, a fellowship grant is defined as an amount paid or allowed to, or for the benefit of, an individual to aid in pursuing studies or research (Treas. Reg. sec. 1.117-3).

However, amounts paid to an individual to enable him or her to pursue studies or research are not excludable from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Reg. sec. 1.117-4(c)). These regulations have been upheld by the U.S. Su-

[1] Sec. 117(d) provides that a reduction in tuition provided to an employee of an educational institution is excluded if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met. P.L. 98-611 provided that for 1984 and 1985, this exclusion also applies to graduate-level education provided by an educational institution to a graduate student who is employed by that institution in teaching or research activities.

preme Court, which described excludable grants as "relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipients."[2]

In the case of degree candidates, the statute also provides that the exclusion does not apply to any portion of an otherwise qualifying scholarship or fellowship grant that represents payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the scholarship or fellowship grant (sec. 117(b)(1)). However, such services are not treated as part-time employment for this purpose if all degree candidates must perform such services; in that case, the recipient may exclude the portion of the scholarship or fellowship grant representing payment for such services.

A special rule provides that amounts received by an individual as a grant under a Federal program that would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future services as a Federal employee, are not includible in gross income if the individual establishes that the amount was used for qualified tuition and related expenses (sec. 117(c)).

Data on exclusion

The exclusion for scholarships and fellowship grants is estimated to reduce fiscal year budget receipts by approximately $600 million annually.

Administration Proposal

The Administration proposal would limit the exclusion for scholarships and fellowship grants. In the case of degree candidates, amounts qualifying as scholarships or fellowship grants would be excludable only to the extent that they were required to be, and in fact were, spent on tuition and equipment required for courses of instruction. Thus, grant amounts used for personal living expenses, including room and board, would be includible in income. In the case of nondegree candidates, only reimbursements for incidental expenses (travel, research, clerical help, or equipment) would be eligible for exclusion as scholarships or fellowship grants. All other amounts received as scholarships or fellowship grants would be includible in gross income.

The special rules concerning future performance of services as a Federal employee and compensation for services required of all degree candidates would be repealed. Thus, the amount of any scholarship or fellowship grant representing compensation for services would be included in income, regardless of the employer for whom the services were performed or whether other degree candidates were required to perform similar services.

The Administration proposal generally would be effective with respect to scholarships and fellowships received in taxable years beginning on or after January 1, 1986. However, if a binding commitment to grant a scholarship in the case of a degree candidate was made before January 1, 1986, amounts received pursuant to

[2] *Bingler* v. *Johnson*, 394 U.S. 741 (1969).

such commitment would be excludable under the present-law rules through the end of 1990.

Other Proposals

Congressional bills

The Bradley-Gephardt bill (S. 409; H.R. 800), the Kemp-Kasten bill (H.R. 2222; S. 1006), and the Roth-Moore bill (S. 411; H.R. 373) would exclude scholarships and fellowship grants only for degree candidates, and only to the extent the amounts are used by the degree candidate for qualified tuition and related expenses. Related expenses would include fees, books, supplies, and equipment, but not room and board or other incidental expenses excluded under present law (such as travel and clerical help). The special rules concerning future performance of services as a Federal employee and compensation for services required of all degree candidates would be retained.

Other possible proposals

Any of the proposals to continue the scholarship and fellowship exclusion on a limited basis could be further modified so that the exclusion is not available for taxpayers with incomes above a dollar ceiling. That is, the exclusion would not apply to the extent the recipient has adjusted gross income plus scholarships and fellowship grants totaling more than a dollar ceiling (such as $20,000) for the year. This modification could apply regardless of whether the special rules concerning future performance of services as a Federal employee and compensation for required services are retained, or whether the exclusion covers incidental expenses of nondegree candidates.

Analysis

Compensation issue

Under present law, the question of whether a particular stipend made in an educational setting constitutes a scholarship or compensation for services generally requires a case-by-case determination. The factual nature of the inquiry, and the lack of objective rules for distinguishing excludable grants from taxable wages, have made section 117 a significant source of tax confusion and controversy.

In particular, numerous court cases have involved resident physicians and graduate teaching fellows who seek to exclude from their income payments received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor. In some instances, individuals seem to litigate section 117 exclusion claims notwithstanding what appears to be substantial case authority, on virtually identical facts, adverse to their position.

The application of present-law rules has been particularly troublesome in situations where the recipient performs services which are related to his or her education and which also benefit the grantor. Taxpayers—in particular, medical doctors employed as residents or interns—have persisted in arguing that the section 117 exclusion covers payments received as compensation so long as the work experience results in educational benefit to the recipient; the courts have generally held that the exclusion does not cover personal service income.[3] The approach of the Administration proposal would be to exclude scholarships and fellowship grants in the amount which is required to be spent on tuition plus equipment; any additional amounts—whether or not representing compensation—which are excludable under present law would be taxable under the proposal.

The Administration proposal, unlike the Congressional bills mentioned above, would not continue the present-law distinction between degree candidates who voluntarily perform teaching or similar services (in which case the exclusion does not apply) and those who must perform them as a condition of receiving a degree (in which case the exclusion applies). Such a distinction arguably is subject to attempts by taxpayers to circumvent it, and also in effect sets up a disincentive to degree candidates who wish to teach, but whose degree programs do not require it.

In some situations, however, the issue would remain under the Administration proposal whether a payment, up to the amount of tuition plus equipment, is compensation or not. Thus, litigation over the compensation issue might not be wholly eliminated under the Administration proposal, although the dollar amounts involved probably would be smaller.

Exclusion of incidental expenses by nondegree candidates

The Administration proposal, unlike the Congressional proposals, would continue to permit the exclusion of incidental expenses of nondegree candidates, on the ground that such expenses would typically be deductible in any event as job-related educational expenses.

Assuming no modifications are made to the present-law deductibility of certain educational expenses, it might appear unnecessary to require inclusion in income of reimbursements for such expenses if in most cases they would be deductible by the recipient.[4] Under current law, however, the exclusion of incidental expenses does not depend on whether such expenses would be deductible as job-related. Thus, a rational limitation on tax-free receipt of incidental expenses arguably could not be achieved without actually requiring that they be included in the recipient's income and deducted only if they meet the requirements for deductibility as job-related educational expenses.

Further, current law provides an exclusion of up to $5,000 per year of an employee's educational expenses paid by an employer

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[3] The Tax Court stated in one case: "Interns and residents have been flooding the courts for years seeking to have their remuneration declared a 'fellowship grant' and hence partially excludable from income. They have advanced such illuminating arguments as they could have earned more elsewhere and they were enjoying a learning experience so therefore what they did receive must have been a grant. They have been almost universally unsuccessful and deservedly so. Why the amounts received by a young doctor just out of school should be treated differently from the amounts received by a young lawyer, engineer, or business school graduate has never been made clear." (*Zonkerman* v. *Comm'r*, 36 T.C.M. 6, 9 (1977), aff'd (4th Cir. 1978)).

[4] Even in cases where the deduction could be available to offset inclusion if allowed in full, the Administration proposal would impose a floor (one percent of adjusted gross income) on deductible employee business expenses, including job-related educational expenses, except for employer-reimbursed amounts.

under an educational assistance program (sec. 127). This exclusion is scheduled to terminate at the end of 1985, but would be made permanent (without the $5,000 cap) under the Administration proposal. Thus, to the extent nondegree candidates could exclude amounts for tuition under that provision (or indeed could deduct them as job-related), nondegree candidates need not rely on the scholarship and fellowship grant exclusion. Moreover, some would argue that the Administration proposal adds complexity, and that it would be inconsistent as well as unfair to permit nondegree candidates to exclude amounts for incidental expenses, while not permitting degree candidates to do so.

Dollar ceiling on exclusion

The rationale proffered for imposing a dollar ceiling on the scholarships and fellowship grants exclusion would be to ensure that the exclusion performs its purpose without giving unintended tax benefits. If the dollar ceiling is realistic, scholarships and fellowship grants based on need would be excluded from income, while those awarded irrespective of need would be taxable if they did not in fact fulfill an economic need for funds for education. A dollar ceiling also has the advantage that it is arguably less subject to manipulation than is a tuition-plus-equipment type of limit. Some add that imposing a dollar ceiling is an improvement over present law, because present law does not take into account the recipients' ability to pay, whether from personal or parental funds.

On the other hand, a dollar ceiling could be viewed as undesirable if it were thought to cause complex calculations, or to be inappropriate because it ignores family income (including that of the scholarship or fellowship recipient's parents) and thus could frustrate the policy of fostering education of only those who might otherwise have no available resources to pay for it.

Retention of the exclusion

Although not recommending complete repeal of the section 117 exclusion, the Administration proposal states that repeal would contribute to fairness on the ground that the full exclusion is unfair to taxpayers not receiving grants who must pay for their education out of after-tax dollars. (Repeal also would eliminate the controversies described above.) A complete repeal, it is argued, would not unduly burden most scholarship and fellowship recipients, since they are often in low tax brackets or below the tax threshold (especially if the personal exemption and ZBA are increased, as proposed by the Administration). The Administration proposal concedes, however, that complete repeal could cause hardships for recipients of scholarships awarded on the basis of need, particularly since these benefits may not be provided in cash out of which any tax liability could be paid.

Colleges, educational groups, and others respond that the exclusion for scholarships and fellowship grants should be retained without modification, in light of national objectives of fostering education. This is especially important if government funding for student-aid programs is reduced. For students at the graduate level, it is argued, the Administration proposal could increase the difficulty of encouraging first-rate students to incur costs and forego earnings in order to pursue advanced studies in science, engineering, and other fields. Proponents of the exclusion also contend that repeal could ultimately have an adverse effect on universities or other grantmaking organizations if they had to provide larger grants to compensate for the change in tax treatment.

Proponents of the Administration proposal and related proposals agree that policy considerations support retaining the exclusion in modified form. They argue that these policy considerations would be satisfied if the exclusion were limited in scope (limited primarily to degree candidates and limited to tuition, with a dollar ceiling), thereby fostering the education of individuals who otherwise might not be able to afford it. Under such a proposal, the exclusion would relate directly to education, since it would be limited to tuition for degree candidates, and would not extend to amounts used for regular living expenses.

C. Prizes and Awards

Present Law and Background

Under section 74, prizes and awards received by a taxpayer (other than scholarships or fellowship grants)[5] generally are includible in gross income. Treasury Regulations provide that taxable prizes and awards include amounts received from giveaway shows, door prizes, awards in contests of all types, and awards from an employer to an employee in recognition of some achievement in connection with employment.

Section 74(b) provides a special exclusion from income for certain prizes and awards that are received for achievements in fields such as charity, the sciences, and the arts. This exclusion does not apply unless the recipient (1) has not specifically applied for the prize or award (for example, by entering a contest), and (2) is not required to render substantial services as a condition of receiving it. Examples of such excludable prizes and awards include Nobel Prizes, Pulitzer Prizes, Rockefeller Public Service Awards, and various American Chemical Society awards. Treasury regulations state that the section 74(b) exclusion does not apply to prizes or awards from an employer to an employee in recognition of some achievement in connection with employment.[6]

While section 74 determines the includability in income of prizes and awards, the treatment of other items provided by an employer to an employee may be affected by section 102, under which gifts generally are excluded from gross income. The U.S. Supreme Court, in a case involving payments made "in a context with business overtones," defined excludable gifts as payments made out of "detached and disinterested generosity" and not in return for past or future services or from motives of anticipated benefit (*Comm'r* v. *Duberstein*, 363 U.S. 278 (1960)). Under this standard, the Court said, transfers made in connection with employment constitute gifts only in the "extraordinary" instance.[7] Under certain circumstances, if an award to an employee constitutes an excludable gift,

[5] See description in Part IV-B, above, of the exclusion under section 117 for scholarships and fellowship grants.

[6] Treas. Reg. sec. 1.74-1(b). *But see Jones v. Comm'r,* 743 F.2d 1429 (9th Cir. 1984), holding that an award from an employer to an employee can qualify for the section 74(b) exclusion under extraordinary circumstances. The court held that the exclusion applied in the case of a prominent scientist who was rewarded by the National Aeronautics and Space Administration (NASA) for lifetime scientific achievement, only part of which was accomplished in NASA's employ.

[7] Under *Duberstein*, the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constitutes a gift to the recipient is to be made on a case-by-case basis, by an "objective inquiry" of the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must in included in income by the recipient.

the employer's deduction may be limited pursuant to section 274(b).[8]

Administration Proposal

Under the Administration proposal, the amount of any prize or award received by a taxpayer would generally be taxable as income, effective January 1, 1986. This involves two changes to present law—repeal of the section 74(b) exclusion for prizes and awards received for extraordinary achievements, and a clarification that employee awards cannot constitute excludable gifts (under sec. 102) in view of the business setting in which they are provided.[9] Under the proposal, the tax treatment of employee awards (as well as other prizes or awards provided in a business or employment context) could still be affected by independent provisions of tax law, such as the rules defining taxable dividends, nontaxable returns of capital, and excludable *de minimis* fringe benefits.

Analysis

Noncompensatory prizes and awards

The proposal to make all prizes and awards taxable to recipients raises tax policy issues relating to the question of whether the tax system should follow principles of economic neutrality, or should provide preferences for particular forms of income that are viewed as especially meritorious or beneficial. As in the case of other exclusions or deductions, the tax benefit of the section 74(b) exclusion depends on the recipient's marginal tax rate, and thus generally is greater in the case of higher-income taxpayers.

Moreover, the receipt of an award for scientific or artistic achievement in the amount (for example) of $10,000 increases the recipient's net wealth and ability to pay taxes to the same extent as the receipt of $10,000 in wages, dividends, or prizes and awards that are taxable under current law (such as lottery winnings). Thus, it can be argued that receipt of an award should have the same effect whether the recipient (for example) had purchased a $1 lottery ticket or been nominated by others for a prize.

In addition to these considerations of equity, repeal of the section 74(b) exclusion would also contribute to tax simplification. The present-law provisions have given rise to administrative disputes and litigation over issues such as whether the recipient was required to render substantial services as a condition of receiving the award, whether the recipient had directly or indirectly applied for the award, and whether particular prizes or awards qualify for ex-

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[8] Sec. 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, etc., to the same individual from the taxpayer during the taxable year exceeds $25. The statute expressly defines the term gift to mean any amount excludable from gross income under sec. 102 which is not excludable under another statutory provision (see discussion of *Duberstein*, *supra*, for definition of gift in a business context).In the case of an excludable gift of an item of tangible personal property awarded to an employee for length of service, safety achievement, or productivity, the ceiling on the deduction allowed to the employer is increased to $400 of the item's cost. In addition, the ceiling on the business gift deduction is $1,600 for such an employee award when provided under a qualified award plan, if the average cost of all plan awards in the year does not exceed $400.

[9] Accordingly, the special deduction limitations on nontaxable employee awards in section 274(b) would become inapplicable and could be repealed. The deductibility of taxable employee awards would be determined under the general section 162 rules.

clusion (e.g., prizes in fishing derbies, awards to professional athletes, and teaching awards to faculty). The Administration proposal would respond to these concerns by treating all prizes and awards as taxable.

While the Nobel Prize is often cited as an example of an excludable award under section 74(b), that exclusion is not in practice restricted to awards of such distinction for extraordinary merit. In addition, a recently decided case[10] held that, notwithstanding Treasury regulations to the contrary, the exclusion may apply, in limited circumstances, to prizes and awards given to employees. There may also be other instances (e.g., relating to independent contractors or business associates) where the exclusion could serve as a vehicle for the payment of disguised compensation. Thus, it is argued that the present-law exclusion is too broad even if items such as the Nobel Prize should be excludable.

Advocates of continued excludability raise several arguments in response. First, they maintain that section 74(b) can serve as an incentive or reward for engaging in certain beneficial forms of behavior—although admittedly a limited one, since the exclusion does not apply to individuals who actively seek a particular prize or award. Second, they assert that excludable prizes and awards are popularly viewed as special gratuities rather than as taxable income, and that the tax law should defer to this view. Finally, they note that the Nobel Prize, which is probably the best-known example of an excludable prize or award, apparently is not subject to taxation in any other country. Of course, this third argument would not necessarily preclude crafting a narrower exclusion applying to the Nobel Prize and other similar awards, but not to other awards presently within the scope of section 74(b). For example, a statutory provision could list the specific awards that would be excludable.

Employee awards

The issue of the proper tax treatment of employee awards overlaps in many respects with the general prize and award issue, and evokes similar arguments on both sides. Thus, the Administration proposal is based on the notion that the tax system should strive for neutrality as between different forms of economic income.

Moreover, the problem of tax avoidance may be viewed as more serious in the context of employee awards than with respect to prizes and awards generally. An exclusion for employee awards could permit employers to make tax-free transfers to employees with respect to regular job performance (e.g., tenure in one's job, or achieving a minimum level of productivity). In the case of highly compensated employees, who often would not be significantly inconvenienced by the fact that the awards are made in the form of property rather than cash, an exclusion could serve as a means of providing tax-free compensation.

Advocates of a special exclusion for employee awards respond to these concerns by asserting that the awards should be favored in order to strengthen ties between employers and employees, foster

[10] *Jones* v. *Comm'r*, 743 F.2d 1429 (9th Cir. 1984).

pride on the part of individual employees, and increase productivity.

Also, an exclusion for employee awards in the form of tangible personal property could avoid valuation difficulties, provided that any dollar limitation on the exclusion were based on the employer's cost rather than the item's value.

A second issue raised by the Administration proposal relates to the administrative consequences arising both from the possibility of frequent controversies on audit and from possible uncertainty about the meaning of present law. Because the legal standard enunciated in *Duberstein* defining gifts in a business context requires a case-by-case determination, it may be difficult for taxpayers to determine whether particular transfers should be regarded as taxable, and some taxpayers may be encouraged to take unjustifiably aggressive reporting positions. The Administration proposal would eliminate any uncertainty by expressly providing that employee awards are not excludable as gifts under section 102.

V. DEDUCTIONS FOR PERSONAL EXPENDITURES

A. Introduction

Computation of tax liability

In computing Federal income tax liability, an individual first calculates gross income by aggregating wages, interest, dividends (less the \$100/\$200 exclusion), the taxable portion of capital gains, net income from a trade or business, net rental income, net partnership income, and other income sources, and then subtracts certain items to determine adjusted gross income (AGI). These adjustments include the deduction for two-earner couples, payments to an IRA or Keogh retirement plan, certain employee business expenses, moving expenses, and alimony.

A taxpayer who does not itemize deductions next subtracts personal exemptions (plus any nonitemizer charitable deduction), and then refers to the tax tables or tax rate schedule for the amount of income tax liability (prior to any credits). The tax tables and schedule in effect allow the nonitemizer a "standard deduction" through the device of a zero bracket amount (ZBA); i.e., the lowest tax bracket has a zero tax rate. (For example, the ZBA for a married couple filing jointly is \$3,540 for 1985.) A nonitemizer thus receives the benefit of the applicable ZBA even if the taxpayer's actual expenditures that would be allowable as itemized deductions are less than the ZBA.

If the sum of the taxpayer's itemized deductions exceeds the applicable ZBA, the taxpayer may deduct that excess, in addition to deducting personal exemptions, from AGI to determine taxable income. (For example, if for 1985 a married couple filing jointly has itemized deductions of \$9,000, they may subtract \$5,460—the excess over their ZBA of \$3,540—in computing taxable income.) The itemizing taxpayer then refers to the table or tax rate schedule for the amount of income tax liability (prior to any credits). Although the aggregate amount of itemized deductions is reduced by the ZBA before being subtracted from adjusted gross income, an itemizer still receives the benefit of the ZBA because that amount is built into the tax table and schedule as a bracket with a zero tax rate.

Types of deductible expenditures

The itemized deductions include deductions specifically provided in the Code for certain expenditures of a personal or consumption nature, notwithstanding the general rule (sec. 262) that personal, living, and family expenses are not deductible. (This general rule reflects a policy that deductions should be allowed only for expenditures essential to earn income, and that personal consumption should not be subsidized through the tax system.) These personal expenditures deductible by itemizers include medical expenses, certain State and local taxes, personal interest expenses, charitable contributions, nonbusiness casualty losses, and certain adoption expenses. Many of these deductions for personal expenditures have been allowed since the beginning of the income tax.

In addition, present law allows the deduction of certain investment and employee business expenses only as itemized deductions, rather than as "above-the-line" trade or business deductions. (Under present law, four specified types of employee business expenses are allowed as above-the-line deductions to both itemizers and nonitemizers.[10a]) These itemized deductions, together with the deductions for certain adoption expenses and for gambling losses (up to gambling income), are collectively referred to on Form 1040, Schedule A as "miscellaneous expenses."

Deductible miscellaneous expenses include unreimbursed employee expenditures for union and professional association dues, subscriptions to professional journals or continuing education courses, and expenses allowable for business use of the taxpayer's home. Also, these miscellaneous expenses may include income-production expenses such as the cost of investment advisory services, subscriptions to financial publications, and tax planning and return preparation. The deductibility of these expenses under the Administration proposal is discussed in Part VI of this pamphlet.

As noted above, nonitemizers also are allowed a deduction for charitable contributions, in addition to benefiting from the ZBA (standard deduction). This nonitemizer deduction, enacted in the Economic Recovery Tax Act of 1981, was subject to special percentage limitations and dollar caps for 1982-85; there is no limitation or cap on the deduction for 1986. Under present law, the charitable deduction for nonitemizers will not be available for contributions made after 1986.

Rationales and issues

The rationales or objectives generally cited as underlying particular itemized deductions include: achieving more equitable treatment of taxpayers by adjusting economic income to reflect relative ability to pay taxes (e.g., deductions for medical expenses and casualty losses above percentage floors); encouraging or facilitating taxpayer expenditures for some social or economic purpose (e.g., deductions for home mortgage interest and property taxes, and for charitable contributions and expenses of adopting children with special needs); refining the tax base so as better to measure taxable income (e.g., the miscellaneous expense deduction); coordinating Federal, State, and local taxation impacts (deduction for State and local taxes generally); or some combination of these factors.

The allowance of itemized deductions has long been recognized as a primary cause of complexity for individual taxpayers, both for itemizers and for other individuals who compute these deductions to determine whether or not they can benefit from itemizing. Also, the enactment in 1981 of the nonitemizer deduction for charitable

[10a] These four "above-the-line" employee business expenses are expenses paid by an employee and reimbursed by the employer; employee travel expenses incurred while away from home; employee transportation expenses; and business expenses of employees who are outside salespersons.

contributions extended complexity to nonitemizers claiming that deduction. Individuals must compile and maintain the necessary records to substantiate their expenditures eligible for these deductions. (For example, if individuals wish to make an exact calculation of sales taxes paid rather than rely on IRS tables, they must keep receipts or other records for every taxable purchase of goods.) In addition, intricate rules and limitations apply in determining eligibility for and in computing most deductions for personal expenditures, as described under "Present Law" in the following sections.

Apart from issues of complexity, questions of fairness have been raised about itemized deductions in general because the allowance of a deduction for personal expenditures provides a greater tax benefit to higher-bracket taxpayers than to lower-bracket taxpayers. By contrast, allowance of a credit (or limiting the deduction to the bottom tax bracket, as in the Bradley-Gephardt bill) generally provides the same dollar tax benefit to all taxpayers. Questions of fairness also may arise with respect to particular aspects of an itemized deduction, as described under "Analysis and Issues" in the following sections.

One method utilized to reduce complexity associated with itemized deductions has been to increase the zero bracket amount (standard deduction). The ZBA was increased in both 1977 and 1979; these increases reduced the percentage of individuals who itemize. At the same time, increased costs of borrowing, health care, etc. can push more individuals into itemizing during times of inflation. For 1983, itemized deductions were claimed on 35.2 million returns, or 36.6 percent of the 95.3 million returns filed by individuals. Itemizing is more common among those tax returns which show a tax liability. Of the 78.1 million taxable returns filed in 1983, 33.4 million, or 42.8 percent, had itemized deductions.

Another approach utilized to alleviate the complexity attributable to itemized deductions has been to place a floor under a particular deduction, thereby reducing the number of taxpayers eligible to claim that deduction. Thus, the Tax Equity and Fiscal Responsibility Act of 1982 increased the floor for deductible medical expenses from three to five percent of adjusted gross income, and imposed a floor for deductible nonbusiness casualty losses of 10 percent of AGI. (Another approach would be to place a percentage floor, such as 10 percent of AGI, under the sum of all allowable itemized deductions.) Also, the use of a floor is consistent with a policy of limiting these deductions to involuntary and unusual expenditures that may exhaust a large proportion of the taxpayer's total income for a particular year, thereby significantly reducing the individual's ability to pay taxes.

Table on itemized returns

Table 14 shows the estimated number of itemizer returns, compared to total taxable returns, by income class and filing status, under present law in 1987. It is estimated that 41 million, out of the total 85 million taxable returns, will itemize deductions in that year; itemizing returns thus will be approximately 48 percent of taxable returns.

High income taxpayers are much more likely to itemize than taxpayers with lower income. For example, among taxpayers with incomes under $10,000, six percent itemize, while in the $200,000 and over income class, 98 percent itemize.

Married couples are more likely to itemize than taxpayers in other filing statuses, reflecting (among other factors) their relatively high incomes. Among joint returns, 64 percent of taxable returns are projected to itemize deductions.

The increase in the ZBA and the repeal of or restrictions on deductions for State and local taxes, interest, and miscellaneous deductions proposed by the Administration would reduce the number of itemizers substantially. It is estimated that approximately 45 percent fewer returns would be itemized returns under the Administration proposal than under present law.

Table 14.—Distribution by Income Class of Taxable Returns and Itemized Returns, by Filing Status, Under Present Law, 1987

[Thousands of tax returns]

Income class (thousands of 1986 dollars)	Taxable returns	Itemized returns
All filing statuses		
Less than 10	13,147	825
10–20	21,854	5,124
20–30	13,091	5,847
30–40	13,995	9,413
40–50	9,012	7,215
50–75	9,380	8,286
75–100	2,257	2,130
100–200	1,428	1,374
200 and above	546	535
Total	84,709	40,750
Joint returns		
Less than 10	578	77
10–20	7,028	1,995
20–30	8,006	3,331
30–40	10,441	6,844
40–50	7,904	6,275
50–75	8,472	7,481
75–100	2,039	1,931
100–200	1,274	1,229
200 and above	476	467
Total	46,216	29,630

Table 14.—Distribution by Income Class of Taxable Returns and Itemized Returns, by Filing Status, Under Present Law, 1987—Continued

[Thousands of tax returns]

Income class (thousands of 1986 dollars)	Taxable returns	Itemized returns
Heads of households		
Less than 10	467	70
10–20	2,963	879
20–30	1,030	629
30–40	715	542
40–50	215	196
50–75	161	151
75–100	36	34
100–200	27	27
200 and above	9	9
Total	5,624	2,537
Unmarried returns		
Less than 10	12,101	679
10–20	11,864	2,250
20–30	4,056	1,888
30–40	2,839	2,028
40–50	893	744
50–75	747	653
75–100	182	165
100–200	127	118
200 and above	60	58
Total	32,871	8,584

B. Medical Expenses

Present Law and Background

In general

Individuals who itemize deductions may deduct amounts paid during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds five percent of adjusted gross income (sec. 213).

Medical care expenses eligible for the deduction are amounts paid by the taxpayer for (1) health insurance (including employee contributions to employer health plans); (2) diagnosis, treatment, or prevention of disease or malfunction of the body; (3) transportation primarily for and essential to medical care; and (4) lodging away from home primarily for and essential to medical care, up to $50 per night. (This last category of deductible medical expenses was added by the Deficit Reduction Act of 1984.) The cost of a medicine or a drug is a medical care expense if it has been prescribed by a physician or is insulin.

Expenses paid for the general improvement of health, such as fees for exercise or weight-reduction programs, are not eligible for deduction unless prescribed by a physician to treat a specific illness or physical defect.

Where an employee's medical care or health insurance costs are paid or reimbursed by the employer, no amount is included in the employee's income on account of the employer's payments (except in the case of a self-insured plan which discriminates in favor of highly compensated employees). The employer may deduct as a business expense its payments for providing health insurance to employees, or for covering employees under a self-insured plan.

Capital expenditures

Under Treasury regulations, an unreimbursed capital expenditure may be deductible as a medical expense if its primary purpose is the taxpayer's (or dependent's) medical care. Qualified capital expenditures may include eyeglasses or contact lenses, motorized chairs, crutches, and artificial teeth. The cost of a movable air conditioner may qualify if purchased for the use of a sick person.

In addition, the cost of a permanent improvement to property that ordinarily would not have a medical purpose, such as central air conditioning or an elevator, may be deductible as a medical expense if directly related to prescribed medical care, but only for the portion of the cost, if any, which exceeds the increased value of the property attributable to the improvement. Under this rule, for example, the excess of the cost of constructing a swimming pool over the value added to the residence by the pool has been held deductible by the courts where the taxpayer's physician prescribed daily swimming exercise as necessary to alleviate severe medical problems. Related operating and maintenance costs also may be deducted provided that the medical reason for the capital expenditure continues to exist.

Background on deduction

From 1954 through 1982, the floor for medical expense deductions was three percent of adjusted gross income (AGI), and a separate floor of one percent of AGI was provided for medicine and drugs.

Medical expense deductions totaling $17.9 billion were claimed on 9.6 million tax returns for 1983, or 27 percent of returns filed by itemizers. The deduction is estimated to reduce fiscal year budget receipts by $2.8 billion in 1986.

Administration Proposal

The Administration proposal does not include modifications to the section 213 medical expense deduction. As described in part IV-1 above, under the Administration proposal, employer contributions to a health plan would be included in the employee's gross income up to $120 per year ($10 per month) for individual coverage of an employee, or $300 per year ($25 per month) for family coverage. Presumably, the amount included in the employee's gross income would be eligible for deduction as a medical expense (subject to the five-percent floor).

Other Proposals

The floor which medical care expenses must exceed before being deductible would be increased to 10 percent of AGI under the Bradley-Gephardt bill (S. 409; H.R. 800), the Kemp-Kasten bill (H.R. 2222; S. 1006), and the Roth-Moore bill (S. 411; H.R. 373).

Analysis

In general

The Congress has long recognized that medical expenses essentially are personal expenses and therefore that no special tax treatment should be provided for them, except where the expenses for a year are so great that they absorb a substantial portion of the taxpayer's income and hence substantially affect the taxpayer's ability to pay taxes. In order to limit the deduction to extraordinary expenses, the tax law provides that medical expenses are deductible only to the extent that they exceed five percent of the taxpayer's AGI.

By utilizing a deduction floor, the Congress provides tax relief when an individual has incurred extraordinary involuntary medical expenses, for example, as a result of uninsured surgery, severe chronic disease, or catastrophic illness, without limiting that relief to specifically defined diseases or types of expenditures deemed to be involuntary. All medical expenses are not involuntary; for example, hair transplants, face lifts, and other forms of cosmetic surgery usually are not considered to be involuntary medical expenses.

The following issues associated with the itemized deduction for medical expenses could be considered in conjunction with tax reform proposals.

Definition of qualified expenditures

The Congress may wish to consider proposals that would restrict the deduction of medical expenditures that are somewhat voluntary, and not allow the deduction for expenditures with a medical component that also provide a high degree of nonmedical personal benefit. To this end, it could be useful to adopt some of the restrictions typically contained in health insurance policies, which are designed to exclude from coverage expenses that individuals may incur without regard to medical need.

Two areas in which the coverage of the medical deduction is broader than the typical insurance policy are transportation and capital expenditures.

Transportation.—Medical costs eligible for the income tax deduction include the round-trip from home costs of taxi, bus, or automobile transportation for routine medical care, as well as costs associated with emergency care or transportation costs for medical care while away from home. Under health insurance policies, ambulance service is typically the only covered cost of transportation.

The Congress could make transportation costs, other than ambulance service, ineligible as deductible medical expenses. This change could be made effective for all transportation, or just transportation incurred when the individual is not away from home overnight. This modification might be considered because these taxi, bus, or automobile expenses involve relatively small costs and hence involve disproportionate recordkeeping and audit burdens, and because these costs are an incidental, rather than a principal, expense of medical care. Also, local transporation costs for medical visits may be combined with other trips, such as commuting to or from work, or combined with a shopping trip, and hence involve elements unrelated to medical care.

Capital expenditures.—A more restrictive definition of capital expenditures for medical care could be formulated, while still making it feasible to allow medical expense deductions to ease the financial burden of extraordinary costs.

Capital expenditures, and related maintenance or rental expenditures, could be made ineligible for the deduction unless the item is prescribed by a physician and is designed specifically for treating an illness, or preventing further deterioration of a medical condition. Items which could continue to be deductible under this proposal would include, for example, wheelchairs, crutches, eyeglasses, and respirators. Nondeductible items could include swimming pools, air conditioners, or elevators. Most private insurance policies do not cover these types of permanent improvements.

Under present law, the deductibility of many capital expenditures often involves complicated valuation questions in order to determine such matters as the portion of a swimming pool's costs that did not add to the value of a house. It is not uncommon for taxpayers and the Internal Revenue Service to be involved in administrative disputes and litigation over such valuation issues. In addition, expenditures for such items as swimming pools and elevators involve a high degree of personal, nonmedical benefit, even when prescribed by a doctor. It is argued that deductions for such items predominantly benefit higher-income taxpayers who are the ones most able to afford such items.

Another approach would be to continue present law as to the eligibility of capital expenditures for the deduction, but to require that the cost (to the extent allowable as a deduction) must be deducted ratably over the useful life of the asset.

Conversely, limiting the scope of the deduction for medical capital expenditures and transportation might be viewed as inequitable, even though more efficient. Narrow definitions of qualified capital expenditures and transportation costs may deprive an individual of equipment that helps alleviate pain or a reduction in otherwise high transportation costs incurred only to obtain the best available medical care. Narrow or rigid definitions that attempt to eliminate personal nonmedical benefits from deductible medical expenses may prevent the tax system from reflecting necessary adjustments in an individual's ability to pay taxes.

Increase in percentage floor

In general

Some simplification could be achieved without dealing with the above definitional issues (or in addition to adopting the proposals described above) by increasing the five-percent floor under the deduction.

An increase to six percent of AGI, for example, would reduce the number of tax returns eligible for the deduction by 24 percent. The maximum tax increase caused by such a change would be the additional taxes attributable to adding one percent of AGI to taxable income; this would affect only individuals who had medical expenditures at least equal to the present-law five-percent floor. Increasing the floor to 10 percent of AGI, as under the Bradley-Gephardt, Kemp-Kasten, and Roth-Moore bills, would reduce the number of returns claiming the deduction by 70 percent.

By reducing the number of individuals who could deduct medical expenses, a higher floor would also alleviate complexity associated with the deduction, including substantiation and audit verification problems and numerous definitional issues. For example, numerous issues (apart from substantiation) have arisen as to the medical expense deduction, including the deductibility of the following types of expenses: various travel and transportation expenses incident to medical treatment, including costs of traveling companions; schooling expenditures for children with handicaps or impairments; domestic help or nursing costs for ill persons; capital expenditures for persons with medical problems; the deductibility of expenditures on behalf of dependents; and the definition of medical care expenses (acupuncture, various therapies, etc.).

Also, a percentage floor higher than five percent could be considered more appropriate to define the level of unreimbursed medical expenditures sufficiently high so that ability-to-pay considerations predominate over general tax policy concepts that personal expenditures should not be deductible.

Prior Congressional action

As reported by the Senate Committee on Finance, the Tax Equity and Fiscal Responsibility Act of 1982 included a provision raising the medical deduction floor to 10 percent of AGI. An amendment on the Senate floor substituted a seven-percent floor; the conferees on the 1982 Act adopted the present-law five-percent floor.[11]

The Finance Committee report stated that increasing numbers of individuals had expenses exceeding the then three-percent floor because medical costs had risen faster than incomes, and because of the broad class of expenses eligible for the deduction. As a result, the report stated, a larger number of individuals had, in effect, received partial reimbursement for their medical expenses, thereby creating an incentive for further health care spending and exacerbating the problem of rising medical care expenditures. Also, the deduction was described as involving complexity, since detailed records must be kept and difficult distinctions must be made between expenses for medical treatment (deductible) and expenses for ordinary consumption (nondeductible).

[11] See S. Rpt. 97-494 (Vol. I), 97th Cong., 2d Sess. 113-14 (1982).

C.. Deduction for Certain State and Local Taxes

Present Law and Background

History of deduction

The first Federal income tax, in effect from 1862 to 1872, allowed deductions for all Federal, State, and local taxes paid, whether or not incurred as trade or business expenses. The Revenue Act of 1913 followed this general rule, other than disallowing deductions for taxes paid directly in exchange for specific local services or benefits. In 1917, the deduction for Federal income taxes paid was repealed in response to revenue pressures related to the country's involvement in World War I. Subsequently, deductions for Federal and State estate, inheritance, and gift taxes were also repealed.

A provision of the Revenue Act of 1964 further narrowed the deductibility of State and local taxes by providing that only those types of taxes specified in the statute could be deducted by individuals, other than taxes incurred in a business or investment activity. These specified deductible taxes were State and local taxes on income, real and personal property, and motor fuels, as well as general sales taxes. State and local taxes incurred in a business or investment activity (e.g., real property taxes on property that the taxpayer rents for profit, or sales taxes on equipment purchased for a business) continued to be deductible—even if, under generally applicable tax accounting rules, they would have been capitalized.

Inasmuch as income, property, and general sales taxes were considered the principal sources for State and local tax revenues, the deductibility of these three types of taxes was continued in the 1964 Revenue Act in order to preserve Federal neutrality as to the relative use made of such taxes by State and local governments. However, the Congress emphasized concerns other than Federal neutrality with respect to selective sales or excise taxes or fees, such as cigarette or liquor taxes or motor vehicle license fees. The Congress determined that it was difficult for taxpayers to keep records of these types of taxes, for which tables of estimated amounts could not be developed, and that the deductibility of such taxes varied depending on formalities of State laws. Accordingly, these types of taxes or fees were made nondeductible in the 1964 Revenue Act.

Finally, in 1978 the Congress repealed the deduction for State taxes on gasoline and other motor fuels not used by the taxpayer in business or investment activities. As taxes on personal expenses for automobile travel, these taxes were viewed principally as user fees; also, the Congress noted difficulties in verifying amounts claimed for gasoline taxes, and viewed the deduction as inconsistent with national energy policy.

Present law

Under present law (sec. 164), itemizers may deduct four types of State and local taxes that are not incurred in a trade or business or in an investment activity—individual income taxes, real property taxes, personal property taxes, and general sales taxes.[12]

In general, personal property taxes on nonbusiness property are deductible by itemizers only if imposed (1) on an annual basis and (2) substantially in proportion to the value of the personal property that is subject to tax. (For example, itemized deductions are allowed for personal property taxes imposed, in some States, on automobiles, motorcycles, and boats used exclusively for personal purposes.) A tax on personal property that is based in part on criteria other than the value of the property, or that is collected either more or less frequently than once per year, may qualify for deductibility, as may a tax imposed in the form of a privilege. For example, vehicle registration fees based partly on value and partly on other criteria (such as weight) may be deductible in part.

A sales tax must satisfy two tests in order to be deductible. First, it must be imposed on sales (either of property or of services) at the retail level. Second, it must apply at one rate to a broad range of items. In addition, the statute provides any sales taxes imposed at lower rates on food, clothing, medical supplies, and motor vehicles are deductible (sec. 164(b)(2)).[13] Other sales taxes, such as any selective-rate taxes on sales of alcoholic beverages, tobacco, admissions, or solely on services, generally are not allowable as itemized deductions.

Background on deduction

In general.—It is estimated that itemized deductions totaling $100.2 billion for State and local taxes were claimed on 34.8 million returns for 1983, or 98.9 percent of returns filed by itemizers. The reduction in fiscal year budget receipts attributable to this itemized deduction is estimated as $34.7 billion in 1986.

Income taxes.—All States (along with the District of Columbia) except for Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose a tax on the net income of their residents, and in some cases on income of nonresidents which is earned within the taxing State.[14] While a few States tax a flat percentage of individual income, most States have graduated rate schedules. These tax rates range, across the different brackets in various States, from one half of one percent to 14 percent. In addition, cities and other local taxing bodies in several States levy income taxes on individuals.

State and local individual income taxes for fiscal year 1984 are estimated to total $66 billion. Overall, individual income taxes con-

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[12] The term general sales tax also includes compensatory use taxes, i.e., taxes on the use, storage, or consumption of items which would have been subject to a general tax if sold in the State or locality imposing the use tax (sec. 164(b)(2)(D)). Deductions are also allowed for foreign real property taxes, foreign income taxes, and the windfall profit tax (imposed by sec. 4986).

[13] Also, the imposition of a sales tax on the purchase of motor vehicles at a rate higher than the general sales tax rate does not completely preclude deductibility of the specific sales tax. However, the deduction is limited to the rate of the "general" sales tax for the State (sec. 164(b)(2)(E)).

[14] Connecticut, New Hampshire, and Tennessee impose only limited taxes on specified forms of income (e.g., interest and dividends).

stituted 20.6 percent of all State and local tax revenues. Reliance on individual income taxes varies substantially among State and local governments, ranging from less than two percent to more than 40 percent of State-local tax revenues.

It is estimated that itemized deductions totaling $50.9 billion for individual income taxes were claimed on 26.6 million returns for 1983, or 75.7 percent of returns filed by itemizers.

Real property taxes.—All States (and the District of Columbia) or their subdivisions currently impose real property taxes. Generally, a real property tax must be levied for the general public welfare to be deductible for Federal income tax purposes. Examples are general property taxes used to finance public education, highway construction and other such programs. Taxes levied on property which directly benefits from the tax are generally not deductible. An example of such a nondeductible local benefit tax is an assessment against homeowners on a block to pay for their newly paved alley.

State and local real property taxes for fiscal year 1984 are estimated to total $93 billion. Overall, real property taxes constituted 29 percent of all State and local tax revenues. Reliance on real property taxes varies substantially among State and local governments, with an estimated range of from less than 13 percent to more than 60 percent of State-local tax revenues.

It is estimated that itemized deductions totaling $29.8 billion for real property taxes were claimed on 29.2 million returns for 1983, or 83 percent of returns filed by itemizers.

Personal property taxes.—26 States (or their subdivisions) impose taxes on one or more types of tangible personal property (i.e., household personal property and motor vehicles) that may be used outside of a business or investment setting. In addition, some States (or their subdivisions) impose personal property taxes on tangible personal property that is used for business (e.g., business inventories, and other commercial, industrial, or agricultural property), or on intangible personal property, such as securities, notes, accounts receivable, and beneficial interests in trusts.

It is estimated that itemized deductions totaling $1.4 billion for nonbusiness personal property taxes were claimed on 9.1 million returns for 1983, or 25.9 percent of returns filed by itemizers.

Sales taxes.—All States (and the District of Columbia) except Delaware, Montana, and New Hampshire impose general sales taxes at either the State or local level. The combined State and local sales tax rates range from 3 to 7.5 percent.

State and local general sales taxes for fiscal year 1984 are estimated to total $81 billion. Overall, general sales taxes constituted 25.2 percent of all State and local tax revenues. Reliance on general sales taxes varies substantially among State and local governments, ranging from less than two percent to more than 40 percent of State and local tax revenues.

It is estimated that itemized deductions totaling $16.3 billion for sales taxes were claimed on 33.3 million returns for 1983, or 94.1 percent of returns filed by itemizers.

Administration Proposal

Under the Administration proposal, no deduction would be allowed for any State or local income, real or personal property, or sales tax paid by an individual, and presently allowable as an itemized deduction[15] other than taxes incurred in a trade or business (sec. 162) or for the production of income (sec. 212), effective for taxable years beginning on or after January 1, 1986. Deductions of taxes paid by corporations would not be affected by the proposal.

The proposal also would impose a limitation on the deductibility of State and local taxes, other than income taxes, that are incurred by an individual in an income-producing (investment) activity. The amount of such taxes would be added to the amount of certain employee business expenses and miscellaneous deductions; that total would be deductible "above-the-line" (i.e., by both itemizers and nonitemizers) to the extent exceeding one percent of AGI. (See discussion in part VI.B., below.) This limitation would not apply to income taxes or to deductible taxes incurred in carrying on an active trade or business.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the itemized deductions for State and local sales taxes and personal property taxes not incurred in carrying on a trade or business or for the production of income. In addition, any taxes incurred in connection with the acquisition or disposition of property would have to be capitalized. The remaining itemized deductions for State and local income and real property taxes, as in the case of other itemized deductions, would be deductible in computing taxable income (taxed at a 14-percent rate), but not in computing adjusted gross income (which would be subject to a surtax of up to an additional 16 percent).

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the itemized deductions for State and local income taxes, sales taxes, and personal property taxes not incurred in carrying on a trade or business or in the production of income. The itemized deduction for real property taxes would be retained.

S. 411 and H.R. 373 (Roth-Moore)

The itemized deductions allowable under section 164 for State and local real and personal property, income, and general sales taxes would be repealed.

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[15] This category includes taxes paid by passthrough entities (i.e., partnerships and subchapter S corporations) and allowable to the investors as itemized deductions.

Analysis Relating to the Administration Proposal

In general

The debate regarding whether nonbusiness State and local taxes should continue to be deductible by itemizers centers on three principal concerns of tax policy—simplicity, fairness, and efficiency.

The dispute about simplicity is largely a factual one. In many cases, individuals may not find it unduly burdensome to keep track of the amount of State and local income and property taxes that they have paid. Determining the exact amount of sales taxes paid does require burdensome recordkeeping. However, most individuals who itemize calculate the deductible sales tax amount from tables printed in the instructions for Form 1040. The IRS develops these sales tax tables from studies of expenditures by families at various income levels.[16] While these tables permit taxpayers to avoid burdensome recordkeeping, some taxpayers could obtain larger deductions and thus reduce their taxes by saving all receipts and deducting actual amounts paid as sales taxes. Both those taxpayers who undertake this effort and those who do not may dislike the fact that greater tax benefits may be available at the cost of tedious recordkeeping and computation.

Perhaps the main effect on simplification that would result from repealing the deduction is a reduction in the number of taxpayers who itemize their deductions. The magnitude of this reduction depends also on other changes proposed by the Administration, such as increases in the zero bracket amount and modifications to other itemized deductions.[17]

The debate about fairness and efficiency raises underlying philosophical issues as to which there is fundamental disagreement between those advocating repeal and retention of the deduction. Those who advocate repealing the deduction advance three principal arguments relating to fairness. First, they argue that the deduction is regressive, since it disproportionately benefits upper-income taxpayers. Second, they contend that the deduction favors taxpayers in high-tax, as compared with low-tax, States and localities, and may accordingly facilitate unnecessary and inefficient State and local government spending. In particular, they argue that the deduction subsidizes personal benefits (e.g., recreational services) of a sort that would not give rise to a deduction if paid for directly, rather than through the medium of State or local taxes.

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[16] There is a separate table for each State having general sales taxes. The deductible amount is based on the taxpayer's AGI plus nontaxable items (such as nontaxed social security benefits and the excludable portion of long-term capital gains), and on the number of persons in the taxpayer's household. Local sales taxes are also imposed in various States. An additional amount for local taxes has been built into the table for some of these jurisdictions. For other States having local sales taxes, a further computation must be made after deriving the table amount (e.g., taxpayers in Wisconsin added sales taxes on electricity or gas during May through October 1984 to the table amount). Also, taxpayers generally may add to the table amount the actual State and local sales taxes paid on purchases of a boat, airplane, motor vehicle, or certain other large items.

[17] In addition, some increase in simplicity would result from elimination of the need to take State and local tax refunds (or additional assessments) into account in the following year. (State and local tax deductions claimed generally reflect withholding and payments of estimated tax, rather than actual tax liability as computed the following year.) Many taxpayers do not understand the need to adjust in the following year to reflect actual liability, and the calculation can be complicated (under the tax benefit rule) if the taxpayer was close to claiming the standard deduction.

Finally, they argue that the payment of State and local taxes is voluntary, on the ground that taxpayers can vote for lower taxes or move to low-tax jurisdictions.

Regressivity

The regressivity of the State and local tax deduction arises from several of its aspects. First, more affluent taxpayers generally have relatively high State and local tax liabilities, and thus are able to claim larger deductions. Second, higher income taxpayers are generally more likely to itemize than lower income taxpayers. Third, the value of any itemized deduction in reducing Federal tax liabilities increases with the marginal rate of the taxpayer. For example, for a taxpayer in the 50 percent bracket, the net cost of paying a dollar of State tax is reduced to 50 cents as a result of the Federal deduction. By contrast, for a taxpayer in the 14-percent bracket, the deduction reduces the net cost of a dollar of State tax only to 86 cents. For these reasons, advocates of repealing the State and local tax deduction argue that it represents an unfair subsidy benefiting upper-income taxpayers and communities, and itemizers generally, at the expense of lower-income taxpayers and nonitemizers.

However, advocates of retaining the deduction make several arguments in response. First, they note that any effects the deduction has on the overall burden of tax liability can be addressed by restructuring tax rates, or by converting the deduction into a partial credit. Second, they maintain that the State and local tax deduction is important to middle-income taxpayers, and also indirectly benefits the poor to the extent that it increases the level of social services that more affluent taxpayers are willing to pay for at the State and local level. (Of course, it may also increase the level of State and local services provided for more affluent taxpayers.) Third, they argue that the deduction cannot accurately be said to benefit only itemizers. As the Administration points out in the section of its proposal concerning repeal of the charitable deduction for nonitemizers, the zero bracket amount "generally is regarded as an allowance for certain personal expenses that . . . all taxpayers are deemed to incur." Thus, it includes an implicit allowance for the deductions foregone by nonitemizers, and hence no itemized deduction should be characterized as discriminating against nonitemizers. Finally, supporters of the State and local tax deduction note that all itemized deductions share with the State and local tax deduction the attribute of having greater value to upper-income taxpayers, and that the Administration proposal would retain most itemized deductions.

Subsidy to State and local governments

Advocates of repealing the State and local tax deduction note its differing effect on the relative tax burdens of taxpayers in high-tax and low-tax States. Since the deduction reduces the after-tax cost of each dollar of State and local tax liability incurred by an itemizer, taxpayers in high-tax States receive a greater tax benefit than taxpayers in low-tax States. To that extent, some view the deduction as a Federal subsidy for State and local government activities that is provided in a manner disproportionately beneficial to high-tax States. In addition, the subsidy is said to promote excessive State and local government spending, especially on items that do not bring benefits outside of the State or locality. Further, it is argued that allowing the deduction encourages these governments to finance expenditures from general taxes rather than from specific user charges that may better match the benefits with the costs of government spending programs.

Advocates and opponents of repealing the deduction for State and local taxes disagree not so much about whether the deduction provides a subsidy to State and local governments and benefits high-tax States, as about whether this is desirable. This dispute turns on three issues.

First, there is a question as to whether the Federal Government should reduce the burden of State and local government expenditures in the first place. The answer to this question depends in part on how significantly repeal of the deduction would actually affect the ability of State and local governments to raise revenues—an issue as to which there is broad disagreement. It depends as well on one's views regarding the fundamental desirability of higher State and local government expenditures. With regard to this issue, advocates of repealing the deduction argue that State and local government expenditures tend to help only those in the taxing jurisdictions—in effect, providing personal benefits (e.g., security or sanitation services) the cost of which could not be deducted if paid for by taxpayers directly other than through the medium of a governmental entity. By contrast, advocates of maintaining the deduction argue that it permits governments to provide important social services (such as education, public safety, and aid to the poor) that advance the general social welfare beyond the taxing jurisdiction and accordingly merit Federal support. These advocates note that the Administration plan retains other itemized deductions (e.g., for charitable contributions) that relate to advancing the general welfare.

The second issue raised by the fact that the deduction provides a subsidy for State and local taxation concerns whether the Internal Revenue Code is the proper mechanism for such a subsidy. Advocates of repealing the deduction argue that State and local spending is also extensively subsidized through the tax exemption for interest on public purpose obligations, and that a block grant or direct subsidy to the States would be more efficient and more easily targeted to particular types of expenditures than utilization of the tax code. For example, the total cost of direct subsidies could be monitored more effectively than the costs of tax benefits, and the States would not have to share the benefit with taxpayers who itemize. However, advocates of retaining the deduction respond that enactment of a new direct Federal expenditure program is unlikely in view of the present budgetary situation. Further, they argue that deductibility has a significant impact on the ability of State and local governments to maintain adequate spending levels, both by lowering voter resistance to high tax levels and by mitigating the substantial migration that might occur if individuals had to face the full differentials between State and local tax levels in different areas of the country. Thus, they conclude that even an inefficient subsidy is better than no subsidy at all.7S6602

Finally, advocates of maintaining the deduction argue that assisting State and local governments in raising revenue is a necessary feature of the Federal system of government. Advocates of repealing the deduction contend that this "Federalism" argument would be equally applicable to the allowance of deductions for Federal taxes paid under State and local income tax systems, and they note that fewer than half of the States with income taxes allow full deductions for Federal taxes.

Voluntariness of paying State and local taxes

The third major argument relied upon by proponents of repealing the State and local tax deduction is a response to one of the principal arguments made in favor of the deduction. Proponents of retaining the deduction argue that, even aside from its effect on State and local governmental services, the deduction should be allowed as a matter of equity toward individual taxpayers. They maintain that the tax system should reach only an individual's disposable income, i.e., income over which he or she has some control. Since taxpayers are required by law to pay their State and local tax obligations, these advocates conclude that repeal of the deduction would give rise to an unfair "tax on a tax."

Proponents of repealing the deduction respond by asserting that taxpayers do have ultimate control over their State and local taxes, through the State and local political process. In addition, they note that taxpayers can "vote with their feet" by moving to a jurisdiction with a lower tax rate. If taxpayers do not exercise these options, it is asserted, this is partly because of the additional public services which are financed by the taxes, thus reinforcing the argument that the taxes are analogous to nondeductible user fees for specific services received by the taxpayer.

However, advocates of retaining the deduction respond by questioning the degree to which individuals can actually control their tax liabilities (or, in some cases, move to low-tax States without excessive personal sacrifice). Moreover, to the extent that migration would take place, they argue that this would involve costly social dislocations. They also assert that, under the Federal system, States should be encouraged to experiment with new programs in order to facilitate assessing the programs' broader desirability. Finally, even to the extent that State and local government expenditures (and taxes to pay for them) could be viewed as voluntary, in the sense that residents have voting control over them, these advocates note that other voluntary expenditures—such as charitable contributions, including contributions to State and local governments—would remain deductible under the Administration proposal. This fact, it is asserted, means that the "voluntariness" argument cannot be the sole basis for the proposal to repeal the deduction for State and local taxes.

In addition to the above arguments relating to fairness, the following additional issues have been raised.

Allowing the State and local tax deduction to corporations

More fundamentally, the argument for repeal could be based on the view that there is no theoretical reason why a person should be able to deduct one portion of total governmental tax liabilities (i.e., the State and local portion) against another portion (i.e., the Federal portion). For example, Federal taxes are spent by many different Federal Government entities for different purposes. Yet taxpayers cannot, for example, deduct social security taxes that are allocated to the Social Security Trust Fund against income taxes allocated to defense, or vice versa. One could argue that, despite the distinctions made between national and State or local governments under the Federal system, Federal and State or local taxes likewise should not be deductible against each other. Thus, most States do not permit Federal income taxes to be deducted for State income tax purposes. Similarly, under present law, State gasoline and excise taxes, unless incurred in a business setting, are not deductible for Federal income tax purposes.

But this argument, if rigorously pursued, suggests that corporations, as well as individuals, should not be allowed a Federal income tax deduction for State and local taxes paid. In addition, it suggests that deductions should be denied for State and local taxes paid by individuals in connection with a business or investment activity. Thus, the argument does not specifically support the Administration proposal.

However, the view that State and local tax deductions should be denied for all taxpayers can be supported on other grounds as well. Some have argued that it is unfair to allow the deduction to corporations but not to individuals. The disparity in treatment may also, under some circumstances, create an incentive for sole proprietorships or partnerships to incorporate—contrary to the goal of the Administration proposal to increase the neutrality of the tax code toward different forms of business organization.

On the other hand, corporations have traditionally been allowed to deduct all expenses that serve legitimate business purposes (including user charges for specific services received by the corporation), with only limited exceptions (e.g., the nondeductibility of bribes) that serve specific policy goals. Denying corporations a deduction for State and local taxes paid would conflict with traditional practice. In support of the practice, it has been argued that all legitimate corporate expenses, by definition, serve business rather than personal purposes, and that it is accordingly justifiable to allow a deduction to corporations for all taxes, but not to individuals for nonbusiness taxes.

The fact that the Administration proposal would permit individuals to deduct all State and local taxes other than income taxes, if incurred in business activities, might also lead to some distortions. In particular, some States might respond by enacting changes in the taxes they impose, either by raising business taxes or by changing the form of current taxes to enable taxpayers to argue that their taxes are business-related. These taxes could be substantially similar in structure to income taxes, but could permit taxpayers to argue that paying them is a cost of doing business.

For example, income taxes on employees could be replaced by payroll taxes on employers. In theory, employees could pay employers for assuming the employees' present share of State and local tax liability by accepting wages that were lower by approximately the same amount as the tax liability that had been transferred to the employers. Yet the payroll taxes, unlike the income taxes, would presumably be deductible. If States did this to a significant degree, the revenue gains anticipated from repealing the State and local tax deduction might not be realized. However, considerations unrelated to Federal income consequences might discourage States from adopting payroll taxes. For example, States might prefer different forms of raising revenue, and employers might resist shifting to a payroll tax if they did not believe they could recapture the added expenditures from employees.

Similarly, taxpayers who work in licensed professions (e.g., medicine, law, and accounting) could be required to pay high occupational or gross receipts taxes which would be credited against State and local income tax liability. Or, more substantively, the nondeductibility of individual taxes could encourage State and local governments to alter their tax policy by shifting more to business-type taxes. This, in turn, could lead to greater State-by-State business tax competition.

One of the most significant distortions that might result from the Administration proposal relates to the fact that some States can raise substantial revenues without directly taxing their own residents. In particular, some States that are rich in natural resources such as oil and coal raise revenues through severance taxes. These taxes, paid by companies for removing the natural resources (and, presumably, passed on to consumers of the resources, including any in other States or abroad), would continue to be deductible under the Administration proposal. Opponents of the proposal argue both that this is unfair, and that it shows that the level of State and local taxation of residents is not solely a function of the level of voluntary spending.[18]

On the other hand, some disparities in Federal tax consequences already exist under current law, to the extent that State and local fees and taxes other than those enumerated in section 164 presently are not deductible. By broadening the category of nondeductible State and local taxes, the Administration proposal would eliminate certain disparities that presently exist—for example, the unfavorable treatment of user fees (e.g., for water or road use) in comparison to income, sales, and real and personal property taxes.

A further possible disparity that is brought to light by the argument that no taxes should be deductible against other taxes relates to the treatment of the foreign tax credit. The view that no taxpayer should be permitted to deduct one tax against another could arguably be applied to foreign as well as to State and local taxes. Even if this view is rejected (on the ground that there is a greater distinction between different countries' governments than between the different levels of government in this country), it can still be argued that the proposed repeal of State and local tax deductions has foreign tax consequences. Some have argued that it is unfair,

[18] A recent study released by the Joint Economic Committee concludes that, largely because of the effect of taxes (such as severance taxes) that can be levied against nonresidents, there is overall a slight negative correlation between taxation of State and local residents and the level of State and local spending; that is, high-tax States tend to spend less than average *per capita* while low-tax States tend to spend more. In particular, the study asserts that the two States that impose the least taxes *per capita* on residents (Alaska and Wyoming) spend the most *per capita*. Both of these States derive significant revenues from severance taxes. Joint Economic Committee, *The Relationship Between State and Local Tax Burdens and Spending by State and Local Government,* (July 26, 1985).

or a disincentive to doing business in this country, to allow a deduction or credit for foreign taxes paid but not even a deduction for State and local taxes paid. However, the foreign tax credit is often viewed, not as a preference, but as a means of establishing neutrality with regard to the treatment of exports and overseas business and as a form of tax comity between sovereign nations (although this argument may not apply to foreign property taxes). Opponents of repeal contend that our Federal system of government has generally given tax comity to State and local governments through deductibility of State and local taxes against Federal income tax (for businesses and individuals) and through nontaxability of interest on general purpose State and local bonds.

Avoiding a confiscatory rate of tax

In past years, it has been argued that the State and local tax deduction is needed to avoid the application of confiscatory rates of taxation to high-income taxpayers. For example, at one time the highest Federal marginal tax rate was 94 percent; at that rate, the top-bracket income of some taxpayers could be taxed at an aggregate State and Federal rate of more than 100 percent if there were no deduction for State and local taxes. At present, however, the highest Federal tax rate on individuals is 50 percent, and the top rate would be reduced to 35 percent under the Administration proposal. Accordingly, at present there should be no basis for real concern that some individuals would pay tax at a marginal rate of more than 100 percent in the absence of a deduction.

Analysis Related to Other Proposals

Repealing the deduction for selected taxes

In general

Instead of disallowing all State and local taxes as itemized deductions, deductions could be allowed only for some specific types of taxes. Thus, for example, the Bradley-Gephardt bill would retain deductions for income and real property taxes, while the Kemp-Kasten bill would retain deductions for real property taxes. The issues raised by proposals of this kind include the merits of allowing a deduction for each particular type of tax, and of treating some types of taxes more favorably than others.

Some have argued that it is important to maintain Federal neutrality toward the different types of taxes among which States may choose. Presumably, eliminating the deduction for one or more nonbusiness taxes would give the States an incentive to rely more heavily on taxes that are still deductible. This can be viewed as an interference with the autonomy of the States in structuring their own affairs, and accordingly as inconsistent with notions of Federalism.

However, it can be argued in response that present law and the Administration proposal already extend different treatment to different types of taxes. For example, certain types of State and local taxes (e.g., State gasoline, telephone, inheritance, and gift taxes) presently are not deductible, and yet are utilized by many State and local taxing bodies. The Administration proposal would arguably create a further incentive regarding the structure of State and local taxation, by permitting taxes on corporations, but not most taxes on individuals, to be deducted. However, it can be argued that the Federal Government may wish to influence the States' choice of taxes—for example, to encourage the use of taxes that create greater progressivity.

Many of the arguments that apply to ending the deductibility of one type of State and local tax apply in equal measure to all other types of tax. For example, for all types of State and local tax, repeal of a deduction would presumably reduce the need to keep records, and lead to a decrease in the number of itemizers, while on the other hand increasing the tax burden for particular taxpayers and encouraging States and localities to switch to other types of taxes. However, there are also arguments that may apply uniquely or with particular force to specific types of presently deductible State and local taxes.

Income taxes

Income taxes are often the most progressive form of tax, although the degree of progressivity depends on how a particular tax is structured. This factor can give rise to the view either that this deduction should be repealed, on the ground that it benefits those with the highest liabilities, (i.e., upper-income taxpayers), or that it should be retained, in order to encourage States to choose a progressive form of tax.

In support of retaining the deductibility of State and local income taxes, it can be argued that the "tax on a tax" argument applies most strongly to State and local income taxes. When incurred in a nonbusiness setting, sales taxes and real and personal property taxes attach tax liability to particular forms of personal consumption; they are not expenses of earning income. By contrast, it can be argued that a State or local income tax is truly a cost of earning income.

It has also been argued that repealing this deduction would give rise to administrative and compliance difficulties if State and local tax liabilities incurred by an individual in a business or investment setting continued to be deductible. For example, various forms of occupational and gross receipts taxes, having some structural resemblances to income taxes, might pose difficult legal questions regarding deductibility.

On the other hand, advocates of repealing this deduction note that the Federal Government "competes" with the States in taxing income, whereas taxes on sales and on real and personal property tend to be left to the States. The use of overlapping forms of tax can lead to coordination problems (such as the creation of unduly high aggregate marginal rates), thus suggesting to some that State and local income taxes should be treated less favorably than other types of taxes. Finally, it can be argued that income taxes pay for governmental services that benefit individuals in their capacities as consumers as well as income producers.

Real property taxes

Allowing a deduction for real property taxes may tend to favor homeowners in comparison to renters (although this depends in part on the extent to which the benefit "flows through" to renters in the form of lower rents). It has been argued that this disparity is unfair and that the deduction should accordingly be repealed. However, advocates of retaining the deduction respond that this form of bias is no greater than that implicit in any other type of property tax (e.g., a personal property tax on automobiles).

It has also been argued that repealing the deduction would eliminate certain administrative difficulties. In some cases, it may be unclear whether a real property tax is nondeductible on the ground that it pays for specific services (e.g., water or sewer services) furnished to property owners. Additional determinations are also necessary when taxpayers seek to prepay real property taxes, or when real property is sold during a taxable year, and the deduction must be apportioned between the former and new owners.

In support of preserving the deductibility of real property taxes, it has been argued that the deduction is an important incentive for home ownership (similar to permitting home mortgage interest to be deducted). Accordingly, some have suggested retaining the deduction solely with respect to the principal residence of the taxpayer. It is also argued that, under current State and local government practice, real property taxes are important in financing public education. Further, since States presumably could switch to other forms of financing education if this deduction, but not deductions for other types of State and local taxes, were repealed, the revenue gain from such a proposal might be significantly less than predicted, and repealing the deduction could be seen as unduly interfering with State and local decisions as to what type of tax is most appropriate.

Sales taxes

The deduction for sales taxes can involve the greatest recordkeeping burden of the itemized deductions for State and local taxes. To alleviate this potential problem, taxpayers are permitted to claim deductions derived from IRS-published tables which contain State-by-State estimates of liability. It can be argued that these tables do not necessarily provide accurate estimates for taxpayers with either unusually low or high levels of consumption, and that, accordingly, the deductions claimed may vary significantly from actual sales taxes paid and should not be allowed. Further, because deductions under the tables may bear so little relationship to actual tax liability, repeal of the deduction might have little effect on the States' willingness to use general sales taxes.

A second argument that can be made in favor of repealing the deduction for sales taxes is that the present rule allowing the deduction creates definitional difficulties. Sales taxes are deductible only if they are general and broadly applicable; nonetheless, some distinctions between different types of sale items are still viewed as consistent with deductibility. Thus, it can be difficult to determine whether a particular sales tax is properly deductible. Repeal would eliminate this source of confusion.

Further, it can be argued that present law creates irrational disparities by not allowing consumers any deduction for taxes levied partly at the wholesale or manufacturers' level, even though these taxes may have the same effect as a retail tax on the price level.

Finally, sales taxes can be viewed as voluntary costs of purchasing the items to which the taxes apply, and thus as inequitably favoring taxpayers with particular consumption patterns.

On the other hand, advocates of retaining the deduction for sales taxes note that this type of tax has traditionally been regarded as the unique province of State and local governments (in contrast to income taxes, which are also imposed at the Federal level). For example, the 1984 Treasury Report argued against imposing a sales or value-added tax at the Federal level, in part on the ground that the Federal Government should not compete with State and local governments in this field. This policy would arguably be undermined by extending comparatively unfavorable Federal tax consequences to State and local sales taxes.

Personal property taxes

It has been argued that allowing personal property taxes to be deducted likewise involves undue administrative difficulty. For example, difficulty can arise in determining the amount and deductibility of certain automobile registration fees (currently deductible if based on value). In addition, the deduction for personal property taxes may discriminate against States which impose nondeductible automobile registration fees (e.g., fees that are flat or that vary with weight rather than value). Moreover, as with sales taxes, it can be argued that the deduction reduces equity by favoring taxpayers with particular consumption patterns.

On the other hand, it has been argued that personal property taxes should be treated no less favorably than real property taxes. Allowing a deduction for the latter tends to favor homeowners in comparison to renters, and it has accordingly been argued that deductions for the former (which may benefit renters as well) should also be allowed. Also, disallowing deductibility for personal property taxes could influence the relative degree to which State and local governments utilize such taxes.

Applying a ceiling on the deduction

One alternative to repealing State and local tax deductions in full would be to place a ceiling on the allowable itemized deduction for State and local taxes. This ceiling could be expressed either as an absolute dollar amount or as a percentage of the taxpayer's adjusted gross income (AGI). Amounts above the ceiling would not be deductible.

A ceiling would lessen the effect of the State and local tax deduction in reducing the cost of State and local taxes above the ceiling and in thus favoring upper-income taxpayers and those in high-tax States and localities. The use of a ceiling could be viewed as distinguishing between necessary and voluntary levels of State and local taxation, and permitting only the former to be deducted. However, it would be difficult to structure a ceiling that actually bore any close relationship to this distinction, even assuming agreement about what types of expenditures should be viewed as necessary. Finally, the greatest effect of a ceiling in reducing the tendency of the State and local tax deduction to produce a greater subsidy for high-income taxpayers would be achieved if it were structured in terms of an absolute dollar amount, since a ceiling expressed as a percentage of AGI would permit more affluent taxpayers to claim larger deductions.

Applying a floor to the deductions

Another alternative would be to allow State and local taxes to be deducted only to the extent in excess of a floor. The floor could be expressed either in dollar terms or as a percentage of AGI.

Application of a floor would broaden the tax base since it would deny a portion of the State and local tax deduction. At the same time, to the extent that the floor was sufficiently low to permit most individuals to qualify for some deduction, a floor would continue to allow larger deductions for individuals in high-tax States and localities. A floor could also tend to benefit high-income individuals, since they might be more likely to exceed it (particularly if it was expressed in dollar terms rather than as a percentage of AGI).

Under present law, floors are applied to deductions for medical expenses (allowed only to the extent in excess of five percent of AGI) and casualty losses (allowed only to the extent in excess of 10 percent of AGI). The rationale generally advanced for applying a floor is that, even if the expenditure to which it applies is generally a personal expense that should not be deductible, some relief should be provided for individuals who (in some cases, involuntarily) incur unusually high expenses that significantly impair the ability to pay taxes. Presumably, a floor for the State and local tax deduction could be based on a similar rationale, especially if a high tax burden were viewed as partially due to factors beyond the control of the State or local government and its citizens (e.g., a high concentration of the poor or a lack of natural resources that can be used to generate tax revenues).

Percentage disallowance

The deduction could be limited to a specified percentage of State and local tax liabilities. Such a rule could be advanced as a means of compromising on the issue, reflecting both the adverse revenue consequences of retaining the deduction in full, and the view that State and local taxes may serve a variety of purposes only some of which properly give rise to a deduction. Such a proposal would reduce the subsidy effects of the deduction uniformly, without regard to the overall level of taxes in a jurisdiction (although individuals with higher State and local tax liabilities might be more likely to itemize). The Administration has similarly proposed to allow business meal expenses above a dollar ceiling to be deducted only in part (i.e., 50 percent), presumably based on the notion that the expenses reflect a mix of business and personal aspects.

Allowing the deduction only against the lowest tax rate; converting deduction to a credit

Under the Bradley-Gephardt bill, all taxable income would be taxed at a 14-percent base tax rate. The plan would also levy a surtax on adjusted gross income above certain levels. To eliminate the greater proportionate benefit that each dollar of deduction confers on taxpayers in higher brackets, the bill would allow deductions for State and local taxes (along with other itemized deductions) only against taxable income taxed at the 14-percent rate, and not against adjusted gross income, which would be subject to the surtax. Such a provision would avoid the conferral of greater relative benefits on taxpayers in higher tax brackets.

Similar results could be derived by converting the deduction into a credit. For example, under the Bradley-Gephardt bill, allowance of a credit equal to 14 percent of qualifying State and local taxes paid would yield the same general result as allowance of a deduction against the 14-percent rate.

D. Deduction for Nonbusiness Interest

Present Law and Background

General present-law rules

Interest paid or accrued by an individual is deductible (sec. 163). Interest arising from indebtedness incurred in a trade or business (other than the performance of services as an employee) or in the production of rental or royalty income is deductible "above the line" in computing adjusted gross income. Other interest is deductible as an itemized deduction. Thus, an individual who itemizes may deduct interest on a mortgage loan on the individual's principal residence, a mortgage loan on the individual's vacation home, a car loan, a typical credit card balance, or other consumption borrowing.

Present-law limitations

Under present law (sec. 163(d)), an individual generally may not deduct interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment to the extent that such interest exceeds the sum of (i) the individual's net investment income (which does not include long-term capital gains), (ii) certain expenses incurred relating to net leases, and (iii) $10,000 ($5,000 if the individual is married and filing separately). Amounts disallowed under this limitation are treated as interest expense incurred in the following year and are subject to the same limitation.

In addition, for purposes of the alternative minimum tax for individuals under present law, interest on any indebtedness relating to qualified housing (which generally includes both principal residences and second homes) generally is deductible without limitation; other nonbusiness interest is deductible to the extent of the taxpayer's net investment income. For this purpose, net investment income includes the taxable portion of long-term capital gains on property held for investment. Present law also disallows deductions for interest on indebtedness incurred or continued by an individual to purchase or carry tax-exempt bonds to the extent that interest on such bonds is excluded from income (sec. 265(2)).

Background on deduction

Itemized deductions totaling $132.5 billion were claimed for interest on 31.7 million tax returns for 1983, or 89.9 percent of all returns filed by itemizers. Approximately 66.6 percent of these deductions were for mortgage interest on principal residences and other homes, and the remaining 33.4 percent were for interest on other loans.

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Administration Proposal

In general

The Administration proposal would limit an individual's ability to deduct interest other than interest on indebtedness incurred in an individual's trade or business or indebtedness on a mortgage on the individual's principal residence (up to the amount of its fair market value). For this purpose, indebtedness incurred by a partnership or S corporation would be treated as nonbusiness interest to the limited partners or the S corporation shareholders who do not actively manage the enterprise.

Subject to two "phase-in" rules, the deductibility of interest on nonbusiness indebtedness (other than a mortgage loan on the individual's principal residence, as discussed above) would be subject to limitations similar to the present-law limitations on the deductibility of "investment interest." Consequently, under the Administration proposal, interest on indebtedness incurred to purchase a second home, an automobile, or other consumer goods would be subject to the same limitation as interest incurred to purchase investment property; i.e., there would be no distinction between investment interest and consumer interest.

To illustrate, assume that an individual pays interest during a year as follows:

—$9,000 of interest on a mortgage on his principal residence;

—$1,200 of interest on a car loan;

—$700 of credit card interest; and

—$4,000 of interest on margin loans that were used in part to purchase common stock and bonds that produce interest and dividend income of $10,000.

Under present law, the individual would be entitled to itemized deductions for all of his interest expense totaling $14,900. The limitations under present law would not apply, since the individual's investment interest ($4,000) does not exceed his investment income plus $10,000 ($20,000). Under the Administration proposal (as fully phased in), the full $14,900 likewise would be deductible, since the individual's total nonbusiness interest other than the home mortgage interest ($5,900) does not exceed his investment income plus $5,000 ($15,000).

In contrast, assume that an individual pays interest as follows during a year:

—$15,000 of interest on a mortgage loan on her principal residence;

—$2,800 of interest on a car loan;

—$1,800 of credit card interest;

—$6,500 of interest on a loan used to purchase a vacation home; and

—$8,000 of interest on margin loans that were used in part to purchase common stocks and corporate bonds that produce dividend and interest income of $17,000. In addition, assume the individual has interest expense equal to $10,000 attributable to her limited partnership share.

Under present law, the individual in this example may deduct her entire interest expense equal to $44,100. Under the Administration proposal (as fully phased in), the deduction would be limited to

$37,000, since the individual's nonbusiness interest other than the home mortgage interest ($29,100) exceeds her investment income plus $5,000 ($22,000) by $7,100. The $7,100 not allowed in the current year would be treated as interest incurred by the individual in the following year.

Effective date; phase-in rules

Subject to two phase-in rules, the Administration proposal generally would apply to interest that is paid or accrued on indebtedness in taxable years beginning after December 31, 1985.

Under the first phase-in rule, for taxable years beginning after December 31, 1987, the amount of interest subject to the limitation that is deductible in excess of net investment income (plus applicable net lease expenses) would be reduced to $5,000 from the present-law figure of $10,000.

Under the second phase-in rule, the amount of interest that is treated as subject to the limitation would be the sum of interest that is subject to the limitation under current law plus a percentage of the taxpayer's other interest that would be subject to limitations because of the proposed changes, as described above. The percentage would be ten percent in the first taxable year beginning on or after January 1, 1986, and would be increased by ten percentage points in each of the nine subsequent taxable years.

The Administration proposal would apply to interest on indebtedness that is paid or accrued in taxable years beginning after December 31, 1985, without regard to the time at which the indebtedness was incurred. Thus, for example, subject to the phase-in rule, the limitation would apply to interest on a vacation home mortgage incurred in taxable years beginning before January 1, 1986.

Other Proposals

Alternative restrictions on interest

The House-passed version of the Tax Reform Act of 1976 (H.R. 10612, 89th Cong.) contained a provision that would have limited an individual's deduction for interest—including interest on debt incurred in the purchase of a principal residence—other than interest on indebtedness incurred in a trade or business. Under that provision, an individual would have been entitled to deduct interest on nonbusiness indebtedness to the extent of the sum of the individual's (1) net investment income, (2) the individual's long-term capital gains, and (3) $12,000. Any investment interest (but not consumer interest) that was not currently deductible on account of this limitation would have been treated as paid in the next year.

If a proposal similar to the Administration proposal is adopted, a possible modification could be to limit the deductibility of interest on a home mortgage to the interest on an original purchase money mortgage, or to the interest on a refinanced mortgage to the extent that the refinanced principal does not exceed the outstanding principal balance of the purchase money mortgage at the time of the refinancing.[19] Alternatively, an unlimited deduction could be pro-

[19] A similar rule applies under the present law alternative minimum tax for individuals.

vided for interest on home mortgage loans regardless of whether the loans have been refinanced, but not in excess of the interest on the original purchase price (basis) of the home. In conjunction with limitations based on the principal amount of a refinanced mortgage, the limitations on the amount of interest that may be deducted without limitation could be implemented based on the amount of interest payable on the appropriate principal amount, either at the rate on the original mortgage, the rate on the refinanced mortgage, the lower of the two, or the higher of the two.

If a taxpayer sells an old residence and purchases a new one in a transaction qualifying for nonrecognition of gain under section 1034, the principal amount of the mortgage on the new residence on which interest may be deducted without limitation could be limited based either on the amount of equity in the old residence, or on the amount of gain on the sale of the old residence that is not invested in the new residence. For example, assume a taxpayer purchased a $100,000 home with a $10,000 downpayment and a $90,000 mortgage. When the outstanding principal balance of the mortgage is $80,000, the taxpayer sells his home for $150,000 and purchases a new home for $180,000. Under the limitation based on the amount of equity in the old residence, the taxpayer would be permitted to deduct interest without limitation on a mortgage on the new residence up to a principal amount of $110,000 (i.e., $180,000 minus $70,000 equity). Alternatively, if the limitation were based on the amount of gain on the sale of the residence, the interest would be fully deductible up to a principal amount of $130,000 (i.e., $180,000 minus $50,000 gain).

The limitation based on the taxpayer's equity would be appropriate in conjunction with the limitation discussed above that would permit a taxpayer to deduct without limitation interest on an original purchase money mortgage or on refinanced mortgages to the extent of the outstanding principal amount of the purchase money mortgage. The limitation based on the amount of the taxpayer's gain would be appropriate in conjunction with the limitation discussed above that would permit a taxpayer to deduct without limitation interest on a mortgage on a principal residence up to the amount of the taxpayer's basis. Either limitation—whether based on the taxpayer's equity or gain—would be inconsistent with the Administration proposal, however, since neither, in effect, permits a taxpayer to borrow against the appreciation in the home while still residing in the home or upon its sale.

Alternative transitional rule

As an alternative to the second of the phase-in rules in the Administration proposal (relating to the 10-percent increments), a possible transitional rule could continue to treat all interest on indebtedness incurred on or before the date of committee action under the rules of prior law, and to treat interest incurred after that date as fully subject to the new limitations adopted by the committee. This was the approach adopted in the House version of the 1976 Reform Act. Adopting this approach would require the determination of how to treat refinancings, extensions, and renewals of existing debt.

Alternate definition of investment income

Investment income, for purposes of defining the limitations on interest deductions, could include the taxable portion of long-term capital gain, as does the present provision limiting the interest deduction allowed under the alternative minimum tax.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill also contains provisions that would limit itemized interest deductions for individuals. Under the bill, an individual could deduct without limitation nonbusiness interest relating to the acquisition, construction or rehabilitation of residential property that is the individual's principal residence or any other residence used by the individual or the individual's family, and also could deduct other deductible nonbusiness interest to the extent of the individual's net investment income. To the extent that a taxpayer's total nonbusiness interest (including qualified housing interest) exceeded his net investment, the excess would not be deductible in determining the so-called surtax under the bill; i.e., the excess would be deductible only at the lowest (14 percent) bracket provided by the bill.

In addition, if an individual incurred interest expense relating to an interest in a limited partnership, a net lease, or an S corporation in which the individual does not actively participate in the management, the amount of such interest expense that is deductible in determining the individual's adjusted gross income would be limited to the income derived from the related activities. The excess, if any, would be deductible as nonbusiness interest subject to the limitations described above.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would deny to individuals all interest deductions on indebtedness related to consumption goods with the exception of indebtedness the proceeds of which were used by the taxpayer either to acquire, construct, or rehabilitate residential property or to pay education expenses of the taxpayer, the taxpayer's spouse or any of the taxpayer's dependents. The bill would retain present law with respect to interest on indebtedness relating to trade or business or investment assets.

S. 411 and H.R. 373 (Roth-Moore)

The Roth-Moore bill would deny to individuals all deductions for interest other than interest on indebtedness incurred in a trade or business or indebtedness incurred to acquire, construct or substantially rehabilitate residential property that is either the individual's principal residence or any other residence used by the individual or members of the individual's family. Thus, under the bill, interest on indebtedness incurred to acquire investment assets would not be deductible.

Analysis [20]

In general

From a theoretical viewpoint, present law excludes or mismeasures certain important sources of investment income. Owner-occupied housing and consumer durables, for example, provide imputed returns to their purchasers, since the purchasers avoid the rental costs of obtaining the use of such property. Similarly, certain types of investments produce a high proportion of their return in forms such as capital gains that are taxed at preferential rates; since capital gains are generally taxed only when realized, recognition of the income may be substantially deferred as well.

The present-law limitations on the deductibility of interest seek to deal with one aspect of the problems that result from this exclusion or mismeasurement of income, by preventing differences in timing and character of deductions arising from interest on indebtedness and the income that is related to that indebtedness. Thus, the present-law limitations on deducting investment interest are intended to prevent the current deduction of interest on indebtedness where income attributable to an asset purchased in whole or in part with the proceeds of such indebtedness is deferred or may be converted to capital gains.

The Administration proposal recognizes that under present law, a purchase with borrowed funds of an item such as a vacation home results in (1) the current deduction of interest expense without any current inclusion of imputed rental value, and (2) the deferral and conversion to capital gain income of any gain resulting from an increase in value in the property.

The most direct methods for dealing with the exclusion and mismeasurement of income, such as including imputed rent in a homeowner's gross income or taxing capital gains on an accrual basis, have been considered to be unfeasible. Limitations on interest deductions associated with such income are not a perfect substitute for the more direct changes, since they may not affect some beneficiaries of the measurement choices and may affect some individuals whose borrowing is not in any way associated with the mismeasurement of income.

For example, consider an individual whose investment in a consumer durable is totally financed by equity. From a theoretical point of view, the same amount of imputed rent should be included in his income as for an individual whose investment is financed by debt. Yet an interest limitation affects only the person who finances with debt without having sufficient investment income to permit the deduction of interest. Thus, from a perspective of correct income measurement, the proposal potentially creates a disparity in tax treatment between individuals who enjoy the same use of a consumer durable but have different amounts of net worth, although it reduces some disparity between an individual who finances with debt and is able under present law to deduct the interest and one who rents the consumer durable using after-tax income.

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[20] *See also* the discussion in Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985, Part III.

In addition, an interest limitation may affect some individuals who do not benefit in any way from mismeasurement of income. For example, an individual who chooses a business or occupation which is generally profitable, but in which income fluctuates from year to year, may need to borrow to make consumption more even than income. Such an individual's interest deductions could be restricted under the Administration proposal, however, since the business or employment income is not considered investment income which is allowed to increase the limitation on the interest deduction.

In spite of these problems, however, it is argued that interest deductions in excess of investment income occur most frequently for individuals who benefit from the mismeasurement of income, and that the borrowing needs of persons whose income fluctuates are accommodated by the provision that allows the deduction of $5,000 of nonbusiness interest in excess of interest on a home mortgage. Moreover, the interest deduction limitation is needed for both equity and efficiency reasons, to prevent higher-income taxpayers from exacerbating tax shelter opportunities by using a high degree of leverage.

Further, the limitation has an independent justification as a savings incentive. By restricting the tax advantages of borrowing, it arguably should decrease borrowing and thereby increase aggregate saving. For taxpayers affected by the limit, each additional dollar of investment income is, in effect, tax-free, since an additional dollar of interest deduction is allowed. Accordingly, for such taxpayers, the marginal tax rate on investment income would be zero and they would have a greater incentive to save and invest than taxpayers who would be subject to tax on investment earnings.

Home mortgages

The same arguments that are made for limiting the deduction for interest on indebtedness incurred to purchase a vacation home, automobile, or other consumer goods may be made with respect to interest on a home mortgage. The Administration proposal recognizes, however, that so extending the limitations could significantly reduce incentives for home ownership. Accordingly, the proposal would not affect the deductibility of interest on a mortgage loan that is used to purchase a home that is the taxpayer's principal residence.

Certain issues arise from the requirement under the proposal that taxpayers make an annual determination of their principal residence. For example, if a husband and wife live separately and thus maintain two principal residences, it may be appropriate to treat interest on mortgages on each of the residences as fully deductible. Alternatively, the couple may be allowed to treat only one home as a principal residence for this purpose, but could be permitted to elect which of the two homes would qualify. Where the parties file separate returns, determining which residence qualifies as the principal residence could present difficult administrative problems.

Similar issues arise for individuals who divide their time more or less equally between two homes, i.e., where the second residence may not fairly be said to be a vacation home. Where the indebtedness on both homes equals the indebtedness on one home of a taxpayer not so dividing his or her time, the tax law would treat the taxpayers who may be said to be in similar circumstances substantially differently.

Also, if interest deductions are not allowed on vacation homes used by their owners, but full interest deductions and accelerated cost recovery methods are allowed to lessors where the lessee uses the property as a vacation home, there may be an incentive to convert vacation homes from owner-occupied to rental.

Tracing loan proceeds

Under the Administration proposal, an individual who has purchased a home and has paid off all or part of the mortgage, or an individual whose home has appreciated in value, may (notwithstanding already having achieved home ownership) borrow additional money using the home as collateral and then use the money for any other purpose, including the purchase of a vacation home or investment asset. The proposal does not provide that such borrowing would be subject to the limits on the deductibility of interest. Likewise, the same result probably could be achieved if the taxpayer has trade or business assets to borrow against, since it is difficult to trace the actual uses of borrowed funds. An individual who had neither a home that had appreciated in value nor any trade or business assets against which to borrow might be unable to deduct interest on loans, the proceeds of which were likewise used for other purposes.

Ultimately, a taxpayer's income and wealth is affected only by the total amount borrowed, regardless of the collateral offered for the borrowing. Thus, a taxpayer is generally indifferent between an additional mortgage of a given amount on the taxpayer's principal residence or an identical mortgage of the same amount on her vacation home. This reflects the fact that money is, in effect, fungible. As a result, to the extent taxpayers can borrow against their homes or against trade or business assets, the rules of the Administration proposal intended to promote home ownership could be used to avoid the proposed limitations.[21]

Alternative proposals limiting the treatment of interest to interest on purchase money debt on a principal residence or to a fixed dollar limit would substantially address the fungibility issue without impeding the ability of individuals to purchase homes. If a fixed dollar limit were adopted, an exception could be provided to the extent interest on a purchase money home mortgage exceeded that limit. Under such an approach, however, individuals could increase their deductible interest simply by selling an old house in which they had substantial equity and buying a new house subject to a larger loan. This could introduce a tax incentive for "churning" houses.

If such a result were viewed as undesirable, then a rule could be constructed which treated interest as subject to limitation if attrib-

[21] In addition, administrative difficulties could arise under the Administration proposal regarding the fair market value of a residence where the taxpayer has used the residence as collateral for additional loans. A creditor willing to lend on an unsecured basis also may be willing to lend on a secured basis even if there is insufficient value in the residence to secure a loan adequately.

utable to indebtedness allocable to equity in or capital gain on the old house, as discussed above. Either such alternative would permit a taxpayer to borrow an amount of money equal to the sum of the amount that could be borrowed upon refinancing the mortgage without selling the home plus the additional money needed to purchase the new home. Accordingly, since any additional borrowing would necessarily have to be invested in the new home, there would be no incentive to "churn" simply to increase the amount of borrowing available for consumer goods.

If such alternative approaches were not employed, strict tracing rules may be appropriate in order to prevent avoidance of the limitations by additional borrowing against a home (or trade or business assets) and use of the proceeds to purchase consumer goods. Such tracing rules could be difficult to administer in practice. A related compliance issue arises with respect to situations where taxpayers might, instead of purchasing a vacation home for personal use, purchase a vacation home for purposes of collecting rent while renting a substantially identical vacation home for personal use.

Problems of complexity and administrability that result from distinguishing between indebtedness on a principal residence and other indebtedness could be minimized by adopting a proposal that limited the deductibility of nonbusiness interest to a fixed dollar amount plus investment income. Such a proposal passed the House of Representatives in 1975. Since the proposal would limit the deductibility of all nonbusiness indebtedness, it could affect incentives to purchase a principal residence. The dollar limit could be set high enough, however, to affect relatively few taxpayers.

Definition of investment income

As discussed above, a principal rationale for limitations on interest deductions is to correct the mismatching of interest expense and related investment income, which may be capital gain income. Under the Administration proposal, long-term capital gains are not included in the definition of investment income. It is possible, therefore, that interest on indebtedness used to purchase an investment asset that produces only capital gain income would never be deductible. Accordingly, assuming that no cutback in the preferential treatment of capital gains is desired, one approach would be to include the taxable portion of long-term capital gains in the definition of investment income for purposes of the limitation.

Definition of interest not subject to limitation

The limitation in the Administration proposal would not apply to interest incurred in connection with a trade or business, other than interest allocable to a limited partner or a passive shareholder of an S corporation. It can be argued that the proposed dividing line between interest which is or is not subject to the limitation is neither clear nor logical. Indeed, it has been argued that all interest expense should be deductible in a normative income tax system, since interest paid reflects a reduction in income available for the consumption of goods and services.

Even if the tracing problems discussed in the above section can be solved, a determination of whether interest is subject to limitation depends on whether the activity to which the corresponding debt can be traced is a trade or business. In many cases, this determination is difficult to make. Taxpayers would have an incentive to adopt broad definitions of trade or business for purposes of filing their tax return.

If taxpayers tended to interpret trade or business broadly, the interest deduction limitation proposal would produce very different results in two very similar cases—one in which the taxpayer owns real estate directly and pays other individuals for all required services, and another case in which the taxpayer is a limited partner in a partnership owning real estate. This difference in results between these two very similar cases may be viewed as inequitable.

The disparity noted in the previous paragraph could be reduced by requiring that the taxpayer actively participate in any activity in order to avoid limitations on the deductibility of interest traceable to that activity. If desired, the definitions currently applicable to the self-employment tax could be used. Use of this definition would treat interest allocable to most real estate activity as subject to limitations, unless the taxpayer were actively providing services in connection with the activity, such as in the role of a dealer or hotel manager.

It can be argued, however, that the need to draw such difficult and arbitrary lines among activities is indicative of inherent problems with the provision. Whether or not a taxpayer participates in an activity arguably has little to do with the income measurement problems that supporters suggest is one of the principal rationales of the proposal. Certain sources of income are measured just as poorly whether or not the taxpayer actively participates in the activity generating the income. If limiting deductions for taxpayers with passive roles in investment activities is one of the more important reasons for considering the interest limitation, then perhaps it would be appropriate also to consider a more comprehensive limitation on all deductions, not just interest, attributable to such passive investment activities.

E. Charitable Contribution Deductions for Itemizers and Nonitemizers

Present Law and Background

Background on deduction

In general

Extent of giving.—In 1984, charitable giving in the United States by individuals, foundations, and corporations, and through bequests, totaled $74.25 billion, an increase of 11.1 percent over 1983.[22] Gifts by individuals, comprising 83 percent of that total, increased by more than 11 percent to $61.55 billion. These contributions from individuals constituted 2.04 percent of personal income for 1984, the highest percentage in more than 15 years. Corporate giving rose 7.8 percent to $3.45 billion.

Religious organizations received $35.56 billion, or almost half (48 percent) of total giving. The approximate share received by hospitals and health agencies was 14 percent; education, 13.5 percent; social service organizations, 11 percent; and the arts and humanities, 6.2 percent.

Deduction for itemizers.—Itemized deductions for charitable contributions totaling $37.5 billion were claimed on some 32.1 million returns for 1983, or about 91 percent of the returns filed by itemizers. Approximately 7.9 million returns included deductions claimed for noncash contributions. The total reduction in budget receipts attributable to the itemized charitable deduction is estimated at $12.2 billion for fiscal year 1986.

Deduction for nonitemizers.—Nonitemized deductions for charitable contributions totaling $0.4 billion were claimed on some 19.3 million returns for 1982 (when the maximum deduction was $25), or about 20 percent of the returns filed by nonitemizers. The total reduction in budget receipts attributable to the charitable deduction for nonitemizers is estimated at $1.5 billion for fiscal year 1986.

Itemized deduction

Since 1917, the Federal income tax law has allowed an itemized deduction for contributions of cash or property to or for the use of religious, charitable, educational, or scientific organizations or certain other qualified donees. Unlike the itemized deductions for medical expenses and casualty losses, the charitable deduction is not subject to a floor (either a percentage or dollar floor) below which no deduction is allowed.

[22] Data for 1984 is estimated. Source: American Assoc. of Fund-Raising Counsel, *Giving USA* (1985).

In the case of donations of appreciated property such as securities, real estate, or art objects, a complex set of rules applies to determine whether the amount of the contribution equals the property's basis (generally, the donor's cost), the basis plus an amount of appreciation, or the full fair market value on the contribution date. This determination depends in part on (1) classification of the donated item as capital-gain property or ordinary-income property, (2) the status of the donee as a public charity, private operating foundation, or private nonoperating foundation, (3) the nature of the transfer, i.e., whether outright or in trust, and whether whole or in part, and (4) in the case of a contribution of tangible personal property, whether the donee will use the property directly in connection with its exempt functions. In light of concerns about inflated valuations of donated property, the Deficit Reduction Act of 1984 (the 1984 Act) required donors to obtain an independent appraisal by a qualified appraiser as a condition for deducting contributions of certain property exceeding $5,000 in claimed value.

The total dollar amount deductible in a year, whether for contributions of cash or property, is subject to a three-tiered system of limitations based on a percentage of the donor's adjusted gross income (AGI). The applicable limitations depend on the type of donation (cash or appreciated property) and on the type of donee (e.g., public charity or private nonoperating foundation). Contributions in excess of the applicable percentage limitations may be carried forward for five years.

Deduction for nonitemizers

The Economic Recovery Tax Act of 1981 (ERTA) enacted a deduction for charitable contributions made by individuals who do not itemize deductions on their returns, to be phased in over a five-year period and then terminated after 1986. For 1985, nonitemizers may deduct 50 percent of their charitable contributions; for 1986, the full amount may be deducted. (In 1982 and 1983, the maximum nonitemizer deduction was $25; in 1984, the maximum was $75.) The deduction for nonitemizers is subject to the tax rules generally applicable to charitable deductions, including the rule that no deduction is allowable unless the contribution is substantiated as required by Treasury regulations.

Generally applicable deduction rules

Percentage limitations

Cash and ordinary-income property.—Under Code section 170, contributions of cash or ordinary-income property[23] by an individual to public charities[24] or private operating foundations[25] are de-

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[23] The term "ordinary-income" property is commonly used in this context to refer to property other than "capital-gain property." The latter term is commonly used in this context to refer to property all the gain on which would have been long-term capital gain if the property had been sold by the taxpayer at its fair market value on the date of contribution, such as stock held by an individual for more than six months before contribution.

[24] The term "public charity" is commonly used to refer to a tax-exempt charitable, etc. organization described in sec. 501(c)(3) other than a private foundation as defined in sec. 509.

[25] In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation that expends directly for the active conduct of its exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value

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ductible up to 50 percent of the donor's contribution base for the year (AGI, with certain modifications). The 50-percent limitation applies to contributions of cash or ordinary-income property made by individuals to a private nonoperating (grantmaking) foundation only if the donee either redistributes all contributions within a specified period after receipt or qualifies as a "pooled fund" foundation. Under a change made by the 1984 Act, contributions of cash or ordinary-income property to other private nonoperating foundations or certain other donees[26] are deductible up to 30 percent of the donor's contribution base (rather than up to 20 percent as under prior law).

Capital-gain property.—In general, a 30-percent limitation applies to contributions of appreciated capital-gain property made to public charities, private operating foundations, or the two special types of nonoperating foundations eligible for the 50-percent limitation in the case of cash gifts. All other contributions of capital-gain property are deductible only up to the lesser of (1) 20 percent of the donor's contribution base or (2) the extent to which the aggregate of gifts to public charities or other 50-percent donees (including gifts of appreciated property, computed without regard to the 30-percent limitation) is less than 50 percent of the contribution base. For example, charitable contributions of capital-gain property to private nonoperating foundations (other than the two special types eligible for the 50-percent limitation in the case of cash gifts), including donations of certain qualified appreciated stock that are deductible under the 1984 Act at fair market value, are subject to the 20-percent limitation.

Notwithstanding the general 30-percent limitation on gifts of appreciated capital-gain property to public charities and certain other donees, the donor may elect to bring all such gifts for a year within the 50-percent limitation category by treating the amount of the contribution as equal to the basis of the donated property plus 60 percent of the unrealized appreciation.

Carryover of excess contributions.—Charitable contributions by individuals which exceed an applicable percentage limitation may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years.

Contributions of appreciated capital-gain property

In the case of charitable contributions of capital-gain property to public charities, private operating foundations, and the two special types of private nonoperating foundations where the 30-percent limitation applies, the amount of the deduction generally equals the asset's fair market value at the time of the contribution, including the amount of unrealized appreciation. The donor is not subject to the tax (at capital gain rates) that would have been due had the appreciation been realized.

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of its investment assets). Also, to qualify as an operating foundation, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support.

[26] The other donees to which the 30-percent limitation for cash contributions applies are (a) certain organizations of war veterans and their auxiliary units, (b) certain fraternal organizations operating under the lodge system, if the gift is used exclusively for certain exempt purposes, and (c) certain nonprofit cemetery companies; also, cash contributions made for the use of (rather than made to) charitable organizations are subject to this rule.

Under a provision of the 1984 Act, the amount of deduction allowable for charitable contributions to private nonoperating foundations of certain qualified stock (that constitutes capital-gain property) is the full fair market value of the stock on the date of contribution; this rule applies for contributions made through 1994. In the case of donations by individuals of any other type of capital-gain property to private nonoperating foundations as to which the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation (i.e., by 40 percent of the amount by which the value exceeded the donor's basis in the donated property).

A special reduction rule applies to "unrelated-use" contributions of appreciated tangible personal property (such as art, antiques, stamp collections, etc.) that otherwise would be deductible at fair market value. Unless the donee's use of the property is directly related to its exempt function (e.g., when a painting is donated to a museum for exhibition), the deduction equals the fair market value reduced by 40 percent of the unrealized appreciation.

Contributions of appreciated ordinary-income property

In general, the amount of a charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution. Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value.[27] In the case of property used in the taxpayer's trade or business (sec. 1231), the charitable deduction must be reduced by the amount of depreciation recapture which would be recognized on sale of the donated property.

Other rules

Other statutory rules applicable to charitable deductions include provisions relating to bargain sales, gifts in trust, gifts of remainder or other partial interests in property, split-interest trusts, pooled income funds, and contributions by trusts or estates.

Deduction for nonitemizers

The Economic Recovery Tax Act of 1981 enacted a deduction for charitable contributions made by individuals who do not itemize deductions on their income tax returns, to be phased in over a five-year period and then terminated after 1986.

Under the phase-in, for taxable years beginning in 1982–1984, the amount of contributions which nonitemizers were allowed to take into account was subject to a dollar cap; in addition, for the years 1982-1985, only a portion of the amount of contributions oth-

[27] Under special rules, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences, or for donations of certain types of ordinary-income property to be used for the care of the needy, the ill, or infants (sec. 170(e)(3),(4)).

erwise deductible is allowed as a deduction for nonitemizers. These percentages and dollar caps are shown in the following table:

Year contribution made	Percentage	Contribution cap
1982	25	$100
1983	25	100
1984	25	300
1985	50	None
1986	100	None

Thus, in 1982 and 1983, nonitemizers were allowed to deduct 25 percent of the first $100 of charitable contributions, for a maximum deduction of $25. For 1984, the maximum deduction was $75 (25 percent of a $300 contribution cap).

For 1985 and 1986, nonitemizers may deduct 50 and 100 percent of their charitable contributions, respectively, without regard to a contribution cap (other than the general percentage limitations, described above). Under present law, no deduction is to be allowed for charitable contributions by nonitemizers made after December 31, 1986.

Substantiation requirements

The Code provides expressly that a charitable contribution is deductible only if verified in the manner required by Treasury regulations. Pursuant to this statutory rule, certain substantiation requirements have been set forth in regulations, including additional information that must be attached to the donor's return in the case of donations of property for which a deduction exceeding $500 is claimed.

The 1984 Act provided that no deduction is allowable for contributions by individuals of property, other than certain publicly listed securities, having a claimed value exceeding $5,000 ($10,000 in the case of certain stock) unless the donor obtains an independent appraisal by a qualified appraiser and attaches a summary of the appraisal to the return. In addition, the Act requires that if a donee charity disposes of such property within two years after receipt, the donee must so inform the IRS on an information return. The 1984 Act also strengthened the incorrect valuation penalty (secs. 6659, 6660).

Minimum tax

Under present law, the itemized deduction for charitable contributions is allowed as a deduction for purposes of the alternative minimum tax on individuals.

Administration Proposal

Appreciated property

The Administration proposal would not modify the present-law income tax rules generally allowing individuals to deduct the amount of untaxed appreciation in capital-gain property donated to public charities or certain other donees, but would treat such unrealized appreciation as a preference item for purposes of the alternative minimum tax on individuals.

For individuals subject to the alternative minimum tax, the Administration proposal has the same effect as limiting the charitable deduction—for minimum tax purposes only—to the donor's basis in the property.[28] (For example, if a donor purchased an antique desk in 1970 for $10,000 and donated it in 1987 to a museum which displayed antique furniture, and if the fair market value of the desk on the date of contribution is $33,000, the untaxed appreciation of $23,000 would be a preference item in computing the alternative minimum tax base.) This rule would be effective January 1, 1986.

Deduction for nonitemizers

The Administration proposal would repeal the nonitemizer charitable deduction for contributions made after December 31, 1985, i.e., one year earlier than the scheduled termination of the nonitemizer deduction under present law.

Other Proposals

Floo: under itemized deduction

The 1984 Treasury report proposed that the itemized deduction for charitable contributions would be allowed only to the extent that the total amount of the taxpayer's contributions exceeded a specified percentage of the taxpayer's AGI. The proposed floor was one percent of AGI for contributions made in 1986, and two percent of AGI for contributions made in 1987 and later years. Thus, for example, if in 1987 a taxpayer with AGI of $50,000 made charitable contributions of $2,500, the amount allowable as an itemized deduction under the 1984 Treasury report would be $1,500, i.e., total contributions ($2,500) less two percent of AGI ($1,000).

Allowing deduction only against lowest tax rate

Under the Bradley-Gephardt bill (S. 409; H.R. 800), charitable contributions would be deductible only against taxable income, which would be taxed at a 14-percent rate, but not against adjusted gross income (which would be subject to a surtax of up to an additional 16 percent). In effect, each donor would receive the same tax benefit (14 cents) for one dollar of contribution, regardless of the donor's tax bracket. (This would be the equivalent to allowing a 14-percent tax credit for charitable contributions.)

Appreciated property

Under the 1984 Treasury report, the amount of deduction for charitable contributions of appreciated capital-gain assets made after 1985 would be limited to the property's basis (generally, the donor's cost) as adjusted for inflation between acquisition and contribution.[29] The deduction would be limited to fair market value if

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[28] Similarly, the excess of the allowable deduction over basis would be treated as a preference item under the corporate minimum tax proposed by the Administration.

[29] The 1984 Treasury report also proposed repealing the percentage limitations on the itemized deduction in the case of gifts by individuals to public charities, etc., to which the 50-per-

Continued

that amount was less than the inflation-adjusted basis. As under present law, the donor would not recognize gain or loss on the transfer.

The inflation-adjusted basis would be determined by reference to an IRS-published table of quarterly adjustment factors, based on the Labor Department's Consumer Price Index. For example, if the property had been purchased in the third quarter of 1984 and donated in the first quarter of 1987, the table would be used to find the number by which the donor's cost would be multiplied in order to obtain the inflation-adjusted basis.

An alternative proposal would be to allow a deduction for basis plus the portion of capital gain which would have been excluded from the donor's income if the donated property had been sold at its fair market value on the date of contribution. This would produce a tax result similar to that which occurs if such a sale actually had taken place and the proceeds had been donated to charity.

For example, assume that an individual purchased securities in 1980 for $30,000 and donates them to a public charity in 1988, when the securities had a fair market value of $54,000. If the donor instead had sold the property, $12,000 of the $24,000 gain would have been excluded (assuming adoption of the Administration proposal on capital gains). Under the alternative proposal described in the preceding paragraph, the donor's deduction would equal $42,000, i.e., basis ($30,000) plus the exclusion ($12,000). Similarly, if the donor had sold the property and donated all the cash receipts of $54,000 to charity, the donor's net deduction would be $42,000 ($54,000 less $12,000 of includible gain).

Analysis

Floor under deduction for itemizers

Efficiency of tax incentive

Both the Administration proposal and the 1984 Treasury report would retain an itemized deduction for charitable contributions, presumably reflecting the general belief that private sector support for charitable, educational, religious, and similar activities would be insufficient—in comparison to society's needs—absent Federal tax subsidies. While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the itemized charitable deduction has been a stimulant to charitable giving, at least for higher-income individuals. Accordingly, the philanthropic community and others who believe that the present-law deduction serves a social purpose are concerned about the potential effects of tax reform proposals on the level of giving.

Some who support Federal tax incentives to encourage charitable contributions nonetheless question the structure of the present-law deduction. Thus, some suggest that the deduction is inefficient be-

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cent/30-percent limitations apply under current law. The Treasury Department argued that with enactment of its appreciated property proposal and reduced tax rates, the limitations would no longer be needed to preclude wealthy individuals from substantially eliminating their tax liability through charitable contributions. Also, repeal of the percentage limitations would achieve simplification for donors to public charities.

cause, in addition to stimulating giving, the deduction also is available for donations that would have been made absent any subsidy. Second, like other itemized deductions, the charitable deduction provides greater benefits to higher income individuals than to lower income individuals. Because educational and cultural institutions typically receive more of their support from higher-bracket taxpayers, while lower-bracket individuals tend to target their giving to religious institutions, the structure of the tax benefit may be viewed as having a more favorable impact on universities, museums, etc. than on religious and similar organizations.

The floor proposed in the 1984 Treasury report (two percent of AGI) was intended to address concerns as to the efficiency of the present-law deduction. A principal argument made by the Treasury to support the proposed floor derived from the proposition that tax benefits are not necessary as an incentive for a substantial portion of the donations which would be below the floor; i.e., a substantial portion of the contributions that would become nondeductible under an appropriate floor would nevertheless continue to be made. Therefore, it is argued, allowing the deduction for contributions up to such a floor has the effect of reducing revenues and thereby contributing to the need for higher tax rates overall, without stimulating additional charitable giving.

The Treasury report stated that the tax benefit of the charitable deduction has a low incentive effect for contributions of relatively small amounts and for the "first dollars" of large contributions. For example, cash donations during attendance at religious services, contributions made in response to door-to-door solicitations for medical research and health organizations, annual giving to colleges, and contributions to the needy at holidays may be influenced more by donative desires, community associations, membership in organizations, and the donor's financial status than by expectations of tax benefits. Thus, the proposed floor would be intended to make the subsidy more efficient by seeking to limit tax benefits to those contributions that would not be made absent tax incentives.

The 1984 Treasury report stated that since the median charitable deduction by itemizers is approximately two percent of AGI, the proposed two-percent floor would totally disallow the deduction to about one-half of itemizers who claim charitable deductions under present law. The Treasury report argued that the impact of the proposed floor on the incentive for giving would not be expected to be significant, since the incentive effect of a deduction becomes greater as giving becomes large relative to income. The Treasury estimated that the proposed two-percent floor would increase revenues by about $24 billion over fiscal years 1986–1990.

On the other hand, the zero bracket amount already imposes a floor under the charitable deduction (and other itemized deductions), inasmuch as individuals may only deduct the total of their itemized deductions over the ZBA. It is argued that the imposition of an additional floor would have an adverse impact on charitable giving at a time when the Administration has called on the private sector to fund a greater portion of expenditures for welfare, health, research, and educational activities.

Representatives of the nonprofit sector contend that while the charitable deduction may not influence the number of gifts an individual makes, the deduction does influence the size of those gifts. In light of the fact that rate reductions enacted as part of tax reform proposals would increase the out-of-pocket cost of giving, it is argued that no further cutbacks in tax benefits (such as imposition of a floor) should be made.

Some economic studies have predicted that the aggregate effect of the rate reductions and charitable deduction changes proposed in the Administration proposal and in the 1984 Treasury report would be to reduce charitable giving, after a lag period of several years, by as much as 18 percent or 20-25 percent, respectively; other studies predict a significantly lesser decline overall.[30] A major portion of any drop in giving would be attributable solely to the rate reductions. Any decline in donations is expected to be steeper for educational and cultural institutions, which receive a greater percentage of their support from higher-income individuals, than for religious groups or other charities which receive a greater percentage of their support from lower-income individuals. This is because higher-income individuals receive relatively larger subsidies through the deduction and are more responsive to changes in the out-of-pocket cost of charitable giving; also, the proposal to treat unrealized appreciation on donations of capital-gain property as a minimum tax preference principally affects higher-income individuals.

Other studies, however, suggest that recent tax return data are not consistent with the proposition that reductions in marginal tax rates lead to dramatic reductions in charitable giving. Thus, total dollars contributed to charity, and the average gift as a percent of income, rose in 1982 and 1983 notwithstanding the three-year reductions in marginal tax rates enacted in ERTA. While the average contribution declined about 30 percent for returns with AGI exceeding $500,000, this reduction was offset by increased numbers of high-income donors and increased giving by donors with AGI below $50,000.

Also, estimates of declines in charitable giving are based on predictions of how individuals might respond to changes in the price of giving (i.e., the after-tax cost) resulting from rate reductions and other proposals. However, if individuals understood that tax reform could result in declines in charitable giving, and hence in the amount of services that can be furnished by charities, some might be willing to donate more, notwithstanding higher costs of giving, than currently estimated. In addition, to the extent rate reductions increase disposable income, charities might have greater success in fund-raising aimed at current nongivers, who have not been stimulated to give by the present-law tax rates and charitable deduction rules, and at increasing the percentage of income donated by current givers. The charitable community responds, however, that any reduction in giving resulting from lowering tax rates should not be

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[30] For recent studies (and citations to other studies), see Bristol, "Tax Cuts and Charitable Giving," 28 Tax Notes 323 (July 15, 1985); Clotfelter, "Tax Reform and Contributions: Reply to Rudney and Davie," 28 Tax Notes 1275 (March 25, 1985); Davie, "Tax Rate Changes and Charitable Contributions, 28 Tax Notes 1037 (March 11, 1985); Clotfelter, "Tax Reform and Charitable Giving in 1985," 28 Tax Notes 477 (Feb. 4, 1985); Rudney, "Charitable Deductions and Tax Reform: New Evidence on Giving Behavior," 28 Tax Notes 367 (Jan. 28, 1985).

aggravated by structural changes in the charitable deduction, such as imposition of a floor.

Tax simplification issues

In addition to efficiency concerns, the 1984 Treasury report also supported the two-percent floor on grounds of tax simplification. As in the case of the present-law floors under the medical expense and casualty loss deductions, use of a floor under the charitable contributions deduction, together with other tax simplification proposals, would reduce the number of itemizers. This, in turn would alleviate recordkeeping and other tax compliance burdens for taxpayers, and administration and enforcement burdens for the IRS.

In addition, compliance problems result from allowing deductions for relatively small contributions. The donor may not have records for many of his or her gifts, which may be in cash, and the IRS, as a practical matter, is not able to audit a large volume of relatively small contributions. (IRS compliance data indicates that in 1979, overstated cash contributions totaled about $2 billion, or 11 percent of claimed cash donations.) Also, the donor may list payments to charitable organizations as contributions that properly constitute, in whole or in part, payments for goods and services received (e.g., books, meals, etc. offered in return for "donations" of specified amounts).

On the other hand, imposition of a floor could cause complication and give rise to time-wasting tax planning activities, because individuals could adjust the timing of their contributions in order to minimize the impact of the floor. For example, if a floor of one percent of AGI were enacted, an individual who normally contributed exactly that amount each year could obtain at least some deductions by "bunching" contributions. Thus, if this taxpayer contributed amounts equal to two percent of AGI every other year, she could obtain a deduction of one percent of AGI in those years, rather than the complete elimination of the deduction which she would experience if she continued to give one percent of AGI in each year.

Thus, it could be argued that a floor could actually complicate the tax system by creating significant tax planning opportunities for some of those affected by it. (Other individuals might still decide to continue regular giving habits, e.g., at religious services or in response to personal solicitations.) To the extent an individual could continue to obtain deductions solely through bunching, the efficiency and simplification objectives of a floor would not be accomplished.

Measurement of income issues

Another argument in favor of a floor relates to the general concept that nonbusiness expenses should be deductible only if they substantially reduce an individual's ability to pay taxes. For example, large unreimbursed medical expenses or losses which have been involuntarily inflicted on a taxpayer by illness or casualty may be viewed as reflecting an economic hardship, beyond the individual's control, that reduces the ability to pay taxes on income. Accordingly, it is argued, allowing such deductions notwithstanding their personal nature achieves more equitable treatment of taxpayers, by making adjustments to reflect the relative ability to bear tax burdens.

Similarly, a relatively high level of charitable giving, while voluntarily undertaken (and hence not properly deductible as a refinement of the definition of income), may be viewed as reducing the ability to pay tax in a manner more like the effect of medical expenses and casualty losses than like large expenditures for clothing, recreation, furniture, etc., which are strictly personal consumption expenditures that directly benefit the taxpayer. A floor would serve to distinguish unusually high levels of devoting income to charitable purposes from more average, expected levels of personal expenditures for giving.

On the other hand, it could be argued that full deductibility of charitable contributions (at least, other than of untaxed appreciation) is justified as consistent with a theoretically "ideal" income tax system, wholly apart from any incentive effect or intent to encourage charitable giving. In this view, the gratuitous transfer of funds from an individual to a charity should not be treated as a personal consumption of income that should be subject to tax even under a theoretically pure, broad-based income or consumption tax.

Thus, receipts voluntarily turned over to philanthropic use by a qualified donee should not be treated as private consumption subject to tax, under this view, whether the amount of the contribution falls below or above a dollar or percentage floor. This result should follow, it is argued, even if charitable contributions are considered as quite different from medical expenses or casualty losses, because such contributions do not offset personal hardships caused by disease, injury, or casualty.

Allowing deduction only against lowest tax rate; converting the deduction to a credit

Another concern that has been expressed about the structure of the charitable deduction is that, as in the case of other itemized deductions, greater benefits are provided to higher-income donors than to lower-income donors. For a taxpayer with a 50-percent marginal tax rate, each additional dollar donated costs the taxpayer 50 cents out-of-pocket; for a lower-income taxpayer in the 25-percent bracket, the out-of-pocket cost rises to 75 cents per dollar contributed. Some have questioned these distributional effects of the deduction.

The Bradley-Gephardt bill would eliminate this differential treatment of donors by allowing the deduction only against the 14-percent bracket (taxable income), but not against the surtax of up to an additional 16 percent (adjusted gross income). In effect, this structure converts the charitable deduction into a 14-percent tax credit. The differential treatment of donors would be narrowed, but not eliminated, by proposals that have a narrower range of brackets than the Administration proposal.

The major argument in favor of converting the deduction to a credit is increased equity; i.e., all donors would have equal after-tax costs for charitable contributions. The result would be increased costs of giving to higher-income individuals and decreased costs to lower-income individuals. This approach, however, is estimated by some economists to cause a sharper drop in total charitable giving than the Administration proposal, the 1984 Treasury report, or the Kemp-Kasten bill, and accordingly raises the concerns discussed above in connection with proposals for a floor under the deduction.

Regardless of any impact on overall giving levels, converting the deduction to a credit may affect the relative proportion of total donations from individuals received by different types of charities. Thus, contributions to universities, museums, orchestras, and the like might decrease as a percent of total giving, while contributions to religious institutions, youth groups, etc. might increase.

Appreciated property

A basic argument made in the 1984 Treasury report against allowing a full deduction for untaxed appreciation (i.e., the excess of the fair market value of donated property over the taxpayer's basis) derived from the general tax law policy of preventing double benefits. In part, this policy operates to prevent a taxpayer from generating deductions in excess of costs or from excluded income or gain. For example, present law disallows a deduction for expenses or interest incurred in earning tax-exempt income (sec. 265), and disallows deductions for educational expenses claimed as employee business expenses to the extent the taxpayer was reimbursed for such expenses under a tax-free program.

This prohibition against doubling of tax benefits is essential to the proper measurement of a taxpayer's income for tax purposes. If a taxpayer pays an otherwise deductible obligation (such as an interest liability) with appreciated property, no deduction can be generated from the payment unless the amount of appreciation was included in the taxpayer's gross income. Similarly, it is argued, a taxpayer should not be able to obtain a charitable deduction for untaxed appreciation. The rationale for allowing a deduction under a theoretically pure income tax system—that gross income should be adjusted, to make it a more accurate measure of private consumption plus accumulation, by allowing an offsetting deduction for receipts turned over to philanthropic use—applies only to the donor's out-of-pocket costs, not to deductions for unrealized gain that will never be included in the donor's gross income.

It is also argued that allowing deductions for untaxed gain adds significant inequity and complexity to the charitable deduction. First, the extra tax advantages of deductibility at fair market value and avoiding tax on the gain are available only to those individuals who possess appreciated securities, real estate, art, etc., i.e., generally the same class of higher-income taxpayers already receiving a relatively greater tax benefit from their charitable contributions because they are in a high tax bracket. The 1984 Treasury report estimated that for returns with AGI below $100,000, less than 10 percent of contributions are of noncash property (including gifts of depreciated property, such as donations of used clothing and furniture); by contrast, about 40 percent of contributions claimed on returns with AGI exceeding $200,000 are for donations of noncash property.[31]

[31] Some evidence suggests that the higher the income of donors, the greater the proportion of the fair market value of property that consists of unrealized appreciation.

Second, it is argued that the present-law treatment of appreciated property creates tax planning opportunities which may waste a taxpayer's time and resources. Theoretically, virtually any individual who both realizes a capital gain on property and makes a cash contribution during the same year to a public charity is paying more tax than necessary, since the taxpayer could have donated the appreciated property (thereby avoiding capital gain tax) instead of giving cash. Many taxpayers are in this position and do not reduce their taxes as much as they could, but may still believe that a tax system which makes it worthwhile to consider such activities is unfair and too complex.

A limitation of the deduction to the donor's basis would effect significant simplification of the complex rules that apply to gifts of property.[32] (These rules are summarized under "Present Law and Background," above.) If the deduction allowed for a gift of property cannot exceed the amount of basis, many of these complex rules and computations could be eliminated. The 1984 Treasury report also argued that limiting the deduction to basis would significantly reduce the extensive controversies under present law over valuation issues, and would also reduce other costs to the donor and to the IRS of compliance with and administration of complex rules in the statute, regulations, rulings, and case law.

In recent years, opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters and by individual donors claiming excessive deductions, in part because valuation of some types of property cannot be determined by reference to readily available and accepted valuation tables. For 1983, the average overvaluation of donated works of art reviewed by the IRS Art Advisory Board was 1,017 percent; the Board adjusted the claimed valuations for almost 75 percent of the items reviewed. According to a GAO report, IRS data on certain audited returns claiming deductions for contributions of conservation easements reflected overvaluations by an average of about 220 percent. The widespread publicity given to gross overvaluations by some donors may contribute to perceptions of noncompliance.

Also, allowing a deduction for unrealized appreciation may encourage gifts of tangible property that the donee charity cannot use or readily convert into cash, even where the related-use test is met. For example, a recent Tax Court case involved 11 taxpayers who purchased scholarly reprint books, held them for slightly longer than the capital gain holding period, and then contributed them to small rural public libraries. In rejecting the taxpayers' valuation (three times what they had paid for the books, producing a tax benefit of 1½ times their out-of-pocket cash investment), the Tax Court found that the books had proved of little use to the vast majority of

[32] For example, different percentage limitations apply for gifts of capital-gain property to different classes of donees; in addition, the interaction among the various percentage limitations where a donor gives appreciated property to more than one type of donee is extremely complicated. Also, complex rules require a partial reduction in the amount of deductible appreciation for gifts of capital-gain property to certain types of donees. This latter rule, in turn, is subject to a special exception, applicable for a ten-year period, for certain types of publicly listed stock donated to private nonoperating foundations. Finally, if the property is classified as tangible personal property, additional difficult determinations must be made as to whether the donee's use of the property is considered related to the donee's exempt functions.

users of the donee libraries. Many donees disposed of large numbers of the books by transfer to other institutions or by selling them at "flea markets" for 25-50 cents each. The Court noted that donee charities may not be in a position to reject unwanted gifts of property, because of public relations concerns if their patrons believed that they were turning down free gifts.[33]

On the other hand, universities, museums, and other charities argue that the incentive of deductibility of appreciated capital-gain property at full fair market value is essential to their existence and their ability to serve society. For example, total voluntary support for institutions of higher education amounted to $5.2 billion in 1983; gifts directly from individuals represented 47 percent of the total ($2.4 billion). It is estimated that about 40 percent of giving by individuals to higher education takes the form of contributions of capital assets, and that about half the gifts exceeding $5,000 consist of appreciated property.

Similarly, museum groups argue that contributions of art from collectors would diminish unless deductibility at full fair market value is retained. The Treasury acknowledged in its 1984 report that elimination of deductibility at full fair market value could have some adverse impact on the level of charitable giving.[34] Apart from the effect of any provision disallowing deductibility at full fair market value, any decline in giving solely attributable to rate reduction is estimated by some to be steeper for gifts of property than for cash gifts.

Also, the charities point out that valuation abuses should be sharply curtailed (for donations of items or collections with a claimed value exceeding $5,000) by the appraisal requirements, donee information reporting rule, and stricter overvaluation penalties enacted in the 1984 Act.

In response to the various tax reform proposals that could adversely affect charitable giving, the nonprofit sector argues that voluntary organizations supported by charitable contributions are indispensable to our society, and that their development should be encouraged by the tax system. Thus, charitable organizations are described as providing many services at little or no cost that otherwise would have to be provided by government at full cost to tax-

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[33] In another recent Tax Court case, a dentist had purchased for $50 each 150 unframed lithographs from the publisher and distributor of the artist's works. After owning them for one month longer than the capital gain holding period, the taxpayer donated them to a museum. The museum did not accession or insure the lithographs and had no intention of exhibiting them; a few were given away as a promotional incentive for museum membership, but almost all were kept in storage.The taxpayer claimed a charitable contribution for the donated lithographs that exceeded three times the purchase price. The claimed deduction was supported by appraisals that had been prepared in accordance with the taxpayer's purchase contract with the distributor. The Tax Court held that, in the absence of evidence of appreciation in value or any special discount to the taxpayer on purchase, the fair market value of the lithographs at donation was the actual price ($50/each) paid by the taxpayer ten months previously.

[34] The 1984 Treasury report also proposed repealing the percentage limitations on the itemized deduction in the case of gifts by individuals to public charities, etc. to which the 50-percent/30-percent limitations apply under current law. The Treasury Department argued that with enactment of its appreciated property proposal and reduced tax rates, the limitations would no longer be needed to preclude wealthy individuals from substantially eliminating their tax liability through charitable contributions. Also, repeal of the percentage limitations would achieve simplification for donors to public charities. The Treasury report estimated that fewer than 50,000 individuals would benefit from deleting the 50-percent/30-percent limitations and that this proposal would reduce fiscal year budget receipts by $1.2 billion over 1986-1990 (with about one-half that loss attributable to donors with AGI exceeding $200,000).

payers, and as being free to innovate and experiment in carrying out charitable functions and to espouse unpopular causes or minority viewpoints. These important functions can best be performed, it is argued, by the private sector without direct governmental involvement other than through tax incentives for giving. Thus, support of philanthropy may be considered so important a social policy objective that it outweighs otherwise applicable tax policy objectives of equity, efficiency, and simplification.

Minimum tax issues

The Administration proposal retains the present-law charitable deduction rules governing donations of appreciated capital-gain property for purposes of the regular income tax, but treats the unrealized appreciation as a preference for purposes of the minimum tax. In general, it is argued that allowing the deduction for purposes of the minimum tax is inconsistent with the objective of that tax to apply to a comprehensive and incentive-free base. On the other hand, the charities respond that wholly denying the deduction would unduly limit its incentive effect. These issues are further discussed in a separate pamphlet.[35]

Deduction for nonitemizers

The Administration proposal states that there is little data indicating whether the nonitemizer charitable deduction enacted in ERTA has had a significant incentive effect on charitable giving by nonitemizers. (In part, this might be explained on the ground that nonitemizers have relatively low marginal tax rates, thus limiting the incentive effect of the deduction for them.) Accordingly, it is argued, allowing the deduction provides an unnecessary tax benefit for taxpayers who make normal, expected levels of charitable gifts. Also, the ZBA in effect includes a component to reflect charitable giving by nonitemizers.

Under this view, the nonitemizer deduction results in revenue loss, and thus contributes to higher marginal tax rates, without a significant compensating benefit to charitable organizations. Thus, the Administration argues that terminating the deduction for nonitemizers one year early would not have a significant adverse effect on charitable giving by nonitemizers. It is estimated that this proposal would increase fiscal year budget receipts by $3.1 billion over 1986–1987.

In addition, allowing a charitable deduction to nonitemizers contributes to recordkeeping burdens and complexity for individuals. Some nonitemizers may not be fully aware of reporting and substantiation requirements for claiming a charitable deduction. Also, the nonitemizer deduction creates enforcement problems for the IRS, because of the disproportionate cost of verifying small deduction amounts claimed on returns that otherwise typically would not contain items likely to be audited. Knowing of this fact, some taxpayers may be claiming amounts to which they are not entitled. Finally, the Administration argues that allowing the deduction to

[35] See Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

nonitemizers would make it more difficult to implement the proposed return-free system.

On the other hand, the legislative history accompanying ERTA indicates that the Congress extended the charitable contribution deduction to nonitemizers in order to stimulate charitable giving by a broader section of taxpayers, i.e., to taxpayers who do not benefit from itemizing. The deduction does have at least some impact in encouraging contributions to religious organizations, to community groups, and to other organizations that receive much of their support from lower-bracket individuals.

Also, if the deduction is terminated, some taxpayers who can now file the short tax forms might switch to filing the more complicated long form, thus conflicting with the goal of simplifying the tax return process. Finally, there is no evidence that individuals who claim the charitable deduction for nonitemizers tend to overstate their deductions more than itemizers, so that it would be unfair to single out the former group on the basis of asserted noncompliance.

If a major concern with extending the charitable deduction for nonitemizers is the revenue loss, the amount of the deduction could be limited to a percentage of such contributions, to a dollar cap, or both, as was the case for pre-1985 years. (For example, in 1984 the deduction was limited to 25 percent of the first $300 in contributions, for a maximum deduction of $75.) Such limitations, however, might reduce the incentive purposes of the deduction.

F. Deduction for Casualty and Theft Losses of Nonbusiness Property

Present Law and Background

General rules and limitations

Since the inception of the income tax laws, individuals have been allowed to claim itemized deductions with respect to losses, caused by sudden casualty or theft, of property that is not used in a trade or business or in an activity entered into for profit (Code sec. 165). The loss is not allowed to the extent compensated by the receipt of insurance proceeds or otherwise. The deduction equals the lower of (1) the property's fair market value immediately prior to the loss or (2) its adjusted basis in the hands of the taxpayer.

The casualty loss deduction is subject to several limitations. First, the amount of each personal casualty loss is taken into account only to the extent that it exceeds $100. Second, the remaining amount of nonbusiness casualty losses is reduced by the amount of personal casualty gains, which generally are gains arising when the casualty or theft loss of nonbusiness property gives rise to insurance proceeds that exceed the lower of the property's basis or fair market value. Finally, the amount of personal casualty losses that still remains is deductible only to the extent that it exceeds 10 percent of the taxpayer's adjusted gross income (AGI) for the year.

Losses covered by insurance

Questions have arisen under present law as to whether a deduction is allowable to the extent that a loss is covered by insurance, but the taxpayer elects not to file a claim (for example, to avoid an increase in insurance premiums or the cancellation of the insurance). While the Internal Revenue Service has taken the position that no deduction is allowable to the extent that a taxpayer voluntarily foregoes insurance, court cases to date have generally held to the contrary, concluding that the amount of the deduction is reduced only by insurance proceeds or other reimbursement actually received.[36]

Data on deduction

For 1983, approximately 191,000 returns (or less than one percent of the returns filed by itemizers) claimed deductions for personal casualty or theft losses exceeding the floor, averaging $4,356. The reduction in budget receipts attributable to this deduction is estimated at $264 million for fiscal year 1986.

[36] *See*, e.g., *Miller* v. *Comm'r*, 723 F.2d 649 (6th Cir. 1984); *Hills v. Comm'r*, 691 F.2d 997 (11th Cir. 1982); *W.J. O'Neill v. Comm'r*, 46 CCH TCM 1476 (1983).

Administration Proposal

The Administration proposal generally does not recommend any change in the itemized deduction for personal casualty and theft losses.[36a]

Other Proposals

The Kemp-Kasten bill (H.R. 2222; S. 1006) and the Roth-Moore bill (S. 411; H.R. 373) each would disallow the deduction, by repealing Code sections 165(c)(3) and 165(h).

A second type of proposal that could be made would concern the treatment of losses that are covered by insurance but as to which the taxpayer declines to file a claim. If the allowance of deductions for such losses is considered improper, deductions could be restricted to those casualty losses that are not covered by insurance.

Analysis

In general

The proposals to repeal the deduction for nonbusiness casualty and theft losses respond to the same tax policy concerns that led the Congress, in enacting the rules under present law, to provide limitations on the amount of the deduction.

One of the grounds relied upon in limiting or repealing the deduction is that of administrative simplicity. The claiming of deductions by taxpayers, and the auditing of deductions by the Internal Revenue Service, can be burdensome for two reasons.

First, losses caused by sudden, unexpected casualty must be distinguished from damage to property resulting over a period of time, such as progressive deterioration caused by continuing action of insects or the weather, since the latter type of losses are not deductible.[37] The inherently factual nature of this inquiry has led to considerable litigation, as the courts, taxpayers, and the IRS have struggled to determine such questions as whether the deduction is allowed for damage caused by phloem necrosis (Dutch elm disease),[38] mass attacks of Southern pine beetles,[39] the two-line chestnut borer,[40] or lethal yellowing of coconut palm trees.[41] Second, it requires determining the fair market value of the property both

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[36a] Under the Administration proposal, taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. In other words, electing taxpayers would be allowed to deduct the loss in the taxable year the loss is incurred as if the loss were uninsured. Insurance proceeds would be taxable income when received, but an exclusion would be given equal to the amount of any portion of the loss that was not deductible. Current law would continue to apply to nonelecting taxpayers.

This proposal will be discussed in a pamphlet, to be prepared by the staff of the Joint Committee on Taxation, covering tax reform proposals relating to insurance companies and products.

[37] For example, the casualty deduction generally is not allowed for losses caused by termites (Rev. Rul. 63-232, 1963-2 C.B. 97); moths (Rev. Rul. 55-327, 1955-1 C.B. 25); carpet beetles (*Meersman* v. *U.S.*, 370 F.2d 109 (6th Cir. 1966)); infestation of rats (*Edward W. Banigan*,, 10 CCH Tax Ct. Mem. 561 (1951)); dry rot (*Hoppe* v. *Comm'r*, 354 F.2d 988 (9th Cir. 1965)); prolonged drought (*Louis Broido*, 36 T.C. 786 (1961); or gradual suffocation of tree roots (*William R. Miller*, 29 CCH Tax Ct. Mem. 741 (1970)).

[38] See, e.g., *Appleman* v. *U.S.*, 338 F.2d 729 (7th Cir. 1964), *cert. denied*, 380 U.S. 956 (1965).

[39] Rev. Rul. 79-174, 1979-1 C.B. 99.

[40] *McKean* v. *Comm'r*, 42 CCH Tax Ct. Mem. 1709 (1981).

[41] *Maher* v. *Comm'r*, 680 F.2d 91 (11th Cir. 1982).

before, and (in the event that it retains some salvage value) after the loss is realized.

Advocates of limiting or repealing the deduction also rely on more fundamental tax policy concerns. First, they note that personal living and consumption expenses and losses generally are not deductible. Second, they argue that allowing a deduction tends disproportionately to benefit high-income taxpayers, who are more able to purchase insurance to compensate for losses but who realize greater tax savings from deductions because of their higher marginal rates.

Advocates of retaining the present law treatment of casualty and theft losses do not necessarily disagree with these arguments. However, they maintain that the limitations under present law sufficiently address the administrative and distributional problems that can result from allowing the deduction.

In addition, while conceding that personal expenses generally are not deductible, those supporting the present-law deduction argue that some deduction should be allowed when a loss is of such major proportions that it may impose serious hardship on the taxpayer and significantly impede the ability to pay taxes. Similar concerns underlie the allowance, under present law, of a deduction for medical expenses to the extent exceeding five percent of AGI.

Losses covered by insurance

With respect to losses which are covered by insurance but as to which the taxpayer elects not to file a claim, the IRS position that they should not be deductible is apparently based on several concerns. First, as a matter of literal statutory interpretation, the IRS maintains that these losses are caused not by casualty, but by the taxpayer's voluntary election to forego reimbursement—a decision of a type that would not ordinarily give rise to a deduction. Second, to the extent that a claim is foregone to avoid an increase in insurance premiums, allowing a deduction would be inconsistent with the nondeductibility of personal insurance premiums generally. In other words, if the premium is not deductible, then a loss voluntarily accepted in order to minimize future premiums likewise should not be deductible.

In response to this argument, advocates of the rule adopted by the case law argue that since a deduction is worth less than cash reimbursement (so long as the taxpayer's marginal tax rate is less than 100 percent), individuals will voluntarily forego insurance reimbursement only for pressing reasons—for example, to avoid cancellation of the insurance policy. Such individuals, according to this argument, are no better off than individuals without any insurance and hence should be treated no differently.

G. Deduction for Expenses of Adopting Children With Special Needs

Present Law and Background

An individual may claim an itemized deduction for up to $1,500 of adoption expenses in connection with the adoption of a child with special needs (Code sec. 222).

The latter term refers to a child as to whom adoption assistance payments are made under section 473 of the Social Security Act. In general, this is a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, because of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental, or emotional handicap), cannot reasonably be expected to be adopted unless adoption assistance is provided under the Social Security Act.

Adoption expenses qualifying for the deduction include adoption fees, court costs, attorneys' fees, and other expenses directly related to the legal adoption of a child with special needs. In enacting the deduction in the Economic Recovey Tax Act of 1981, the Congress believed that these costs, coupled with the other problems of raising children with special needs, provided too much of an obstacle to the adoption of such children.

Administration Proposal

The Administration proposal would repeal the deduction for adoption expenses, generally effective January 1, 1987. The proposal calls for Federal support of individuals who adopt children with special needs, through a direct Federal expenditure program to deliver this support, to be phased in as the deduction is phased out.

Under the Administration proposal, adoption expenses for special needs children adopted before January 1, 1986 would continue to be deductible as under current law. Adoption expenses for such children adopted during 1986 would be deductible in 1986, but not thereafter. There would be no deduction for adoption expenses of special needs children who are adopted after December 31, 1986.

Analysis

Those supporting retention of the deduction question whether the creation of another direct expenditure program, as recommended in the Administration proposal, is in keeping with recent efforts to limit the number of entitlement programs and the size of the Federal Government. There is also some question whether the provision of benefits through a Federal agency would be more cost effective than the current tax deduction mechanism.

Others argue, however, that the tax system is an inefficient way to deliver this subsidy, because few people may be aware of its existence and because the agencies with responsibility for the children have no budgetary control to direct the available resources to uses with the most effectiveness. It also is argued that the deduction (like other itemized deductions) is unfair because it is worth more to high-bracket than low-bracket taxpayers, and because it is unavailable to nonitemizers and to taxpayers whose income is so low that they do not have tax liability.

VI. DEDUCTIONS FOR CERTAIN BUSINESS OR INVESTMENT EXPENSES

A. Travel and Entertainment Expenses

Background

Since the 1960's, the Congress has sought to address various aspects of deductions for travel and entertainment expenses that have been perceived as abuses or as unfair. In his 1961 Tax Message, President Kennedy reported that "too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government." He stated: "This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

The 1961 Tax Message pointed out that "even though in some instances entertainment and related expenses have an association with the needs of business, they nevertheless confer substantial tax-free personal benefits to the recipients." Accordingly, President Kennedy recommended completely disallowing deductions for business entertainment expenses and for the costs of maintaining entertainment facilities (such as yachts and hunting lodges), and imposing restrictions on deductions for excessive personal living expenses incurred on business travel away from home, costs of business trips combined with vacations, and business gifts.

Responding to these concerns, the Congress enacted special restrictions and substantiation requirements applicable to deductions for travel and entertainment expenses. The legislative history of the Revenue Act of 1962 indicates that these rules were intended in part to prevent abuses that had occurred because many entertainment expenses had been considered deductible even though they had only a remote connection with the taxpayer's trade or business.

However, the Congress did not accept President Kennedy's recommendation of complete disallowance of entertainment expenses, because it viewed entertainment expenses incurred for valid business purposes (particularly those associated with selling functions) as facilitating business transactions and hence increasing business taxable income. Also, concern was expressed that if disallowing the deduction were to cause unemployment in the entertainment industry, this could impose hardship on unskilled workers and other service personnel in that industry and the loss of tax revenues from those workers.[42]

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[42] S. Rpt. No. 1881, 87th Cong., 2d Sess., 24-38 (1962); see also H. Rpt. No. 1447, 87th Cong., 2d Sess., 19-26 (1962).

In 1978, President Carter recommended further restrictions on the deductibility of entertainment expenses, arguing that the 1962 Act had proved ineffective in precluding availability of deductions, based on some business connection, for such items as vacation trips, yacht expenses, club dues, home parties, "educational" cruises, and sports tickets. Since the statutory and regulatory tests under the 1962 Act are basically subjective, rather than objective, taxpayers had been able to play the "audit lottery," taking aggressive positions as to deductibility on their returns; if audited, they could contest an adverse IRS position, thereby causing a voluminous amount of controversies.

The President's 1978 Tax Program recommended (1) disallowing deductions for the costs of any entertainment facilities or activities, except that 50 percent of the cost of business meals would remain deductible; (2) disallowing the amount of first-class air fare to the extent exceeding coach fare; and (3) disallowing expenses of attending conventions held outside the United States without a business justification. The Tax Program argued that "business entertainment" provides significant tax-free personal benefits to the recipient, sometimes of a luxurious nature, and in some cases was simply disguised personal entertainment. Also, the benefits of deductions for entertainment expenses were said to be disproportionately distributed to upper-income individuals.

In response, the Revenue Act of 1978 generally disallowed deductions for entertainment facilities, with less restrictive rules as to deductions for club dues, but did not impose additional limitations on deductions for business meals or other entertainment activities. Restrictions were also placed on deductions for attending foreign conventions; these rules were modified in 1980.

The general substantiation rules for these types of expenses that were enacted in 1962 were tightened and expanded in scope by the Tax Reform Act of 1984. However, the specific requirement for contemporaneous recordkeeping as to automobiles and certain other property enacted by that statute was repealed in Public Law 99-44.

Present Law

Overview

In general, deductions are allowable for ordinary and necessary expenditures paid or incurred in carrying on a trade or business or for the production or collection of income (Code secs. 162, 212). Travel expenses incurred while away from home in the pursuit of a trade or business, including amounts expended for meals and lodging (other than amounts which are lavish or extravagant under the circumstances), generally qualify for the deduction (sec. 162(a)(2)).

The taxpayer bears the burden of proving both the eligibility of an expenditure as a deduction and also the amount of any such eligible expenditure.[43] In addition, certain limitations and special substantiation requirements apply to travel and entertainment deductions (sec. 274).

[43] See, e.g., *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943); *Comm'r* v. *Heininger*, 320 U.S. 467 (1943).

No deduction is allowed for personal, family, or living expenses (sec. 262). For example, the costs of commuting to and from work are nondeductible personal expenses.[44]

Entertainment activities

In general

Under present law, expenditures relating to activities generally considered to constitute entertainment, amusement, or recreation are deductible only if the taxpayer establishes that (1) the item was directly related to the active conduct of the taxpayer's business or (2), in the case of an item directly preceding or following a substantial and bona fide business discussion, the item was associated with the active conduct of the taxpayer's business. The "directly related" or "associated with" tests are intended to require a more proximate relation between the entertainment expense and the taxpayer's business than would be required under the "ordinary and necessary" requirement applicable to all business expenses (including business entertainment expenses).

These special limitations apply, subject to ten statutory exceptions (including an exception for meals, and discussed in greater detail below), to expenses of the taxpayer and the taxpayer's guests at nightclubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, and sporting events, and on hunting, fishing, or vacation trips or yachts, as well as to expenses of providing food or beverages, hotel suites or other lodging, or the personal use of automobiles. If either statutory test is met or an exception applies, entertainment expenses of the taxpayer as well as entertainment expenses of the taxpayer's business guests (such as present or potential customers or clients, legal or business advisors, suppliers, etc.) are deductible.

"Directly related" test

The regulations under section 274 provide several alternative tests for satisfying the "directly related" requirement, generally designed to require the taxpayer to show a clear business purpose for and a reasonable expectation of business benefits to be derived from the expenditure. For example, under an "active business discussion" test, the taxpayer must have actively engaged in a business meeting during the entertainment period for the purpose of business benefit, and must have had more than a general expectation of deriving some income or other business benefit (other than merely goodwill) at some indefinite future time.

On the other hand, the regulations presume that the "active business discussion" test is not met if the entertainment occurred under circumstances where there was little or no possibility of engaging in business. For example, the test is presumed not to have been met if there were substantial distractions, e.g., because the entertainment took place at a nightclub or a cocktail party, or if the taxpayer met with a group including nonbusiness-related individuals at a vacation resort.

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[44] *Fausner* v. *Comm'r*, 413 U.S. 838 (1973).

Even if the "active business discussion" test is not met, entertainment expenses are deemed "directly related" to business and hence satisfy the special section 274 limitation if incurred in a "clear business setting" directly in furtherance of the taxpayer's business. For example, the "clear business setting" test is met for expenses of entertainment taking place in a hospitality room at a convention, where business goodwill may be generated through the display of business products, or where civic leaders are entertained at the opening of a new hotel or theatrical production, provided that the clear purpose is to obtain business publicity. However, because of distracting circumstances, entertainment is presumed not to have occurred in a clear business setting in the case of a meeting or discussion taking place at a nightclub, theater, or sporting event, or during a cocktail party.

"Associated with" test

The second category of entertainment expenditures that are deductible under present law are expenses associated with the taxpayer's business that are incurred directly preceding or following a substantial and bona fide business discussion. This test generally permits the deduction of entertainment costs intended to encourage goodwill, where the taxpayer establishes a clear business purpose for the expenditure. Entertainment costs for the taxpayer's spouse, or the spouses of business customers, also may qualify for deduction under this test if meeting the general ordinary and necessary standard.

The "associated with" test does not require that business actually be transacted or discussed during the entertainment, that the discussion and entertainment take place on the same day, that the discussion last for any specified period, or that more time be devoted to business than to entertainment. Thus, if a taxpayer conducts negotiations with a group of business associates and that evening entertains them and their spouses at a restaurant, theater, concert, or sporting event, the entertainment expenses generally are deductible as "associated with" the active conduct of the taxpayer's business, even though the purpose of the entertainment is merely to promote goodwill. Entertainment taking place between business sessions or during evening hours at a convention is treated as directly preceding or following a business discussion.

Entertainment facilities

The section 274 rules were amended by the Revenue Act of 1978 to disallow any deduction (or the investment tax credit) for the cost of entertainment facilities, unless one of the specific statutory exceptions applies. This general disallowance rule applies to property such as fishing camps, tennis courts, bowling alleys, yachts, hotel suites, swimming pools, hunting lodges, and vacation resorts.

Dues or fees paid to a social, athletic, or sporting club are deductible provided that more than half the taxpayer's use of the club was in furtherance of the taxpayer's business and the item was directly related to the active conduct of the taxpayer's business. The expenses of box seats and season tickets to theaters and sporting events are not disallowed as expenses related to entertainment facilities. Instead, such costs are fully deductible if they meet the tests applied to entertainment activities.

Exceptions for certain entertainment

In general

There are ten statutory exceptions to the general section 274 rules that an entertainment, recreation, or amusement activity expenditure must satisfy either the "directly related" or "associated with" tests, and that entertainment facility costs are not deductible. If an exception applies, the entertainment expenditure is deductible if it is ordinary and necessary and if any applicable section 274(d) substantiation requirements are satisfied.

These exceptions are for (1) business meals (discussed below), (2) food and beverage furnished to employees on the taxpayer's business premises, (3) entertainment expenses treated by the employer and employee as compensation to the employee, (4) expenses paid by the taxpayer under a reimbursement or other expense allowance arrangement in connection with the performance of services, (5) expenses for recreational, social, or similar facility or activities for the benefit of employees generally, (6) entertainment expenses directly related to bona fide meetings of a taxpayer's employees, stockholders, or directors, (7) entertainment expenses directly related to and necessary to attendance at a business meeting or convention of a tax-exempt trade association, (8) expenditures for entertainment (or a related facility) made available by the taxpayer to the general public, (9) expenses for entertainment sold by the taxpayer to the public, and (10) expenses includible in the income of persons who are not employees.

The regulations under section 274 provide that entertainment expenditures are not deductible to the extent they are lavish or extravagant. The IRS has not interpreted this provision to disallow deductions merely because entertainment expenses exceed a fixed dollar amount, are incurred at expensive restaurants, hotels, nightclubs, or resorts, or because they involve first-class accommodations or services (see Rev. Rul. 63–144, 1963–2 C.B. 129).

Meals

Expenses for food and beverage are deductible, without regard to the "directly related" or "associated with" requirements generally applicable to entertainment expenses, if the meal or drinks take place in an atmosphere conducive to business discussion (sec. 274(e)(1)). In general, the deduction covers both the expenses of the taxpayer's business guest and of the taxpayer, notwithstanding that meal expenses of an individual (unless incurred away from home on a business trip) otherwise are nondeductible personal expenses.

There is no requirement that business actually be discussed either before, during, or after the meal. For example, if the taxpayer takes a potential customer to breakfast, lunch, or dinner at a restaurant or hotel, or to a bar for drinks, the costs of the food and beverages are deductible whether or not any business is discussed. The legislative history of the 1962 Act indicates that this "business meals" exception to section 274(a) thus exempted a significant portion of business "goodwill" entertaining from the restrictions generally applicable to entertainment expenses.

Under the exception, meals in a restaurant or hotel dining room qualify for deduction in the absence of distractions such as floor shows. Business entertaining at the taxpayer's home also qualifies if the taxpayer shows that the expenditure was commercially, rather than socially, motivated. In such situations, expenditures for meals of a customer's spouse, and for the taxpayer's spouse who helps entertain a business customer, are deductible if they meet the general "ordinary and necessary" standard. However, entertainment at a night club, sporting event, or large cocktail party generally does not qualify for the exception.

Travel

In general

Traveling expenses incurred by the taxpayer while "away from home" in the conduct of a trade or business (e.g., where the taxpayer travels to another city for business reasons and stays there overnight) generally are deductible. The "away from home" deduction applies to personal living expenses such as food and lodging incurred during the trip, without regard to the business meals rule (discussed above) under section 274. However, travel deductions for meals and lodging are subject to the rule disallowing them to the extent that they are "lavish and extravagant" (sec. 162(a)(2)), and must be substantiated pursuant to section 274(d). The cost of commuting to and from work is a nondeductible personal expenditure under section 262.[45]

Traveling expenses are considered to be incurred while away from home in several different situations. One such situation is when the traveling expenses are incurred in connection with temporary employment and the taxpayer has a regular or principal place of business (or, in its absence, a regular place of abode) away from which the temporary employment takes place. For this purpose, the term "temporary" generally is defined by the IRS and the majority of courts to mean employment that can reasonably be expected to last only for a short period of time.

By contrast, traveling expenses incurred in connection with employment that is considered to be of indefinite or indeterminate duration generally are not deductible. On numerous occasions, the courts have considered the issue of whether a particular taxpayer's employment is temporary or indefinite in nature.

Travel outside U.S.

In the case of travel outside of the United States and lasting for more than one week (not counting travel inside the United States), certain additional rules apply.

If more than 25 percent of the time outside of the United States is attributable to nonbusiness activity, the taxpayer is required to allocate the travel costs between business and personal elements, and to deduct only the former. Both the allocation and the 25 percent rules are applied on a day-by-day basis, counting as business-

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[45] See note 44, *supra*.

related those days which the taxpayer devotes primarily to business or travel, or which constitute weekends or legal holidays, or on which the taxpayer is prevented from working by circumstances beyond his or her control, or on which the taxpayer's presence is required for a business reason.

Conventions

Additional rules apply to costs of travel to conventions and other similar meetings that are held outside of the North American area. Such costs are not deductible unless the taxpayer can show that it was as reasonable to hold the convention outside of the North American area as within it. The North American area is defined to include all States and possessions of the United States, as well as Canada, Mexico, and certain Caribbean countries. Conventions held within the North American area are subject only to the limitations applying generally to deductions for travel.

Deductions for conventions held on cruise ships are limited to $2,000 per taxpayer per year, and are wholly disallowed unless the cruise ship is registered in the United States and stops only at ports of call in this country (including United States possessions).

Traveling expenses as deductible education expenses

Traveling expenses can be deducted as business expenses if the travel (1) maintains or improves existing employment skills or is required by the employer or by applicable rules or regulations, and (2) is directly related to the taxpayer's duties in his employment or trade or business. Typical examples of travel that may qualify for this deduction, depending on the particular circumstances, include a trip to France by a teacher of French who is on sabbatical leave from school, and a management professor's tour of foreign factories.

General substantiation requirements

As a general rule, deductions for certain travel and entertainment expenses are subject to stricter substantiation requirements than other business deductions (sec. 274(d)). These stricter rules were enacted because the Congress recognized that "in many instances deductions are obtained by disguising personal expenses as business expenses." [46]

Under the section 274 rules, the taxpayer must substantiate by adequate records, or sufficient evidence corroborating the taxpayer's statement, the amount of: (1) the expense or item subject to section 274(d); (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. These substantiation rules apply to: (1) traveling expenses (including meals and lodging while away from home); (2) expenditures with respect to entertainment, amusement, or recreation activities or facilities; and (3) business gifts. In addition, the

[46] H. Rpt. No. 87-1447, 87th Cong., 2d Sess. (1962), at 19.

Tax Reform Act of 1984 made additional property subject to the section 274(d) rules, including automobiles used for local travel.[47]

Administration Proposal

The Administration has proposed the following changes, effective January 1, 1986, in the rules governing travel and entertainment deductions.

Meals

The amount deductible for a business meal would be limited to the sum of (1) $25 multiplied by the number of participants plus (2) 50 percent of costs above that ceiling. For example, if the taxpayer and three business associates had dinner costing a total of $150, the amount deductible would be $125 ($25 times four, plus half of the excess). The amount deductible is not affected by the amount actually spent on any individual participant.

The limitation would apply where a taxpayer traveling away from home eats alone, as well as to meals when the taxpayer entertains business associates at home or away from home. The dollar limitation would not apply to food and beverage furnished on the premises of an employer primarily for its employees.

Entertainment

In general, no deduction would be allowed for entertainment activities other than business meals. For example, amounts spent on theater or sports tickets would not be deductible.

This disallowance rule would not apply to amounts treated as taxable compensation to the beneficiaries or paid under a reimbursement arrangement (in which case the deduction would be denied to the person making the reimbursement), or to certain recreational expenses for employees (e.g., occasional holiday parties and summer outings), and expenses for goods, services, and facilities that are made available to the general public (e.g., samples and promotional activities).

In the case of business travel by luxury water transportation (such as a yacht, ocean liner, or cruise ship), no deduction would be allowed for the portion of cost in excess of the cost of otherwise available business transportation, unless the taxpayer could prove that travel by boat was medically necessary.

Travel

For purposes of determining whether a taxpayer is away from home, the Administration proposal would provide that any work assignment which extends for more than one year is treated as indefinite. Thus, no deduction would be allowed for travel costs (including meals, lodging, and commuting) with respect to an assignment that lasted for more than one year.

All deductions would be denied for conventions aboard cruise ships and for travel as a form of education.

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[47] Pursuant to P.L. 99-44, these additional categories of expenses will become subject to the sec. 274(d) substantiation requirements on January 1, 1986.

In general, the Administration's proposed limitations on travel deductions would not apply to amounts paid by an employer that were treated as compensation to the employee traveler. For expenses paid by one party under a reimbursement arrangement with another party, the party that was reimbursed would be treated as having offsetting income inclusions and deductions, while the rules limiting deductions would apply to the party making the reimbursement.

Other Proposals

1984 Treasury Report

The 1984 Treasury Report included the following additional or alternate proposals.

Meals.—For breakfast and lunch, deductions would be limited to \$10 and \$15 per person, respectively; dinner costs would be deductible only up to \$25 per person. For all meals, no deduction would be allowed for any amount in excess of the dollar ceiling.

Travel.—Deductions for meals, lodging, and incidental expenses (such as taxi fares) incurred during business travel away from home would be limited to twice the maximum Federal reimbursement per diem rate for the area, and to 150 percent for a trip lasting for more than 30 days. For example, the current applicable limit for travel to Baltimore, Maryland, lasting 30 days or less, would be \$150 per day. In addition, the present-law rules requiring proration of foreign travel that has both business and vacation elements (if more than 25 percent of the days do not qualify as business-related) would also apply to domestic travel.

Commuting.—For taxpayers (such as construction workers) who have no regular place of work and who must travel at least 35 miles (one way) to job assignments that last less than one year, a deduction would be allowed for expenses of commuting in excess of the first 35 miles (one way).

Other proposals

Other proposals that have been made or discussed in recent years include the following:

(1) disallowing a portion, such as one-third or one-half, of all entertainment and meal expenses, but without distinguishing between the two or applying any dollar ceilings;

(2) disallowing deductions for the cost of first-class airfare, to the extent in excess of the cost of available coach airfare;

(3) disallowing all deductions for travel by a spouse who accompanies a business traveler, unless both spouses are full-time employees of the employer or are active on a full-time basis in the business to which the travel relates;

(4) disallowing all deductions for meals where all the participants are employees or owners of a single employer, unless the participants are away from home or the meals satisfy the requirements for exclusion as a de minimis fringe benefit; and

(5) disallowing deductions for attending foreign conventions except under narrowly defined circumstances (e.g., a convention held by a foreign organization, or at which more than one-half of the persons in attendance are from foreign countries).

Analysis

General considerations

As a general rule, the tax law distinguishes between expenses of engaging in a trade or business or earning investment income, which generally are deductible, and expenses for personal consumption, which generally are not. However, this distinction becomes blurred when taxpayers engage in personal consumption activities—such as meals, travel, and entertainment—that have some business connection.

In advocating stricter limitations on deductions for travel and entertainment expenses, the Administration proposal stresses the unfairness of permitting taxpayers who can arrange business settings for personal consumption to receive a Federal tax subsidy that is denied to other taxpayers. These taxpayers tend to be those with relatively high incomes, and in some cases the consumption may bear only a loose relationship to business necessity. When executives have dinner at an expensive restaurant following business discussions and then deduct the cost of the meal, the fact that there may be some bona fide business connection does not alter the imbalance between the treatment of these persons, who have effectively transferred a portion of the cost of their meal to the Federal Government, and other individuals, who cannot deduct the cost of their meals.

The significance of this imbalance is heightened by the fact that business travel, meals, and entertainment are often more lavish and expensive than comparable activities in a nonbusiness setting. For example, meals at expensive restaurants, first class airplane tickets, and luxury boxes for sporting events are all purchased to a significant degree by taxpayers who can claim business deductions for these expenses. This disparity often is highly visible, and contributes to public perceptions that the tax system is unfair.

On the other hand, others respond that present-law restrictions are sufficient, and that imposing stricter rules would cause substantial harm to the food and entertainment industries and might force some expensive restaurants, sports teams, and theaters to suffer financial hardships.

For example, it has been argued that season ticket sales by sports teams would decline significantly if the deduction for entertainment expenses were repealed, and that restaurants serving meals that cost more than the proposed $25 per-person cap would lose significant business. These advocates suggest that the resulting losses would be passed on to nonbusiness consumers in the form of higher prices. Finally, with respect to taxpayers claiming deductions for meals or entertainment, the advocates argue that it is unfair to exact a "penalty" with respect to activities in which the beneficiaries may have engaged involuntarily for business reasons, and that in some cases may not convey substantial personal benefits.

Advocates of stricter deduction limits respond to this by disputing that economic dislocations would be that great. For example, the Administration's analysis of its proposals suggests that less than 15 percent of all business meals would be affected by the proposed limits in 1986. Moreover, these advocates view the fact that some business entertainment activity may be engaged in "involuntarily" as evidence of the economic distortions caused by the deductions—i.e., "bidding-up" of the price of entertainment events to the financial detriment of consumers who actually desire to attend apart from business considerations, but who must pay for tickets in after-tax dollars.

Finally, because a major rationale for limiting the deductibility of travel and entertainment expenses is the element of personal consumption in such expenses, some argue that the recipient of a benefit should bear the burden of any limitations. Under such a rule, for example, all amounts paid by an employer for travel and entertainment benefiting employees would be deductible (assuming the expenditures served a business purpose). However, a benefited employee would be treated as having compensation in the amount of the fair market value of the benefits received. Arguably, this inclusion could be reduced by the amount that would have been deductible by the employee (under whatever deduction limitation rules are adopted) had the employee himself or herself paid for the travel or entertainment activity.

In opposition to such a rule, it can be argued that the rule, even if theoretically more correct than limiting deductions, would create undue administrative difficulty. In particular, such a rule would require taxpayers to make determinations of fair market value and could increase the number of taxpayers whose returns would reflect an item of travel or entertainment expense, thus engendering both compliance and audit difficulties.

Specific issues

Apart from the overall question of the merits of changing the rules governing travel and entertainment deductions, the Administration and other proposals involve a variety of determinations and questions.

Meals

Definition of a meal.—Definitional rules would be needed to determine whether particular activities constitute entertainment, one meal, or more than one meal—e.g., in the case of parties where food is available, where a buffet meal is served, and where a sit-down meal is served, or gatherings where drinks are served with no food, some food, or a full meal. Similarly, clarifications would be needed as to whether one meal is involved when during an evening taxpayers have drinks or appetizers in one location, entrees in a second location, and after-dinner drinks in a third location, with varying amounts of time between the different stages.

Allocating costs.—An activity qualifying as a meal may have entertainment components as to which no deduction would be intended to be allowed. Examples include a social gathering at which food is served (and which arguably constitutes either a party or a meal), dinner theaters (where customers pay a single price for a meal followed by a show), meals served at an entertainment setting (e.g., a sporting event) and restaurants where the meal is followed by live entertainment. When such a restaurant charges a cover or a minimum, the amount of that charge may or may not bear a reliable relationship to the breakdown between food and entertainment elements.

Number of people at a meal.—The Administration proposal to apply the deduction ceiling on an average basis, rather than individually to each person in attendance, significantly reduces administrative difficulties in one respect. Instead of requiring taxpayers to determine which individuals ordered particular items (and, presumably, who ate or drank how much of any item that was shared), the proposal calls for multiplying the number of people in attendance by $25, thereby determining the maximum amount that can be deducted in full. However, the Administration proposal would still require additional recordkeeping by taxpayers, since under present law there is no need to trace the relationship between cost and the number of individuals in attendance.

The Administration proposal also creates a new substantive issue. If one person in attendance at a meal does not order any food, or stays for only a portion of the meal, it is unclear whether that person should be counted for purposes of the aggregated limit. If that person were counted, taxpayers could try to circumvent the ceiling, for example, by inviting a large number of persons for drinks or dessert but only a smaller number for a complete meal.

Cost-splitting by different taxpayers.—The proposal also raises questions when different taxpayers pay for different portions of the same meal. For example, one taxpayer may pay for entrees in one restaurant, while a second may pay for dessert in another. If the aggregate cost exceeds $25 per person, problems may arise both for the IRS, which may have no means of comparing different taxpayers' deductions on audit, and for the taxpayers themselves, who may not know the amount of each others' costs or may disagree about the proper allocation of the benefits of the $25 ceiling.

Possible modifications to Administration proposal.—In general, these problems have two underlying causes: the distinction in the tax treatment of meals and entertainment, and the application of a dollar ceiling. Both problems could be eliminated, and the possible administrative difficulties alleviated, if (1) rules were added either clarifying or eliminating the distinction between meal and entertainment deductions, and (2) the disallowance rules, instead of applying a dollar ceiling, disallowed a percentage of each deductible expenditure. For example, the Administration proposal to permit deductions for only 50 percent of meal costs above the ceiling of $25 per person could be modified to apply some percentage disallowance to the full meal cost.[48]

Disallowing a specified percentage of all meal deductions would significantly broaden the proposal's effect, since the Administration estimates that its proposed rule would affect less than 15 percent of all business meals. The determination of whether the proposed percentage disallowance of business meal deductions should apply to the deductions in full, or only to the extent that they exceed a dollar ceiling, also raises a theoretical question relating to

[48] Similarly, the Senate in 1982 passed a provision, as a proposed section of the Tax Equity and Fiscal Responsibility Act of 1982, under which 50 percent of all business meal deductions would have been disallowed. This provision was dropped in conference (see S. Rpt. 97-760, 97th Cong., 2d Sess. 556 (1982)).

the reason for imposing limitations. If business meal deductions are limited because of concern about abuse by taxpayers with unusually high expenditures, then a dollar ceiling is necessary to protect those taxpayers whose expenditures are reasonable. On the other hand, if the reason for disallowance is concern that all business meals by their nature provide personal as well as business benefits, then it can be argued that all such deductions should be disallowed in part.

With respect to the disparate treatment of meal and entertainment deductions, arguably the problems in distinguishing between them would be relatively slight. Thus, these problems could be addressed through specific rules describing how particular marginal items should be treated.

However, it can be argued more broadly that meal deductions should not be treated more favorably than entertainment deductions. While both types of activities convey personal benefits, in the case of a meal the benefit arguably is even clearer. Since food is a physical necessity, the recipient of a business meal presumably would have had to pay for his or her own meal (without receiving a deduction) if not for the business expenditure, while a beneficiary from business entertainment is not necessarily realizing a comparable personal saving.

One ground that can be advanced for treating meal deductions more favorably than entertainment deductions is that business is more likely to be discussed at a meal than during an entertainment activity, particularly since deductions are not allowed for meals occurring under circumstances that are not conducive to business discussions. However, this distinction is undercut by the fact that, under present law, business need not actually be discussed at the meal in order for a deduction to be allowable. Moreover, it is questionable whether a rule requiring that business be discussed at any meal for which a deduction is claimed could be enforced.

With respect to eliminating the proposed dollar ceiling for meals, it could be argued that this ceiling better serves certain policy goals than would reliance solely on a percentage disallowance rule. The latter rule has the arguably undesirable effect of permitting taxpayers whose travel and entertainment expenses are more lavish and abusive to claim larger deductions. A dollar ceiling may also be better suited to address the public perception of unfairness that results from large travel and entertainment deductions. In effect, it would propose a normative rule to taxpayers regarding the level of expenditure that is deemed reasonable for tax purposes.

The proposal not to apply the dollar ceiling to employee meals arguably creates a disparity in the Administration proposal. For example, it would permit professional corporations (e.g., law or accounting firms that incorporate) to provide expensive meals to employees at a lower after-tax cost than would be possible in the case of a partnership. It can be argued that employee meals merit favorable treatment because of the business purposes that they serve (e.g., the convenience of the employer in providing food on the premises, and the benefit of encouraging communication between employees). On the other hand, it can be argued that these purposes would not be undermined significantly by limiting deductions for employee meals to $25 per person per meal (plus half of the excess). In fact, it can be argued that the present deductibility of meals provided only to employees who are not away from home and for whom the meal is not a de minimis fringe benefit should be completely eliminated.

Entertainment

Since the Administration proposal disallows entertainment deductions in full, it involves no administrative difficulties other than the determination of what constitutes an entertainment activity or facility. It is possible that this determination would cause few significant problems, other than the distinction between meals and entertainment. The rules in present law concerning travel and entertainment deductions refer to activities "of a type generally considered to constitute entertainment, amusement, or recreation" (sec. 274(a)).

One possible issue that could arise relates to the distinction between entertainment and a business gift—for example, when individuals are provided with tickets to attend the theater. Under section 274(b), business deductions for gifts are allowed to the extent that the total cost of all gifts made by the taxpayer to the same individual during the taxable year does not exceed $25. An item does not constitute a gift unless it is given out of "detached and disinterested generosity," [49] and few, if any, items that so qualify are properly deductible under the business purpose requirements of sections 162 and 274. Nonetheless, in order to maintain consistent application of a rule denying entertainment deductions, it might be necessary to clarify that the rule applied to gifts of tickets to attend entertainment events.

Travel

The Administration proposal regarding travel expenses, although administratively simpler than the meal deduction proposal, raises several questions.

First, there is the fundamental issue as to whether stricter rules are needed. Some maintain that travel deductions are already adequately limited by the rule disallowing deductions for meal and lodging expenses that are "lavish and extravagant." However, it has been argued that this limitation is too imprecise either to inform taxpayers about what expenses are deductible or to empower the IRS to eliminate all serious instances of abuse. Moreover, even travel expenses that are not lavish or extravagant arguably should not be fully deductible, since they can convey untaxed personal benefits.

A second issue relates to the proposal to treat luxury water transportation as an activity inherently involving personal benefits such as entertainment and meals, as to which deductions would be limited to the cost of available alternate means of transportation. On the one hand, it can be argued that the proposal singles out luxury water transportation, and that this activity should be treat-

[49] *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960).

ed equally with comparable other items (e.g., other uses of luxurious travel or living accommodations). On the other hand, it could be argued on the same ground that the Administration proposal should be expanded rather than dropped. For example, there is little apparent difference between choosing luxury water travel instead of a cheaper form of transportation, and traveling first class by air when coach fares are available.

Another example of possible abuse that the Administration proposal does not address is the rule under present law denying deductions for convention expenses only when the conventions are held outside of the North American area. Conventions held in the North American area—for example, at popular resort and vacation sites—may also give taxpayers the benefit of shifting a portion of the cost of personal consumption to the government. The "North American area" rule also does not appear to be specifically designed to encourage spending in the United States rather than in foreign countries. The North American area is defined as including Canada, Mexico, and certain Caribbean countries, as well as the United States.

Stricter rules also could be applied to limit possible abuse with respect to deductions allowable under present law for attending foreign conventions. The present-law restriction, that holding the convention abroad must be as reasonable as holding it in the North American area, has arguably been abused by some U.S. organizations with predominantly U.S. members, which hold conventions in attractive foreign locations based on asserted business reasons that may bear little relationship to the actual activities of many attendees.

Any such abuse could be addressed by denying deductions for expenses of attending foreign conventions (defined either as those held outside of the United States, or as those held outside of the North American area) except under narrowly defined circumstances. For example, such deductions could be allowed only in the case of a convention held by a foreign organization, or at which more than one-half of the attendees are from foreign countries.

It has also been argued that stricter rules should be applied to expenses for travel by spouses.[50] When taxpayers claim deductions for travel by spouses or other companions of individuals who are traveling for business reasons, and the spouses or other companions are not directly involved in the business activity, the government—i.e., the taxpaying public—ends up sharing the costs for the personal benefit of companionship.

While present law would disallow deducting expenses for spouses absent a showing of business purpose, there still may be circumstances of abuse. For example, taxpayers may argue that socializing by spouses in itself serves a business purpose, or may give spouses relatively minor business roles solely for the purpose of justifying the deduction. These abuses could be addressed by denying any deduction for travel (as well as meal and entertainment) expenses that relate to a spouse of a business traveler unless the

[50] Such arguments apply not only to travel expenses, but also to deductions for meals and entertainment.

spouse is either a full-time employee of an employer, or is active on a full-time basis in a business to which the travel relates.

It can also be argued that any revision of the rules for business travel should impose per diem limits, such as those in the 1984 Treasury Report, on deductible living and incidental expenses. Although the cost of basic lodging while one is traveling can be viewed as a business necessity that conveys no positive personal benefit, the arguments that are applied to other proposed limitations (e.g., the proposed ceiling on meal deductions) could be thought to apply here as well. For example, excessive lodging costs that reflect an unusual degree of luxury cannot easily be distinguished from lavish meals or traveling by luxury boat rather than by train or plane.

On the other hand, one could argue that the cost of staying in a very luxurious hotel is no more abusive than deducting the cost of a luxurious office as one's regular place of business. No limitations have been suggested regarding the latter item.

Of course, applying per diem limits to deductions for travel expenses would involve some of the same administrative problems as those resulting from the proposed dollar cap on the full deductibility of meal expenses. In order to be effective, these limits would have to apply without reference to who paid for any particular expense. Otherwise, the ceiling could be avoided by the simple expedient of having different taxpayers pay for different items (although this problem might be less serious in practice for hotel expenses than, for example, for meals). Yet, if different taxpayers are subject to a single aggregated limit on deductions, both the taxpayers and the IRS may have difficulty in determining what amount is properly deductible.

Commuting

It can be argued that the rules governing the deduction of commuting expenses should be liberalized along the lines suggested in the initial Treasury proposal, on the ground that taxpayers such as construction workers often have unusually high commuting expenses due to the nature of their work (i.e., the lack of a permanent place of business). Thus, accurate measurement of their true level of net income arguably requires allowing a deduction for the portion of their commuting costs that significantly exceeds the norm.

On the other hand, it can be argued that commuting is a personal expenditure of a sort that fundamentally should not be deductible. Despite its business overtones (since it is a necessary cost of going to work), it substantially reflects the taxpayer's decision about where to live. Other personal expenses that are necessary for work (e.g., buying clothes to wear to work, or eating enough food to stay healthy) are not deductible. Thus, it can be argued that having unusually high commuting expenses is no different in principle than having other high personal living expenses (e.g., for meals in a city with a high cost of living) that do not give rise to a deduction. Finally, permitting deductions for commuting under special circumstances, while continuing to deny commuting deductions generally, would add to the complexity of the tax laws.

Travel as a form of education

The Administration proposal to deny deductions for travel as a form of education (e.g., a trip to Europe by a high school language teacher) is apparently based on concern about abuse. Travel that is undertaken for educational purposes can serve vacation purposes as well. While this is true of business travel generally, it can be argued that the business purpose of providing work-related education is relatively indirect and insubstantial (when compared, for example, with attending a business meeting).

On the other hand, it can be argued that, so long as the business purpose underlying a particular instance of educational travel is sufficient to support a deduction under present law, there is no basis for applying less favorable treatment than that applying to other business travel.

B. Employee Business Expenses, Investment Expenses, and Other Miscellaneous Itemized Deductions

Present Law and Background

The list of itemized deductions on Schedule A of Form 1040 includes a category labeled "miscellaneous deductions," following the listings for medical expenses, charitable expenses, interest, taxes, and casualty and theft losses. This category generally includes four types of deductions: certain employee business expenses (sec. 162); expenses of producing income (sec. 212); expenses related to filing tax returns (sec. 212); and expenses of adopting children with special needs (sec. 223), discussed in Part V-G of this pamphlet.

Employee business expenses

In general

An employee business expense is a cost incurred by an employee in the course of performing his or her job. These include unreimbursed expenditures for subscriptions to professional journals or continuing education courses, union or professional dues, costs of looking for new employment, and expenses allowable for business use of the taxpayer's home. Employee business expenses generally are deductible, since they are viewed as costs of earning income.

Under present law, employee business expenses generally can be claimed only as itemized deductions. However, four types of employee business expenses are deductible "above-the-line" in calculating adjusted gross income, and thus are directly available to nonitemizers: expenses paid by an employee and reimbursed by the employer; employee travel expenses incurred while away from home; employee transportation expenses; and business expenses of employees who are outside salespersons. For taxpayers in a trade or business other than being an employee (e.g., as sole proprietors and partners), all business expenses are deductible above-the-line.

Some business expense deductions are subject to specific limitations or restrictions (applicable to both employees and others engaged in a trade or business) that involve complexity and enforcement problems for taxpayers and the IRS, and have resulted in numerous court cases. For example, educational expenses are deductible only if the education is (1) required by the employer, by law, or by regulations, or (2) maintains or improves skills required to perform the taxpayer's present occupation. This rule has led to litigation involving various factual situations as to whether the specific education related to the taxpayer's current occupation, or prepared him or her for a new field of work.

Business use of home

Another area of complexity has involved the deduction for business use of a residence. A taxpayer's business use of his or her home does not give rise to a deduction for the "business" portion of expenses related to operating the home (e.g., rent, depreciation, and repairs) unless the taxpayer uses a part of the home regularly and exclusively as the principal place of business or a place of business used by patients, clients, or customers (sec. 280A).

For an employee, a further requirement for the deduction is that the use of the home is for the convenience of the employer. The interpretation of this provision is not always clear. For example, under some circumstances a college professor may be entitled to a deduction with respect to a study area that the professor uses regularly and exclusively for work-related research and writing, even if the employer provides an on-campus office.

In a recent Tax Court case, these limitations were held inapplicable where an employer rented a portion of the employee's home.[51] The court held that the rent received by the employee was includible in gross income, but that all offsetting expenses were deductible without reference to the above limitations. It has been suggested that some taxpayers might view this decision as support for transactions whereby payments of disguised compensation, in the form of rent, could be made to employees.[52]

Investment expenses

In general, expenses of producing income other than rental or royalty income are treated as itemized deductions if the related activity does not constitute a trade or business. (Trade or business expenses and expenses of producing rental or royalty income are deductible above-the-line.) Among the typical investment expenses that generally are eligible for deduction are investment counsel fees, subscriptions to investment advisory publications, the cost of clerical help and office rent relating to one's investments, gambling losses to the extent of gambling gains, and attorneys' fees incurred in collecting income.

Other miscellaneous itemized deductions

Tax counsel and assistance fees, as well as appraisal fees paid to determine the amount of a casualty loss or a charitable contribution of property, can be claimed as itemized deductions (sec. 212(3)). Also, expenses incurred with respect to a "hobby"—i.e., an activity that may generate some gross income but that the taxpayer conducts for personal recreational reasons, rather than with the goal of earning a profit—are deductible to the extent such expenses would be deductible regardless of profit motivation (e.g., certain interest and taxes) or to the extent of income from the hobby.

Unless the IRS establishes to the contrary, an activity is presumed to be engaged in for profit if, for two or more out of five consecutive years (seven consecutive years in the case of an activity involving the breeding, training, showing, or racing of horses), the

[51] *Feldman* v. *Comm'r*, 84 T.C. No. 1 (1/1/85).
[52] *See* C. Landstraat, "Increasing Deductions by Renting A Home Office to the Employer," 63 TAXES 497 (1985).

gross income from the activity exceeds the related deductions. An individual may elect to have a determination to which such a presumption applies deferred for several years, but if this election is made the determination applies retroactively to each year in which the individual engaged in the activity (sec. 183).

Administration Proposal

Under the Administration proposal (and the 1984 Treasury report), the amount of employee business expenses (whether allowed under present law above-the-line or only as itemized deductions) would be added to the amount of the other items presently allowed as miscellaneous itemized deductions (i.e., expenses for production of income or filing tax returns). This total would be deductible above-the-line, both by nonitemizers as well as itemizers, but only to the extent exceeding one percent of the taxpayer's adjusted gross income (as measured before allowing any miscellaneous deductions). The proposal would not affect the deductibility of nonemployee trade or business expenses or of expenses of producing rental or royalty income.

Two special rules would apply. First, employee business expenses that are reimbursed by the employer would not be subject to the one-percent floor. Second, State and local real or personal property taxes and sales taxes, if incurred in carrying on an income-producing activity but presently allowable only to itemizers, would be aggregated with the employee expenses, etc., described above; hence, the amount of such taxes incurred in producing income would be deductible to the extent the aggregate amount exceeds the floor.

In general, State and local taxes incurred with respect to investment activities (e.g., real property taxes on vacant land held for investment, and intangible personal property taxes on stocks and bonds) would be subject to the floor. However, the floor would not apply to taxes incurred with respect to property held for the production of rents or royalties, or in carrying on an active trade or business.

Other Possible Proposals

Either instead of or in addition to the changes proposed by the Administration, certain miscellaneous deductions could be subjected to new restrictions or disallowed.

Thus, deductions could be wholly denied for one or more of the following expenses: (1) business use of a home (including under a lease arrangement with one's employer) in the case of an employee with a regular place of business outside of the home; (2) costs of looking for a new job; and (3) dues to professional societies and for subscriptions to professional journals. Also, deductions for investment expenses could be limited to the amount of related investment income, and could be denied altogether in the case of activities serving both personal and investment purposes (e.g., rental of a safe deposit box). In addition, the definition of hobby losses, which are deductible only to the extent of hobby income, could be expanded.

The Administration proposal could also be adopted only in part. For example, the one-percent floor could be adopted without moving miscellaneous deductions above-the-line, and without affecting the present above-the-line employee business expenses. Alternatively, the above-the-line employee business expenses could be moved below-the-line, and aggregated with the miscellaneous deductions for purposes of applying the one-percent floor.

If miscellaneous deductions continue to be allowed only below-the-line, they could be treated in the manner proposed for all itemized deductions under the Bradley-Gephardt bill (S. 409; H.R. 800). Under this bill, all taxable income would be taxed at a 14-percent base rate. The bill would also levy a surtax on adjusted gross income above certain levels. To eliminate the greater proportionate benefit that each dollar of deduction confers on taxpayers in higher brackets, the bill would allow itemized deductions (including the miscellaneous deductions) only against taxable income taxed at the 14 percent rate, and not against adjusted gross income, which would be subject to the surtax.

Analysis

In general

The proposal to impose a floor under deductions for certain employee business expenses and other miscellaneous expenses, and to allow the excess as an above-the-line deduction, raises a number of issues.

The question of whether a deduction should be allowed in full, or only to the extent in excess of a percentage of adjusted gross income, involves several considerations. In one sense, the use of a deduction floor fosters simplicity. It relieves taxpayers of the need to keep records substantiating incidental expenses unless they have reason to expect that their allowable deductions may exceed the floor. It also relieves the Internal Revenue Service of the need to audit and verify deductions claimed for numerous small items. The Administration proposal is based on the view that this problem is particularly significant in the case of miscellaneous deductions, and that taxpayers make numerous errors of law regarding allowable deductions in the miscellaneous category.[53]

On the other hand, to the extent a deduction that ought in theory to be allowable in full is restricted by the use of a floor, the floor arguably is unfair. It penalizes taxpayers who have deductions that are subject to the floor, in comparison to other taxpayers, by depriving them at least in part of a deduction that may be important to the accurate measurement of income. For example, a taxpayer who earned $1,000 in a stock transaction, but paid a broker $500 to manage his assets, would not be able to deduct the fee if his or her total miscellaneous deductions equalled less than one percent of adjusted gross income. Taxpayers with miscellaneous deductions might not object to the burden of keeping accurate records if the result were to reduce their tax liabilities.

[53] Common taxpayer errors may include disregarding the restrictions on the home office deduction, and on the types of education expenses that are deductible; claiming a deduction for safe deposit expenses even if used only to store personal belongings; and deducting the cost of subscribing to widely read publications outlining business information without a sufficient business or investment purpose.

Further, since the floor on employee expenses would not apply to the same types of expenses when incurred by independent contractors, partners, or sole proprietors, it can be argued that a floor unfairly distinguishes among individuals simply based on the nature of their employment relationship. Moreover, it would put pressure on the distinction between reimbursed and nonreimbursed expenses (e.g., potential differences in tax treatment between those reimbursed item-by-item, and those covered by a general allowance), and could be avoided if employers agreed to reimburse employees for specific expenses which employees presently deduct. Finally, the use of a floor lessens simplicity to the extent that it requires taxpayers who keep track of their miscellaneous deductions to make an extra calculation.

By allowing miscellaneous deductions above-the-line, the Administration proposal would permit nonitemizers, as well as itemizers, to claim them. The decision whether to allow a deduction above-the-line, rather than only as an itemized deduction, generally rests on one of two considerations.

First, there may be a policy decision that all taxpayers should be allowed to benefit from the deduction. However, it is not necessarily clear why this concern should be more applicable to miscellaneous deductions than, for example, to deductions for home mortgage or consumer interest, casualty losses, or medical expenses. Further, nonitemizers benefit from the allowance of deductions that can be claimed only by itemizers, since the zero bracket amount is intended to reflect such expenditures typically made by nonitemizers.

Second, as a matter of tax policy there is a general distinction between above-the-line and itemized deductions, although many deductions may be allocated inconsistently with this theoretical distinction. In principle, a deduction is allowed above-the-line if, as an expense of generating income, it must be subtracted from gross income in order to arrive at an accurate measurement of the taxpayer's true net income. By contrast, itemized deductions generally are considered to reflect personal expenditures which, although not properly deductible in measuring economic income, are allowed for reasons of social policy.

The proposal to allow miscellaneous deductions above-the-line may rest in part on a decision to benefit nonitemizers. As a whole, the Administration proposal should lower the percentage of taxpayers who itemize, in large part due to the proposed repeal of itemized deductions for State and local taxes. However, in view of the fact that the Administration proposal generally keeps other itemized deductions below-the-line, the proposal to move miscellaneous deductions above-the-line may instead be based on the view that they are properly allowable in calculating economic income—a view theoretically inconsistent with the decision to allow them only to the extent in excess of a floor, although arguably supportable for simplification purposes.

This seeming inconsistency may be the result of drawing two conflicting conclusions about the miscellaneous deductions allowed under present law. On the one hand, miscellaneous deductions generally appear to be allowable based on the premise that they are costs of earning income, rather than personal expenditures allowed for policy reasons. For example, employee business expenses and investment expenses are generally business-related rather than personal. On the other hand, however, it can be argued that many miscellaneous deductions are not properly deductible under this rationale, either because they are not truly costs of earning income (since the expenses are sufficiently personal that they would have been incurred whether or not the income was earned) or because they are subject to significant abuse.

The Administration proposal provides one possible response to the view that miscellaneous deductions are legitimate in theory but questionable in practice. It allows them above-the-line but limits them by imposing a floor. A second possible approach, however, would be to allow miscellaneous deductions in full (whether above-the-line or as itemized deductions), but to respond to concerns that some of them are inappropriate or subject to abuse by wholly repealing specific deductions or else limiting them in particular respects.

To the extent that the one-percent floor is designed to increase simplicity, by relieving many taxpayers of the need to keep track of numerous small expenditures, its effectiveness may be counteracted in part by the proposal to move miscellaneous deductions above-the-line. Allowing miscellaneous deductions only to itemizers (as under present law) would further reduce the number of taxpayers who would be required to keep track of numerous small expenditures.

The Bradley-Gephardt bill, under which itemized deductions would be allowable only against the lowest marginal rate, raises issues that are related to the dispute about whether miscellaneous deductions are costs of earning income. The proposed rule is meant to equalize the effect of deductions that are provided for reasons of equity and social policy, instead of providing larger reductions in tax to taxpayers in higher brackets. However, the proposal generally is not meant to apply to deductions which represent costs of earning income. Thus, the appropriateness of applying it to the miscellaneous deductions depends in part upon one's views of the merits, and reasons for allowing, those deductions.

Particular items

The miscellaneous deductions that arguably could be repealed or limited on this ground include the following.

Business use of the home

In some cases, deductions for a portion of the costs of acquiring and maintaining a building that includes the taxpayer's home are clearly proper. For example, if an individual owns a building and operates a grocery on the first floor, and lives on the second floor, costs relating to the first-floor store are properly deductible. In other cases, however, the appropriateness of the deduction for business use of one's home is less clear.

For example, some taxpayers who have regular places of business but prefer to do some work at home deduct a portion of the costs of operating their homes as a miscellaneous expense. Even under the limitations applying to this deduction under present law (i.e., the rule that the portion of the home giving rise to the deduction must be used both regularly and exclusively for business purposes), allowing this deduction may be questionable.

First, the fact that a taxpayer can set aside room to work at home may be viewed as a personal benefit that enhances the home's value. Second, it is difficult on audit to verify the accuracy of taxpayers' statements about how they use particular portions of their homes. In addition, some believe that the courts are applying the statutory standard in a more liberal manner than the Congress intended.

Accordingly, it could be argued that no deduction should be allowed for use of a home in the case of a taxpayer who has a regular place of work outside of the home. For example, employees could be denied any deduction for home business costs unless they had no outside office or other regular place of business. On the other hand, it can be argued that an individual who maintains a home office for a business totally separate from the one for which the other office is established should continue to be allowed a deduction for the home office.

Additionally (or alternatively), the restrictions on this deduction could be extended to instances where the employer leases a portion of the employee's home.[54] Allowing employees to use this method of circumventing restrictions on home office deductions invites abuse in the form of sham transactions whereby a portion of salary is nominally paid as rent. Moreover, it may be questioned whether such lease transactions between employers and employees are likely ever to be negotiated truly at arm's length. Thus, it may be difficult to prevent abuse even under the general rule of tax law whereby sham transactions are disregarded.

Costs of looking for a new job

Under present law, the cost of looking for a new job is deductible if it is in the same occupation as the taxpayer's present job, but not if it is in a new occupation. Arguably, this distinction is untenable and both types of expenditures should be viewed as nondeductible personal items. For example, if an accounting student and a practicing accountant fly from New York to California, in both cases to attend job interviews with accounting firms, it is unclear why the latter but not the former should be allowed a deduction.

Certain professional dues and expenses

Although membership dues paid to professional societies (e.g., bar associations, business groups, and unions) may serve business purposes and, in some cases, be professionally required, these expenditures often have voluntary and personal aspects. Subscriptions to professional journals, although they may help taxpayers in conducting their professions, may also convey personal and recreational benefits. Accordingly, all deductions for these expenditures could be denied, possibly with an exception for membership dues that are required by law.

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[54] Allowance of this deduction may be questionable even under present law, although the Congress may wish to clarify the rules involved.

Investment expenses

Under present law, investment expenses, unlike costs related to a trade or business, are generally allowed only as itemized deductions. One of the principal distinctions between an investment activity and a trade or business is that the taxpayer is not personally or regularly active in the investment activity.

However, there are certain exceptions to the general grounds for distinguishing between above-the-line and below-the-line income-producing activities. In particular, expenses related to royalty or rental income (e.g., commercial real estate) are allowed above-the-line without reference to the taxpayer's degree of personal activity.

If expenses incurred in activities in which the taxpayer is not personally active are viewed as less properly allowable than deductions incurred in trade or business activities (in part, because the former may frequently give rise to tax shelters), then investment expenses could be limited to the amount of offsetting investment income. For example, deductions for investment advice could be limited to the amount of related taxable investment income.

Deductions could be also denied for investment expenses that may convey personal as well as investment benefits. For example, it could be argued that subscriptions to investment journals and amounts paid to rent safety deposit boxes should not be deductible because they would be incurred regardless of whether income is earned.

Finally, expenses related to the production of rental and royalty income (e.g., commercial real estate and certain oil and gas or other mineral-producing properties), when not part of a trade or business, could be treated the same way as other investment activities. In other words, where the taxpayer is not personally or regularly active in the income-producing activity, these expenses could be allowed only as itemized deductions.

Such a change would eliminate the disparity under present law between the treatment of rental and royalty activities, on the one hand, and other income-producing activities, on the other. However, it might create administrative difficulty, since rental and royalty activities are often conducted through agents, and accordingly can be difficult to characterize under the active-passive distinction.

Hobby losses

In general, expenses arising from hobbies (which are defined as activities not engaged in for profit) are deductible only to the extent that they would be allowable as itemized deductions without reference to whether they were incurred in an activity designed to produce income (i.e., certain interest and taxes), or to the extent of hobby income. This limitation applies, for example, to activities such as horse-breeding, farming, and researching a restaurant or travel guide, if the taxpayer's motivations are recreational rather than concerned with earning a profit.

Present law generally requires application of a broad facts and circumstances test to determine whether a particular activity constitutes a hobby. However, it can be argued that the hobby loss restrictions should apply in practice to a broader range of activities. Taxpayers may be able to manipulate their hobby activities to provide the appearance of profit motivation, while expecting and realizing losses which can be claimed against other income.

This problem could be addressed by disallowing all net losses that relate to activities of a kind that are viewed as common hobby pursuits. These activities could be specifically listed, instead of being identified through a facts and circumstances test as under present law. Among the activities that have been treated in some instances as hobbies under present law are the following: (1) the preparation of restaurant and travel guides, (2) breeding, showing, or racing dogs or horses, (3) farming when it is not the taxpayer's principal business, (4) car racing, (5) flying airplanes, (6) collecting antiques, (7) boat chartering and racing, (8) lecturing, (9) painting or maintaining an art studio, (10) photography, (11) writing articles or books, and (12) growing trees or flowers.

Since the hobby loss restrictions only would have the effect of disallowing the use of losses from one type of activity to offset income from other profitable activities, they would have no adverse impact on individuals who engage exclusively in, or realize a profit from, any of the above activities. Moreover, a rule could be established permitting disallowed losses, instead of being lost permanently, to be carried forward and claimed against subsequent income from the same activity.

VII. PRESIDENTIAL CAMPAIGN CHECKOFF; POLITICAL CONTRIBUTIONS CREDIT

A. Presidential Campaign Checkoff

Present Law and Background

Under present law, individual taxpayers may allocate $1 ($2 on a joint return) of their Federal income tax liability to the Presidential Election Campaign Fund, a fund established to provide financing to the campaigns of presidential and vice-presidential candidates (Code sec. 6096). Allocating this amount to the Fund neither increases nor decreases the taxpayer's income tax liability, but merely determines whether the allocated amount is to be used by the Federal Government for presidential campaign funding.

The campaign fund checkoff provision was enacted in 1966 as part of the Presidential Election Campaign Fund Act. Its effective date was postponed, however, until 1973, when guidelines on the distribution of the funds had been formulated. Additional legislation adopted in 1974 provided for partial matching of contributions received by presidential primary candidates, and extended public funding to political parties to finance their nominating conventions.

The enactment of the checkoff provision was a response to dramatic increases in the cost of conducting a presidential campaign in the 1960's, and the corresponding increase in the candidates' dependence on large political contributions. The Congress believed it was important to preserve the President's independence on national issues and responsiveness to the needs of the general population, rather than to particular persons, groups, or entities capable of making large contributions.

As originally enacted, the checkoff provision permitted an individual to designate which political party would receive the allocated amount rather than to make an allocation to a general fund.[55] The political party designation aspect of the checkoff was eliminated in 1973 out of concern that the requirement that party affiliation be indicated on the face of the return might create, or be perceived by taxpayers as creating, a bias in the selection of returns for audit. Placing the designation on a separate form was not considered an acceptable alternative, since many attributed the poor response to the checkoff during its initial year to the requirement of a separate form.

The solution ultimately adopted by the Congress was to require the checkoff on the first page of the return, but to eliminate any designation as to party preference. The allocation of amounts in

[55] Presumably, this reflected a judgment that the difficult decision as to how the funds should be allocated among the various parties was better left to individual taxpayers.

the campaign fund among political parties is now prescribed by statute.[56]

The checkoff was marked "yes" on approximately 23 million returns for 1984, or approximately 24 percent of the individual returns filed for that year.[57] The total dollar amount of the designation in 1984 was approximately $35 million.

Administration Proposal

The checkoff for the Presidential Election Campaign Fund would be repealed, effective for returns filed for 1986.

Analysis

The campaign fund checkoff permits taxpayers to determine whether $1 ($2 in the case of a joint return) of their taxes will be devoted to presidential campaign funding. In essence, individual taxpayers determine the extent to which the Federal Government directly subsidizes national political campaigns.

The checkoff is unique in the sense that no other provision of present law permits taxpayers to designate on the face of their tax return for what purpose an amount of tax liability must be used by the Government. Also, present law does not permit taxpayers to make contributions for charitable or other purposes through their Federal income tax return.[58]

In proposing repeal of the checkoff provision, the Administration argues that it is confusing to taxpayers, who often do not understand its purpose or effect, and that it contributes to the complexity of the Federal income tax forms. Others favoring repeal point out that there are numerous worthy causes that would benefit from a provision allowing taxpayers to earmark a portion of their tax liability for specific purposes. It is inappropriate, they argue, to single out presidential and vice-presidential candidates (and their parties) for favored treatment.

Proponents of the campaign fund checkoff, on the other hand, contend that taxpayers, rather than the Congress, should make the decision whether Federal funds should be used be used to finance political campaigns.[59] Moreover, making funds available to political candidates through this mechanism helps relieve the pressure on candidates to accept contributions from special interest groups.

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[56] The allocation varies according to whether the party is a major party (receiving at least 25 percent of the total popular vote in the preceding presidential election), a minor party (receiving 5 percent or more but less than 25 percent of the vote), or a new party (receiving less than 5 percent of the popular vote). Allocations to major parties are based upon the maximum spending limits of the Federal Election Campaign Act of 1971. Minor parties receive allocations based on the ratio of the number of votes received in the last election to the average number of votes received by the major parties. New parties may receive allocations after the election results demonstrate that their candidates have received more than five percent of the vote in the current election.

[57] These figures are typical of checkoff usage in recent years. For example, 24.2 percent of the returns marked the checkoff "yes" in 1983, and 26.9 percent in 1982.

[58] In the instructions accompanying individual and corporate tax returns, however, the Commissioner of Internal Revenue has encouraged taxpayers to include with their tax return voluntary contributions to reduce the public debt. Taxpayers wishing to do so must enclose a separate check payable to the Bureau of Public Debt.

[59] It should be noted that one purpose of the original checkoff provision—to let taxpayers rather than the Congress allocate Federal funds among political parties—is no longer valid. The allocation is now prescribed by a statutory formula, and the sole function of the checkoff is to permit taxpayers to "vote" for or against Federal funding.

The present system encourages candidates to solicit from small contributors, since only small contributions are eligible for matching under the Federal matching program.

In addition, it is argued that the present direct funding system results in greater public disclosure of campaign finance information. In order to receive Federal funds, candidates must make full disclosure of political contributions and expenditures to the Federal Election Commission, which makes this information available to the public.

Data collected by the Internal Revenue Service indicate that, in recent years, one-fourth of the returns received marked the checkoff "yes." This may suggest that a majority of the taxpaying public opposes public funding of presidential campaigns and that it should be discontinued. On the other hand, it may simply reflect general apathy about politics, opposition or indifference to the particular candidates for office in an election, or a lack of understanding of the provision.[60] If the level of response is attributable to a lack of understanding, it could perhaps be remedied by a better taxpayer information program.

If the checkoff were eliminated and no direct appropriation were made by the Congress, presidential candidates would have to rely solely upon private contributions. Thus, the original motivation for the checkoff provision—concern over the possibility of excessive political influence over holders of national office by large campaign contributors—would have to be reexamined to determine its continued validity in light of today's laws and circumstances. Furthermore, some loss of the ability to oversee campaign receipts and expenditures might occur as a result of the elimination of the campaign fund. Accordingly, it could be appropriate to examine current Federal election laws to determine whether a strengthening of those laws would be needed to protect against campaign abuses.

[60] Although statistics show that a majority of the taxpayers who do not respond affirmatively to the checkoff respond "no," a significant portion simply fail to indicate either "yes" or "no."

B. Political Contributions Tax Credit

Present Law and Background

Individual taxpayers may claim a nonrefundable income tax credit equal to one-half the amount of their contributions to political candidates and certain political campaign organizations during the taxable year (Code sec. 24). The maximum allowable credit is $50 for an individual and $100 for a married couple filing a joint return.[61]

This provision was enacted in 1971 in response to the rising cost of political campaigns and the increasing dependence of candidates on large contributions from wealthy individuals and special interest groups. The Congress was concerned that this trend threatened the political independence of candidates once they were elected; the provision was added to encourage smaller contributions by numerous individuals and create a broader and more democratic financial base for political candidates and parties. Some viewed this as an appropriate alternative to more far-reaching proposals for direct Federal funding of Congressional campaigns.

The political contributions credit was claimed on approximately 5.2 million returns in 1982, or about 6.6 percent of individual returns with some tax liability before credits. The credit is estimated to reduce fiscal year budget receipts by about $300 million annually.

Administration Proposal

The Administration proposal would repeal the credit for political contributions, effective for taxable years beginning after 1985.

Other Proposals

Both the Kemp-Kasten bill (H.R. 2222; S. 1006) and the Bradley-Gephardt bill (S. 409; H.R. 800) would repeal the political contributions credit.

Analysis

The Administration proposes repeal of the political contribution credit on several grounds. First, it questions the efficacy of the credit, observing that no incentive is provided in the case of contributions exceeding the specified limits or in the case of taxpayers having no tax liability. Second, the Administration argues, the credit has no relationship to economic income; instead, political

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[61] Prior to 1979, a taxpayer who itemized deductions could claim a deduction for political contributions up to $100 ($200 on a joint return) in lieu of a credit of up to $25 ($50 on joint returns). The Revenue Act of 1978 repealed the alternative deduction, on the ground that it added complexity to the tax forms and instructions, and increased the maximum credit to its present level.

contributions represent personal expenditures of the contributor. Third, the credit creates administrative and compliance problems for the Internal Revenue Service. The small amount allowed per return makes verification costly relative to the revenue in issue; moreover, verification may require the IRS to make sensitive inquiries concerning political affiliation. Finally, the Administration asserts, the credit causes increased complexity for taxpayers, who are forced to maintain records of their contributions and fill out an additional line on their income tax forms.

Those who favor retaining the political contribution credit respond that the purposes that originally gave rise to the credit are as valid today as when it was enacted. Political campaigns are more expensive than ever, and the potential for undue influence and abuse persists. It is important, they argue, that tax incentives for small contributors be retained. This will help to assure political candidates and parties a broad base of financial support, reducing their dependence on a few wealthy contributors. Such broad-based financial support is especially crucial, they argue, for candidates in State and local campaigns and for nonincumbent Congressional candidates, who are less likely to receive large contributions.

Finally, proponents contend, the additional contributions generated by the allowance of the credit serve the public interest by encouraging fuller dissemination and discussion of ideas and issues. Without these funds, the candidates would be less capable of communicating their views to the public through media advertising and other means.

In examining this issue, the question arises whether the credit is fully accomplishing the objective of reducing candidates' reliance on large contributors. The Federal revenue loss from the political contribution credit in fiscal year 1982 was $270 million, which represents only a small fraction of the total expenditures for all political campaigns (national, State, and local) in the United States for that year. Thus, it can be argued that the impact of the credit has not been significant.

Moreover, data compiled by the Treasury Department and IRS suggest that a significant percentage of the users of the credit are individuals with sufficiently high incomes to make political contributions in after-tax dollars, without the benefit of a credit. Also, since the maximum credit is $50 for individual returns and $100 for joint returns, repealing the credit would not significantly increase any taxpayer's liability.

On the other hand, it can be argued that the credit continues to serve the purpose of encouraging the participation of average citizens in the political process at the Federal, State, and local levels.

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