

SIMPLIFICATION OF THE TAX RETURN  
AND OTHER MISCELLANEOUS  
SIMPLIFICATION ITEMS

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PREPARED FOR THE USE OF THE  
COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE  
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION



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## A. DEDUCTION FOR ALIMONY PAYMENTS

### Present law

Under present law, a deduction for alimony paid is available for the taxpayer only as an itemized deduction. The recipient of alimony must include such payments in his or her income and pay tax on them. Payments for the support of a spouse which are not required by a divorce or separation agreement and payments for the support of children are considered normal living expenditures on the part of a taxpayer. Such expenditures are not deductible and are not included in the income of the recipients.

### Problem

Questions have been raised as to whether the splitting of income or assignment of income through the payment of alimony is properly treated under current law which permits only an itemized deduction for alimony. Some contend that the payment of alimony should be taken into account in determining net income. Items taken into account in determining net income are generally treated as deductions in arriving at adjusted gross income, rather than as itemized deductions which are generally limited to personal expenses. A deduction from gross income is available to taxpayers who elect the standard deduction instead of itemized deductions.

### Proposals

#### *1974 committee bill*

Last year the committee moved the deduction of alimony payments from an itemized deduction to a deduction from gross income to arrive at adjusted gross income.

#### *Mr. Ullman*

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

## B. TREATMENT OF LOSSES FROM CERTAIN NON-BUSINESS GUARANTIES

### Present law

Under present law, in the case of a noncorporate taxpayer, business bad debts are deductible as ordinary losses for the year in which the debt becomes worthless or partially worthless. On the other hand, non-business bad debts are treated as short-term capital losses, which means that the losses are offset first against the taxpayer's capital gains (if any), and may then be deducted against ordinary income to the extent of \$1,000 per year.

However, where the noncorporate taxpayer's loss results from a situation where he guaranteed the debt of a noncorporate person, and was required to make good on that guaranty because the borrower defaulted, section 166(f) of the code provides that the guarantor may

treat the payment under the guaranty as a business bad debt (even though the guaranty did not arise in connection with the guarantor's trade or business) if (1) the proceeds of the loan were used by the borrower in his trade or business, and (2) the debt was worthless when payment was made by the guarantor (i.e., the borrower was insolvent). The deduction is allowed for the year in which the payment is made.

However, the guarantor of a corporate obligation which becomes worthless must treat the guaranty payment as a nonbusiness bad debt (Reg. §1.166-8(b)).

If the loan is not used in the borrower's trade or business, the provisions of section 166(f) do not apply. However, the guarantor's payment will still be deductible as a nonbusiness bad debt (short-term capital loss) if the debt is worthless when paid and the guarantor has a right of reimbursement (subrogation) against the borrower.<sup>1</sup>

In cases where the guarantor has no right of subrogation, there has been some uncertainty as to whether, and under what circumstances, the guarantor was entitled to deduct his guaranty payment. For some time it was believed that the payment could not be deducted as a bad debt on the theory that unless there is a right of recovery against the borrower, there is no "debt" which might become worthless in the hands of the guarantor. However, if the guaranty transaction was entered into in connection with the taxpayer's trade or business, or the agreement was part of a transaction entered into for profit on the part of the taxpayer, then the payment was thought to be deductible as a loss under section 165.

This legal theory led to attempts on the part of some taxpayers to take themselves out of the general rules relating to guaranties of debts, by taking steps to insure that they would have no right of subrogation against the borrower if he defaulted. (This was particularly true in the case of guaranties by taxpayers of corporate obligations where the taxpayer was a shareholder in a closely held corporation.) The taxpayer would then attempt to claim an ordinary loss deduction under section 165, instead of receiving nonbusiness bad debt treatment under section 166.

More recently, courts have stifled such attempted avoidance of the bad debt rules, by finding an implied promise on the part of the borrower to reimburse the guarantor for his payments, and holding that this implied promise constituted the bad debt.<sup>2</sup> Thus, taxpayers were required to claim their deduction under section 166. However, there is no assurance that the rationale of these cases will be applicable in all fact situations where there is potential for avoidance of the bad debt rules, or that these opinions will be followed in every jurisdiction.

### Problem

As discussed above, where a taxpayer makes a loan which is not connected with his trade or business, and the debt becomes worthless, he is generally required to treat the loss as a short-term capital loss. On the other hand, where the taxpayer and the borrower can persuade a third party to make the loan, which is guaranteed by the taxpayer, and the proceeds of the loan are used by the borrower in his trade or

<sup>1</sup> If the debt is not worthless, no deduction is generally allowed (on the theory that payment by the guarantor was voluntary).

<sup>2</sup> See e.g., *Bert W. Martin*, 52 T.C. 140 (reviewed by the Court), aff'd per curiam, 424 F.2d 1368 (9th Cir.) cert. denied, 400 U.S. 902 (1970).

business, the loss, if one results, may generally be deducted by the taxpayer against ordinary income. This distinction makes little sense. It appears to provide a tax incentive for careful planning, particularly in transactions between closely related parties, such as family members, with no emphasis on the actual substance of the loan transaction.

The committee may also wish to clarify that in the case of a guarantor of a corporate obligation, any payment under the guaranty agreement must be deducted as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business.<sup>3</sup>

Another issue which the committee may wish to consider is what the result should be in the case of a guaranty agreement which is not entered into as part of the guarantor's trade or business, or as a transaction for profit.

Generally, in the case of a direct loan, it may be presumed that the transaction is entered into for profit by the lender, who hopes to realize interest on the loan. While this may not be true in the case of certain loans made between friends or family members, in these cases the Internal Revenue Service might well treat any loss resulting from such a "loan" as a gift, with respect to which no bad debt deduction would be available. (Reg. § 1.166-1(c))

In the case of a guaranty agreement, however, it is not always easy to tell whether the transaction has been entered into for profit on the part of the guarantor. It is not uncommon for guaranty agreements to provide for no direct consideration to be paid to the guarantor. Often this may be because the guarantor is receiving indirect consideration in the form of improved business relationships. On the other hand, many other guaranties are given without consideration as a matter of accommodation to friends and relatives.

One solution in this area would be to place the burden of substantiation on the guarantor, and provide that no deduction should be available unless the guaranty is entered as part of the guarantor's trade or business, or unless the transaction has been entered into for profit, as evidenced by the fact that the guarantor can demonstrate that he has received reasonable consideration for giving the guaranty.

## Proposals

### *1974 committee bill*

As part of the tentative decisions made in connection with the Tax Reform Bill of 1974, the committee decided to repeal section 166(f), and to clarify that in all respects, where a taxpayer has a loss arising from the guaranty of a loan, he is to receive the same treatment as where he has a loss from a loan which he makes directly. Thus, if the guaranty agreement arose out of the guarantor's trade or business, the guarantor would still be permitted to deduct the loss resulting from the transaction against ordinary income. If the guaranty agreement was a transaction entered into for profit by the guarantor, he would be able to deduct the resulting loss as a nonbusiness debt.

<sup>3</sup> Of course, if the payment under the guaranty by a corporate shareholder constitutes a contribution to capital, under the facts and circumstances of the particular case, the payment would not be deductible but would increase the stockholder's basis in his shares in the corporation.

*Mr. Ullman*

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

### C. SIMPLIFICATION OF ITEMIZED DEDUCTIONS AND EXCLUSIONS WITH A SIMPLIFICATION DEDUCTION TO REPLACE THOSE MODIFIED

A major objective of tax reform is simplification of the tax forms. Taxpayer complaints about the difficulty of understanding and filling out the tax form and the substantial number of taxpayers who pay others to fill out their tax returns indicate an unhealthy lack of understanding and mistrust of our tax forms and tax laws. Unfortunately, this tendency seems to be worsening, in part because the law and the tax form are becoming more complex through the addition of new provisions.

Simplification of the tax return is almost entirely dependent on simplifying the tax law. The forms generally used by the public have been simplified about as much as possible. Further simplification of the tax form will require something similar to what the Treasury in 1973 called "reverse legislation" wherein desired changes in the tax form are converted into the requisite changes in the tax law. This should be viewed as a continuing process rather than a one-time effort.

There are two general approaches to simplifying the tax form through reduction in the number of items with which a taxpayer must deal. One approach would increase the standard deduction so that more taxpayers can avoid itemizing their deductions (and some can switch to the short form 1040-A). Another would eliminate or simplify itemized deduction or exclusion items. In addition to simplifying the appearance of the tax form, the latter approach facilitates taxpayer compliance, recordkeeping and audit procedures.

At the present time, the case for greater simplification through changes in itemized deductions and exclusions rather than further increases (beyond those provided for 1975) in the standard deduction is based on the following reasons.

(1) The standard deduction under the 1975 law (as enacted in the Tax Reduction Act of 1975 for 1975 only) has reached a substantial level—the minimum standard deduction is \$1,600 for single persons and \$1,900 for joint returns and the percentage standard deduction is 16 percent of AGI with a maximum of \$2,300 for single persons and \$2,600 for joint returns.<sup>1</sup>

The number and proportion of returns taking the standard deduction or itemizing under 1974 law and 1975 law are estimated as follows:

[Returns in millions]

	1974 law		1975 law	
	Number	Percent	Number	Percent
Standard.....	51.1	60	58.9	69
Itemized.....	33.9	40	26.6	31

<sup>1</sup> Under the 1974 committee bill, the minimum standard deduction was increased from \$1,300 generally to \$1,400 for single persons and \$1,500 for joint returns. The percentage standard deduction was increased from 15 percent up to \$2,000 to 17 percent with a \$2,500 maximum.

(2) Further increases in the standard deduction are expensive in terms of the number of returns switching from itemized deductions to the standard deduction per dollar of revenue loss. This is because of the substantial portion of the revenue loss that goes to those already taking the standard deduction. (The committee, however, may want to increase the minimum standard deduction for other reasons such as removing poverty level families from the tax rolls.)

(3) Simplification of the tax form and the law, for those who continue to itemize is desirable. (Taxpayers who take the standard deduction and use the long form would also benefit somewhat from a simpler appearing form and instructions.)

The following discussion of simplification is in terms of a package which includes the modification or elimination of certain itemized deductions and exclusions and their replacement by a "simplification deduction" (a "standard" deduction for itemizers to compensate for the deductions or exclusions eliminated).

The presentation is first an overview of the 1974 committee bill and then a detailed discussion of each of the deductions or exclusions in the package. Other simplifying changes are also proposed (see above) but these are not part of the "package" containing the simplification deduction.

## Proposals

### *1974 committee bill.*

Last year the committee provided a series of simplification revisions which are as follows:

(a) The dividend exclusion would be repealed.

(b) The deduction for State and local gasoline taxes would be repealed.

(c) The deduction for property transfer taxes and disability taxes would be repealed.

(d) The casualty loss deduction would be subject to a floor of 3 percent of adjusted gross income, but only casualty losses in excess of \$50 per loss (instead of \$100 as under present law) would be taken into account for the floor.

(e) Medical expenses: The deduction for one-half of medical insurance premiums (up to \$150) which is allowable without regard to the 3-percent floor applicable to other medical expenses would be repealed.

The 3-percent floor applicable to the medical expense deduction would be increased to 5 percent, and the 1-percent floor with respect to drugs would be eliminated. Expenses for drugs would be covered under the 5-percent floor but the deduction would apply only to prescription drugs.

(f) Deduction for certain employee business expenses: The deduction for miscellaneous expenses (which includes employee business expenses and expenses for the production of income) would be continued, but a \$200 floor would be provided so that only the total miscellaneous expenses above \$200 would be deducted.

(g) Simplification deduction: To replace itemized deductions eliminated by the proposals outlined above a "simplification deduction" would be provided to taxpayers who itemize their deductions. This special simplification deduction would be taken

in addition to a taxpayer's other itemized deductions and would be equal to \$350 plus 2 percent of adjusted gross income, up to a maximum of \$650.

*Mr. Ullman*

His proposal is the same as the 1974 committee bill except that he would make two changes in the deduction for certain employee business expenses. First, he would provide that the deduction for professional fees, union dues, and other similar expenses would be changed from an itemized deduction to a deduction from gross income in arriving at adjusted gross income. Second, he would provide that the deduction for miscellaneous expenses (which includes employee business expenses and expenses for the production of income) would be continued, but a \$200 floor would be provided so that only the total miscellaneous expenses above \$200 would be deducted. (See detailed discussion of specific provisions below.)

## **Specific Provisions of the Simplification Package**

### **1. Elimination of Dividends Received Exclusion**

#### **Present law**

An individual taxpayer can exclude from adjusted gross income up to \$100 of qualified dividends received from most domestic corporations. A married couple filing a joint return may exclude \$200.

#### **Problem**

The dividend exclusion may complicate the filing and verification of tax returns. Taxpayers find it difficult in certain cases to determine which dividends qualify for the exclusion. Married couples filing joint returns must determine which spouse owns the stock for which dividends have been received so that each spouse may properly claim the \$100 exclusion to which he or she is entitled.

The dividends received exclusion accounts for a high incidence of taxpayer error in reporting dividend income. Computer verification and auditing of the income would be considerably facilitated by the repeal of the exclusion. Moreover, elimination of the dividend exclusion would equalize the tax treatment of dividend and interest income.

#### **Proposals**

*1974 Committee bill*

The committee bill would eliminate the dividend exclusion.

*Mr. Ullman*

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

*Mr. Martin*

His proposal would retain and expand the \$100 dividend exclusion to include interest from savings institutions.

### **2. Repeal of Deduction for State and Local Taxes on Gasoline**

#### **Present law**

Under present law, a taxpayer who itemizes his deductions may deduct State and local taxes paid by him for the purchase of gasoline,

diesel fuel, and other motor fuels. In practice, the amount of this deduction may be computed either from a record of taxes actually paid by the taxpayer on his gasoline or the amount provided in the gasoline tax tables provided by the Internal Revenue Service. These tables are based on a taxpayer's calculation of the mileage he drove during the year, the size of his car and the gasoline tax rates in each State.

### **Problem**

Many contend that the gasoline tax deduction involves complications out of proportion to any benefit. Not only is there much guessing in the gasoline tax calculation but the amount of tax savings to the average taxpayer is generally small. (For example, where a taxpayer and his family drove as much as 20,000 nonbusiness miles in a year, the tax saving would be only \$25 in most States if the taxpayer is in the 25-percent bracket).

In addition, State and local gasoline taxes, like the nondeductible Federal gasoline tax, are essentially charges by a State for the use of its highways. Therefore, they seem more like a personal expense for automobile travel (such as tolls) than a tax. Its deductibility in this sense is inconsistent with the user charge character of the tax in that it serves to shift part of the cost from the highway user to the general taxpayer.

The gasoline tax deduction may be considered inconsistent with the national energy policy. The deduction lowers the price of gasoline for taxpayers who itemize deductions. Eliminating the deduction could reduce gasoline consumption by an estimated 60,000 barrels per day.

### **Proposals**

#### *1974 Committee bill*

The committee bill eliminated the gas tax deduction.

#### *Mr. Ullman*

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

## **3. Deduction for Property Transfer Taxes and Disability Taxes**

### **Present law**

Under present law, property transfer taxes in the case of an activity engaged in for profit may be taken as an itemized deduction. In addition, the taxes imposed by certain States on employees for the purpose of financing unemployment compensation or disability compensation are treated as deductible taxes under present law.

### **Problem**

In the interests of simplification and uniformity, the Revenue Act of 1964 limited the deduction for taxes paid to those of a general applicability. In so doing, it eliminated the deduction for a number of special taxes and fees, such as selective sales taxes, alcohol and tobacco taxes, and fees for license plates. A few miscellaneous taxes such as taxes on the transfer of stock or other property and unemployment compensation taxes still exist in a few States. Simplicity of the tax

form, uniformity of deductions, and IRS administration of the tax law might all be improved if these taxes were not deductible.

## Proposals

### *1974 Committee bill*

Last year the committee eliminated the deduction for individuals (under sec. 164(e)) for stock or other property transfer taxes paid in connection with an activity entered into for profit (under sec. 212). These taxes would not be currently deductible, but because they represent the cost of acquiring the property, they are properly included in the basis of that property. These taxes do not include general or selective sales taxes.

In addition, the deduction for unemployment compensation, disability or similar taxes imposed on the employee was eliminated by specifically prohibiting the deduction for such taxes under section 275(a). Such taxes are imposed by a State to finance its unemployment or disability compensation programs. Such taxes are imposed by Alabama, Alaska, California, New Jersey, Rhode Island, Washington, Pennsylvania and several cities. The deduction does not cover gross receipts or wage-based taxes such as "commuter taxes" imposed by some cities.

### *Mr. Ullman*

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

## 4. Limitation on Casualty Losses

### Present law

Nonbusiness casualty and theft losses are deductible to the extent that they are not covered by insurance and to the extent that they exceed \$100 for each occurrence.

### Problem

The purpose of the \$100 floor on casualty losses is analogous to the percent-of-AGI floor on medical expense deductions. That is, it is intended, in part, to distinguish ordinary from extraordinary casualty losses. It is designed to permit a deduction only for those casualty losses which reduce a taxpayer's ability to pay taxes because they are unusual and extraordinary reductions in his net worth. In addition, the \$100 floor is designed to eliminate a proliferation of small claims.

An alternative method of distinguishing ordinary from extraordinary casualty losses might be to adopt an approach similar to that used for the medical expense deduction which would distinguish ordinary from extraordinary losses on the basis of a percentage-of-income test. It seems undesirable to give up the administrative advantage and simplifying function of the dollar floor entirely, however. A compromise could be achieved between the absolute dollar floor and the percent of income floor which retains the desirable feature of the absolute dollar floor in eliminating trivial deductions while refining the extraordinary versus ordinary distinction by relating it to income.

## Proposals

### *1974 Committee bill*

Last year the committee limited the deduction of casualty and theft losses to those in excess of \$50 per occurrence and then only to the

extent that the remaining amount exceeds 3 percent of the taxpayer's AGI.

**Mr. Ullman**

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

## 5. Revision of Deduction For Medical Expenses

### Present law.

Under present law, eligible medical expenses are permitted as an itemized deduction only to the extent that they exceed 3 percent of the taxpayer's adjusted gross income. In addition, one-half of the amount spent for medical insurance premiums up to a maximum of \$150 may be deducted without regard to the 3-percent floor, and the remainder included as a medical expense subject to the 3-percent floor. Only the amounts spent for drugs which exceed one percent of the taxpayer's AGI are to be taken into account as eligible medical expenses subject to the overall 3-percent floor.

### Problem

Several ways of updating and simplifying the medical expense deduction have been suggested. The basic rationale for permitting medical expenses as itemized deductions rather than treating them as nondeductible personal expenses is that extraordinary medical expenses are considered a hardship which reduces a taxpayer's ability to pay taxes. At the time the 3-percent floor was adopted, 3 percent represented roughly the average percent of income spent for medical purposes. Since that time, the increase in the price of medical services and the greater use of these services has resulted in the average amount spent in this area increasing to approximately 5 percent of income. Thus, to maintain the concept of the deductibility of only extraordinary medical expenses, the floor on medical expenses should be increased from 3 to 5 percent of AGI.

In addition, the computation of the medical expense deduction could be substantially simplified. The deduction of one-half of medical insurance premiums without regard to the floor and the inclusion of the remainder of other medical expenses subject to the floor is complicated, contributes to taxpayer errors and adds additional lines to the return. The exception is also inconsistent with the basic concept of extraordinary medical expenses.

The rationale for exempting one-half of medical insurance premiums from the 3-percent floor was that individuals who have insurance may never have large unreimbursed medical expenses. To the extent that such taxpayers do not have extraordinary medical expenses, they do not have expenditures which necessarily reduce their ability to pay taxes and for which a deduction should be provided.

The one-percent floor on drug expenses is an additional source of complexity. The principal purpose of this floor has been to provide a rough method of distinguishing between expenditures for medicine and drugs and items that taxpayers may also purchase in drug stores and tend to lump together with medicine and drugs as deductible medical expenditures. It might better serve simplification to remove the separate one-percent floor on drug expenses and achieve the same intended result by limiting the deduction to necessary medicine

and drugs as determined by the fact that they are available only with a prescription.

## Proposals

### *1974 Committee bill*

Last year the committee increased the overall floor on medical expenses from 3 to 5 percent of AGI and eliminated the separate deduction for medical insurance premiums. It also eliminated the one-percent floor on drug deductions.

The medicine and drugs eligible for the medical expense deduction would be only prescription drugs or insulin. (A drug means a drug or biological which requires the prescription of a physician or a dentist in order for an individual to obtain it. The requirement of a physician's prescription for the purchase of medicine or drugs is a matter of State or local law). This prescription requirement would eliminate the deductibility of items such as aspirin, mouthwash used for medicinal purposes, etc., as well as the present deduction for the cost of special diets.

*Mr. Ullman*

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

*Mrs. Keys*

The proposal would make three modifications of the medical expense revisions: (1) put the deduction for medical insurance premiums within the general medical expense floor, (2) eliminate the one-percent floor for drugs and medicines, and (3) reduce the overall floor on medical expenses from 3 percent to 2 percent.

*Mr. Jones*

In the case of the medical expense deduction, the proposal would eliminate all floors and would also provide for a review of the possible use of a credit rather than a deduction for medical expenses.

*Mr. Martin*

The proposal would provide a refundable tax credit for extraordinarily large medical expenses, supplementing or replacing the present deduction.

*Messrs. Bafalis and Ketchum*

The proposal would reinstate the previously deleted provision which allows a full medical expense deduction (without a floor) for those age 65 or over, as well as full deductions for prescription drug expenses.

## **6. Floor of \$200 on Deduction for Trade or Business Expenses of Employee or Expenses of Activities Engaged in for Profit**

### **Present law**

Under present law, an individual may take an itemized deduction for certain employee business expenses and investment expenses. Employee business expenses are items such as professional dues, subscriptions to professional journals, union dues, work clothes, small tools, and certain education expenses. Investment expenses eligible for the deduction are items such as costs of making investments, periodi-

icals, safe deposit boxes, financial newspapers and investment advisory services.

### **Problem**

The miscellaneous deductions for employee business expenses and investment expenses create considerable difficulty for taxpayers because they must keep records of a number of relatively small items. These expenditures arise from a number of small transactions which occur in various places throughout the course of the year. The aggregation of small expenditures may result in an expenditure of time and effort disproportionate to the tax saving involved. By limiting these deductions to cases where a taxpayer incurred a significant amount of such expenditures some difficulties in completing tax returns might be eliminated.

### **Proposals**

#### *1974 Committee bill*

Last year the committee placed a \$200 floor under the amounts that may be deducted as trade or business expenses of an employee or deductible as investment expenses.

#### *Mr. Ullman*

His proposal is the same as the 1974 committee bill except that he would make two changes in the deduction for certain employee business expenses. First, he would provide that the deduction for professional fees, union dues, and other similar expenses would be changed from an itemized deduction to a deduction from gross income in arriving at adjusted gross income. Second he would provide that the deduction for miscellaneous expenses (which includes employee business expenses and expenses for the production of income) would be continued, but a \$200 floor would be provided so that only the total miscellaneous expenses above \$200 would be deducted.

#### *Mr. Schneebeli*

His proposal would provide that professional dues and fees and other miscellaneous expenses would be treated identically.

#### *Mr. Martin*

His proposal would allow all miscellaneous deductions to be taken from gross income rather than deductions from adjusted gross income.

## **7. Simplification Deduction**

### **Present law**

There is no comparable deduction under present law.

### **Problem**

Eliminating certain itemized deductions could result in a net tax increase for some low- and middle-income taxpayers. Some believe that such a tax increase would place an undue share of the cost of simplification on these taxpayers.

A new type of deduction could be designed to give back to these low- and middle-income taxpayers approximately the same amount on the average that they would give up as a result of the repeal of the various deductions. Several different approaches might provide tax reductions

to offset the tax increases resulting from simplification measures which repeal certain deductions. Alternative approaches include rate reductions, an increase in the percentage standard deduction, and an increase in the minimum standard deduction. However, these approaches probably could not both efficiently offset tax increases and maintain prior revenue levels. An approximate balance between tax increases and tax reductions might be achieved by a simplification deduction related to adjusted gross income.

## Proposals

### *1974 Committee bill*

Last year the Committee provided for individuals, in addition to allowable itemized deductions, a simplification deduction of an amount equal to \$350 plus 2 percent of adjusted gross income up to a maximum of \$650. For a married individual filing a separate return, the \$350 and \$650 minimum and maximum were cut in half to \$175 and \$325, respectively.

### *Mr. Ullman*

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

### *Mr. Stark and Mrs. Keys*

They would make the simplification deduction a flat \$500.

## 8. Other Proposals

*Mr. Vander Veen.*—The proposal would provide that mortgage interest and State and local taxes be allowed as deductions (or credits) from gross income rather than as itemized deductions. In addition, the proposal would revise the low income allowance, and the percentage and the maximum standard deduction in order to encourage more taxpayers to use the standard deduction.

## D. LIMITATION ON THE DEDUCTION FOR NONBUSINESS INTEREST

### Present Law

Section 163 of the Internal Revenue Code provides, in general that a taxpayer who itemizes his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness.

A limitation is imposed under section 163(d) on interest on investment indebtedness. Under this provision, the deduction for such interest is limited to \$25,000 per year, plus the taxpayer's net investment income and his long-term capital gain, plus one-half of any interest in excess of these amounts. Other sections of the code disallow the deduction for certain amounts paid in connection with insurance, endowment, or annuity contracts (sec. 264), interest relating tax-exempt income (sec. 265), carrying charges which are chargeable to a capital account (sec. 266), and interest with respect to transactions between related taxpayers (sec. 267). These limitations, however, do not generally prevent an individual from deducting interest paid in connection with personal, nonbusiness, nonincome-producing matters, such as the purchase of a home or an automobile, interest paid on loans for educational services, or interest paid in connection with consumer credit loans on home appliances.

## Problem

Generally under present law, items of personal expense are not deductible. Thus, where indebtedness is incurred to enable an individual to purchase a home, a car, or appliances, it could be argued that the interest on that indebtedness is also personal in nature, and should not be deductible.

There is a strong argument, however, that certain economic goals, such as home ownership, should be within the reach of as many people as possible and thus the deduction for interest should be continued.

On the other hand, these considerations do not necessarily militate against suggestions to place a limitation on the amount of the deduction for nonbusiness interest. The argument here is that interest on borrowing should not be deductible where the underlying loan is spent for items of a luxury nature. In other words, where the loan is used for personal purposes to provide the taxpayer with a standard of living which is clearly out of the ordinary, many believe that no deduction should be available for interest paid on the loan.

It is also argued that a limitation on the amount of interest which may be deducted would assure that a higher percentage of the benefit of this deduction would go to lower- and middle-income taxpayers. The tax benefits of the current deduction, by income class, are shown on the following table (which is based on data for fiscal year 1974).

Adjusted gross income class	Deduction of mortgage interest on owner-occupied homes <sup>1</sup>	Percentage distribution	Deduction of interest on consumer credit <sup>1</sup>	Percentage distribution
0 to \$3,000.....	( <sup>2</sup> )	*	( <sup>2</sup> )	( <sup>2</sup> )
\$3,000 to \$5,000.....	\$13	0.3	\$7	0.3
\$5,000 to \$7,000.....	52	1.1	26	1.1
\$7,000 to \$10,000.....	265	5.4	133	5.5
\$10,000 to \$15,000.....	886	18.2	443	18.2
\$15,000 to \$20,000.....	1,133	23.3	567	23.3
\$20,000 to \$50,000.....	2,078	42.7	1,039	42.7
\$50,000 to \$100,000.....	348	7.1	174	7.1
\$100,000 and over.....	95	2.0	46	1.9
Total.....	4,870	100.0	2,435	100.0

<sup>1</sup> Amounts are in millions.

<sup>2</sup> Less than \$500,000 or one-tenth of 1 percent.

In addition to these considerations, there is also a question (similar in many ways to the problems considered by the committee in connection with tax shelters) as to the extent to which a taxpayer should be permitted to shelter or reduce tax on income from the taxpayer's professional or other income producing activities by incurring unrelated deductions. Thus, there is an argument that a dollar limitation should also be applied to the deductible interest on a taxpayer's investment indebtedness which is not related to his trade or business. (This limitation, if imposed, could replace the limitation on interest on investment indebtedness which is currently imposed under section 163(d) of the Code.)

## Proposals

*Mr. Ullman*

He would limit the amount of interest an individual could claim as an itemized deduction for nonbusiness interest (including invest-

ment interest) to \$9,000 a year, or to the equivalent of 9 percent on \$100,000.

*Messrs. Jones and Schneebeli*

The proposal would exclude from the above provision the interest on the mortgage on a taxpayer's place of residence.

## E. REVISION OF TAX TABLES FOR INDIVIDUALS

### Present law

Under present law, a taxpayer whose adjusted gross income is under \$10,000 and who takes the standard deduction is required to use the optional tax tables. These tables have AGI brackets as row designations, marital status and number of exemptions as column headings and the amount of tax in the resulting cell. A taxpayer whose income is greater than \$10,000 or who itemizes his deductions must compute his tax using the tax rates.

### Problem

The present optional tax table format which provides a different table for each number of exemptions claimed by the taxpayer has resulted in 12 optional tax tables which require 6 pages of fine print in the instructions accompanying the income tax return. This has been a considerable source of taxpayer error. Substitution of a simplified table based on taxable income might increase accuracy and compliance. Such a table could be printed on two pages.

### Proposals

*Committee 1974 bill*

Last year the committee revised the existing optional tax tables by providing that taxpayers with taxable income of \$20,000 or less are to use a tax table based on taxable income which is to be prescribed by the Secretary of the Treasury on the basis of the existing tax rates.

*Mr. Ullman*

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

## F. ACCUMULATION TRUSTS

### General

A trust is generally treated as a separate entity which is taxed in the same manner as an individual. However, there is one important difference: the trust is allowed a special deduction for any distributions of ordinary income to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Thus, in the case of income distributed currently, the trust is treated as a conduit through which income passes to the beneficiaries, and the income so distributed retains the same character in the hands of the beneficiary as it possessed in the hands of the trust.

If a grantor creates a trust under which the trustee is either required, or is given discretion, to accumulate the income for the benefit of designated beneficiaries, however, then, to the extent the income is accumulated, it is taxed at individual rates to the trust. An important factor in the trustee's (or grantor's) decision to accumulate the income may be the fact that the beneficiaries are in higher tax brackets than the trust.

## Present law

Present law provides that beneficiaries are taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust.

This is referred to as the throwback rule under which distributions of accumulated income to beneficiaries are thrown back to the year in which they would have been taxed to the beneficiary if they had been distributed currently. The Tax Reform Act of 1969 revised the prior throwback rule to provide an unlimited throwback rule with respect to accumulation distributions.

The tax on accumulation distributions is computed in either of two ways. One method is the "exact" method, and the other is a "shortcut" method which does not require the more extensive computations required by the exact method. Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years when earned. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust and the taxes of the beneficiary can be determined for each year. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner, the beneficiary is allowed a credit for his share of the taxes paid by the trust during his life. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called shortcut method in effect averages the tax attributable to the distribution over a number of years equal to the number of years over which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for each of the 3 immediately prior years. The fraction of the income included in each of these years is based upon the number of years in which the income was accumulated by the trust.

*Capital gain throwback rule.*—Present law provides an unlimited throwback rule for capital gains allocated to the corpus of an accumulation trust. This provision does not apply to "simple trusts" (any trust which is required by the terms of its governing instrument to distribute all of its income currently) or any other trusts, which in fact distribute all their income currently, until the first year they accumulate income. For purposes of this provision, a capital gains distribution is deemed to have been made only when the distribution is greater than all of the accumulated ordinary income. If the trust has no accumulated ordinary income or capital gains, or if the distribution is greater than the ordinary income or capital gain accumulations, then to this extent it is considered a distribution of corpus and no additional tax is imposed.

## Problem

The progressive tax rate structure for individuals is avoided if a grantor creates a trust to accumulate income taxed at low rates, and

the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary, even when he is in a high tax bracket. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

The throwback rule (as amended by the Tax Reform Act of 1969) theoretically prevents this result by taxing beneficiaries on distributions they receive from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as it was earned. The 1969 act made a number of significant revisions in the treatment of accumulation trusts. In applying the throwback rule to beneficiaries with respect to the accumulation distributions they receive, the act provided two alternative methods, as indicated above, the exact method and the shortcut method. A number of administrative problems have resulted in the application of these alternative methods for both the Internal Revenue Service and the beneficiaries.

For example, trustees are under an obligation to the beneficiaries of the trust to compute the throwback under the rule which results in the least tax; thus, the short-cut method, which was intended to simplify calculations and eliminate recordkeeping problems involved with the exact method has not achieved this result because trustees must compute the tax under both methods. As a result, it would appear more desirable to have one simplified method rather than having two alternative methods in applying the throwback rule.

In addition, a number of questions have been raised as to whether the capital gains throwback rule, which was enacted in the 1969 act, presents more complexity in its application than is warranted by the concerns raised in 1969 with respect to capital gains. It may be more appropriate for the capital gains throwback rule to be repealed and instead a rule provided to deal more directly with the transferring of appreciated assets by grantors into trusts. Other concerns have been raised with respect to other modifications dealing with accumulation trusts, such as, the treatment of minors, the election of simple trust treatment for a year in which all income is to be paid out currently, and certain other technical modifications of the trust rules.

## Proposals

### *1974 committee bill*

For the two alternative methods used in computing the throwback rule for accumulation distributions, the committee last year substituted a single method, a revision of the present "short-cut method." This method would throw back the average accumulation distributions (as determined under present law) to the 5 preceding years of the beneficiary (rather than the 3 preceding years under present law). This average amount would be added to the beneficiary's taxable income for these years (rather than requiring the recomputation of his tax returns as under present law). Of these 5 preceding years, the year with the highest expanded taxable income and the year with the lowest would not be considered; in effect, then, the computation of the additional tax on the accumulation distribution under this short-cut method would continue to be based on a 3-year average basis. In other respects generally, the present rules under the short-cut method would continue to be applicable, except that no refunds would be available.

Income accumulated by a trust prior to the beneficiary's attaining the age of 21 and the years a beneficiary was not in existence would not be subject to the throwback rule (except in the case of distributions from multiple trusts, as described below).

A special rule would be provided for 3 or more trusts which accumulate income in the same year for a beneficiary.

The capital gains throwback rule would be repealed. A special rule would be provided to cover the possible tax abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of any capital gains tax to the trust at its lower progressive rate structure.

*Mr. Ullman*

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

## G. MOVING EXPENSES

### Present law

An employee or self-employed individual may claim a deduction from gross income for the expenses of moving to a new residence in connection with beginning work at a new location (sec. 217). Any amount received directly or indirectly as a reimbursement of moving expenses must be included in a taxpayer's gross income as compensation for services (sec. 82), but he may offset this income by deducting expenses which would otherwise qualify as deductible items.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old to the new residence; the cost of meals and lodging enroute; the expenses for pre-move house-hunting trips; temporary living expenses for up to 30 days at the new job location; and certain expenses related to the sale or settlement of a lease on the old residence and the purchase of a new one at the new job location.

The moving expense deduction is subject to a number of limitations. A maximum of \$1,000 may be deducted for pre-move house hunting and temporary living expenses at the new job location. A maximum of \$2,500 (reduced by any deduction claimed for house hunting or temporary living expenses) may be deducted for certain qualified expenses for the sale and purchase of a residence or settlement of a lease. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts are halved.

In order for a taxpayer to claim a moving expense deduction, his new principal place of work must be at least 50 miles farther from his former residence than was his former principal place of work. During the 12-month period following his move, the taxpayer must be a full-time employee in the new general location for at least three-fourths of the following year, that is, 39 weeks during the next 12-month period. A self-employed person must, during the 24-month period following his arrival at his new work location, perform services on a full-time basis for at least 78 weeks, with at least 39 weeks of full-time work falling within the first 12 months. Even if the 39- or 78-week requirement has not been fulfilled at the end of a taxable year (but may still

be fulfilled), the taxpayer may elect to deduct any qualified moving expenses which he has paid or incurred provided he has met all the other requirements. If he fails to meet the full-time employment period requirements in a subsequent taxable year, he must include the amounts previously deducted in his gross income for the subsequent year.<sup>1</sup>

### Problem

The provisions for moving expenses reflect significant revisions made by the Tax Reform Act of 1969. Since 1969, both the 50-mile test and the dollar limitations have been criticized, particularly by persons suggesting a return to the former 20-mile test and dollar adjustments to reflect inflation.

Proponents of simplification have urged that a single dollar limit be adopted instead of the \$1,000 and \$2,500 tests; that the 39- and 78-week rules be replaced by a general rule allowing the taxpayer to obtain work within two years in the new location or at a third location, if necessary. Instead of the allowance of 30 days' temporary living expenses at the new place of work, some would substitute a deduction for such expenses whether incurred at the former place of work, or enroute to or at the new place for a continuous 30 or 45 day period in the process of moving. Both employee and employer tax recordkeeping might be reduced, if the reimbursements for expenses which are deductible by the employee are not required to be included in the employee's gross income, provided the employee provides the employer with documentation of his expenses.

One suggestion for changing the \$2,500 maximum on qualified expenses for the sale or purchase of a residence would replace the dollar limit with a deduction based on a percentage of the taxpayer's sales price in order to reflect inflation in real estate selling commissions.

*Application to the military.*—According to the Department of Defense, certain changes made in the 1969 Act present significant problems with respect to their application to members of the military services. It is reported that this is especially the case with the requirement that all moving expense reimbursements, whether in-kind or cash, be included in gross income as compensation and reported both to the individual and the Internal Revenue Service for withholding tax purposes. The Department of Defense has indicated that identification of in-kind "reimbursements" for each serviceman where the Department of Defense pays for the moving expense to the mover, or does the moving itself, would involve substantial administrative burdens for the department as well as increasing its expenses at no revenue gain to the Treasury.

The Department of Defense also has indicated that the requirements that the new place of work be at least a 50-mile move and that the individual work for at least 39 weeks at the new location represent hardships for military personnel because many mandatory personnel moves are made for less than 39 weeks and for less than 50 miles. As a result, the servicemen involved would not be allowed any deduction for their moving expenses, but still would be required to report the moving expense "reimbursement," whether paid by the Government or paid directly to them as a cash reimbursement.

<sup>1</sup>The 39- and 78-week tests are waived if the employee is unable to satisfy them as a result of death, disability, or involuntary separation (other than for willful misconduct).

Through 1973, the Internal Revenue Service had by administrative determination provided a moratorium on withholding and reporting with respect to the application of the new moving expense rules to members of the military services.<sup>2</sup> The moratorium was extended until

January 1, 1976, by legislative action.<sup>3</sup> The moratorium does not apply to cash reimbursements of moving expenses, which are still required to be reported. In addition, where the moving expenses paid by a serviceman exceed his reimbursements for his expenses, the excess amounts may be allowable as a deduction if they are otherwise deductible under section 217.

The Department of Defense has submitted legislative proposals to Congress dealing with the application of the deduction for moving expenses to the military.<sup>4</sup>

### Proposals

#### *Mr. Ullman*

The moving expense deductions would be simplified and certain problems would be worked out as to their application to the military.

#### *Mr. Burke*

He would make several changes in the moving expense deduction but believes the single most important change is raising the \$1,000 and \$2,500 limitations (see H.R. 1789).

#### *Messrs. Schneebeli and Conable*

The proposal would make a series of changes in the moving expense deduction, including allowing a deduction for the cost of meals and lodging while in temporary quarters at the "old" place of employment for a period of up to 5 days and while at the "new" place of employment for up to 60 days instead of 30 days, decreasing the distance an individual must move from his former place of work from 50 miles down to 20 miles, doubling the dollar limitations applicable to the various types of moving expenses, and allowing an exclusion for employer-reimbursed moving expenses, instead of a deduction (see H.R. 8044).

#### *Mr. Duncan*

The proposal would amend the present moving expense provision to provide for the exclusion from income for moving expenses reimbursed by an employer (rather than including them in income and taking a deduction), permitting a deduction for temporary living quarters for 5 days while at the "old" place of work and 60 days rather than 30 days while at the "new" place of work, removing entirely the dollar limitations on moving expense deductions and substituting for the present 50-mile requirement to qualify for the deduction the requirement that the individual's move involve only a move of 20 miles (see H.R. 3414).

<sup>2</sup> Internal Revenue Service, Public Information Fact Sheet, November 30, 1970 (letter to the Secretary of Defense).

<sup>3</sup> Sec. 2 of P.L. 93-490 (H.R. 6642, 93d Cong., 2d Sess., October 26, 1974).

<sup>4</sup> Letter from the General Counsel of the Department of Defense to the Speaker of the House of Representatives, August 15, 1975.

*Mr. Ketchum*

The proposal would eliminate the requirement that in order to be eligible for the moving expense deduction the taxpayer's new place of work must be 50 miles further from his former residence than his former place of work.

*Department of Defense*

The Department of Defense has proposed legislative changes that would (1) eliminate the requirement of the Department reporting to the Internal Revenue Service, or the member of the Armed Forces including as income, amounts paid by the Department directly to carriers, warehouses, etc., incident to a permanent change of station; (2) exempt members of the Armed Forces from the 39-week requirement and the 50-mile rule; (3) permit members to deduct otherwise proper moving expenses when a member serves an unaccompanied tour outside the Continental United States or in Alaska and dependents' move to a place designated by the Secretary concerned; and (4) extend existing provisions of law relating to expenses of meals and lodging while occupying temporary quarters at the *new* duty station, to also apply to such expenses when incurred under similar circumstances prior to departure from the old duty station.

**H. DISASTER LOAN PROVISIONS****1. Crop Insurance Proceeds****Present Law**

Under present law (sec. 451(d)), insurance proceeds received by a taxpayer as a result of destruction or damage to crops may be included in income in the taxable year following the year of their receipt, if he can establish that the income from the crops which were destroyed or damaged would otherwise have been properly included in income in the following taxable year.

Section 451 was amended by the Tax Reform Act of 1969 by adding subsection (d). The reason for this amendment was to avoid the problem of doubling up income for a cash basis farmer by including crop insurance proceeds in income in the taxable year they were received rather than in the taxable year following the year of receipt, which would generally be the pattern of income receipt from sales of crops.

Because of this doubling up of income in the year of receipt, the farmer would have only deductions and no income to report in the next year and therefore would be likely to have a net operating loss to carry back and offset against income in the prior year. However, the farmer in such cases was faced with the payment of tax and subsequent filing for a refund. He also loses the benefit of his personal exemptions and his standard or itemized deductions in the year of loss.

**Problem**

The Agriculture and Consumer Protection Act of 1973 (Public Law 93-86, which amended the Agricultural Act of 1949) provides that specified payments by the Department of Agriculture are to be made to farmers in the event that they are either prevented from planting certain crops because of drought, flood, or other natural disaster or condition or, because of such a disaster or condition, the total quantity of certain planted crops which the producers are able to harvest on any

farm is less than 66 $\frac{2}{3}$  percent of the projected yield of the crop. The crops covered by these disaster payments are wheat, corn, grain sorghum, barley, and upland cotton. Premium payments are not required for this protection.

The Service has ruled that the provisions of section 451(d) are not applicable to the payments provided to the producers who are covered by the Agriculture and Consumer Protection Act of 1973 on the grounds that the proceeds are not insurance proceeds since no premium was paid by the farmer.

### Proposal

*Mr. Ullman*

He would amend section 451(d) to include the disaster payments described above. Under the special election, cash basis farmers who receive payments under the Agriculture and Consumer Protection Act of 1973, for losses to crops caused by natural disasters, may elect to report the disaster proceeds as income in the taxable year in which the income normally received from the crops would have been reported.

### 2. Other

*Mr. Schneebeli*

The proposal deals with cases where an individual is allowed a tax deduction in connection with a disaster occurring in 1972 or 1973, which was determined by the President to warrant disaster assistance, and who received a disaster loan. Such an individual is not to be required to take into account in his income (or in determining the deduction otherwise allowable for the loss) any part of the loan which is cancelled except where the adjusted gross income of the individual for the taxable year in question exceeded \$15,000. Where the income of the individual for the year in question exceeded \$15,000, the cancellation of indebtedness which need not be taken into account would be in the ratio of \$15,000 to the individual's adjusted gross income for the year in question (see H.R. 9135).

## I. TAX TREATMENT OF SCHOLARSHIPS AND FELLOWSHIPS

The IRS is currently reexamining its position as to the proper treatment of scholarships and fellowships in general. However, it is the position of the IRS that the cancellation of indebtedness with respect to certain student loan programs is to be included in income, but only with respect to loans made after June 11, 1973. (Rev. Bul. 74-540, C. B. 1974-2, 38)

*Mr. Ullman*

He would not require any amount to be taken into income under the programs pending a review by the committee.

