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97TH CONGRESS, 1st Session | SENATE | REPORT No. 97-144

ECONOMIC RECOVERY TAX ACT OF 1981

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.J. Res. 266

together with

ADDITIONAL AND MINORITY VIEWS

JULY 6, 1981.—Ordered to be printed

Filed under authority of the order of the Senate of June 25 (legislative day, June 1), 1981

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ECONOMIC RECOVERY TAX ACT OF 1981

JULY 6, 1981.—Ordered to be printed
Filed under authority of the order of the Senate of June 25 (legislative day, JUNE 1), 1981

Mr. DOLE, from the Committee on Finance, submitted the following

REPORT

together with

ADDITIONAL AND MINORITY VIEWS

[To accompany H.J. Res. 266]

The Committee on Finance, to which was referred the joint resolution (H.J. Res. 266) to provide for a temporary increase in the public debt limit, having considered the same, reports favorably thereon with an amendment to the text and an amendment to the title and recommends that the resolution as amended do pass.
The amendment is shown in the text of the resolution in italic.

HOUSE-PASSED PROVISION

H.J. Res. 266, as passed the House, provides for a temporary increase in the public debt limit through September 30, 1981.

FINANCE COMMITTEE AMENDMENT

The Committee on Finance approved H.J. Res. 266, with an amendment in the nature of a substitute—the Economic Recovery Tax Act of 1981—summarized below.

I. SUMMARY OF THE BILL

A. Overview

The Economic Recovery Tax Act of 1981, as reported by the Finance Committee, provides the largest tax reduction in history. Tax relief in the committee's bill amounts to $37.0 billion in fiscal year 1982, $93.1 billion in 1983, and $149.5 billion in 1984. The tax cuts are carefully structured to stimulate economic growth and improve the equity of the tax system.

The principal provisions of the bill are the following:

- An across-the-board individual income tax rate reduction of approximately 1 percent in 1981, 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984 and subsequent years. This reduction in tax liabilities will be reflected in reductions of taxes withheld from workers' paychecks of 5 percent on October 1, 1981, a further 10 percent on July 1, 1982, and a final 10 percent on July 1, 1983.
- A new deduction for two-earner married couples of 10 percent of the first $30,000 of earnings of the spouse with the lesser amount of earnings (5 percent in 1982).
- A reduction in the maximum tax rate on all income to 50 percent, effective January 1, 1982.
- A maximum tax rate on individuals' long-term capital gains of 20 percent for sales or exchanges after June 10, 1981.
- A complete revision of rules for recovering the cost of depreciable assets, called the Accelerated Cost Recovery System (ACRS), under which equipment will be written off over either 3, 5, 10, or 15 years and most structures will be written off over 15 years.
- Replacement of the existing 10-percent investment credit for rehabilitating industrial and commercial buildings with a credit of 15 percent for 30 to 39 year old commercial or industrial buildings, 20 percent for such buildings at least 40 years old, and 25 percent for certified historic structures.
- Optional expensing of up to $10,000 of investment in tangible personal property, phased in over a 5-year period.
- Elimination of the $100,000 limit on the amount of used property eligible for the investment tax credit and changes in the recapture rules for that credit.
- Various other tax changes to aid small businesses, including an increase in the number of shareholders for subchapter S corporations and an increase in the minimum accumulated earnings tax credit.
- An increase in the limit on deductible contributions for individual retirement accounts (IRAs) from $1,500 to $2,000 (from $1,750 to $2,250 when a nonearning spouse is a beneficiary).
- Extension of eligibility for IRAs to active participants in employer sponsored pension plans with a $1,500 limit on deductible contributions ($1,625 when a nonearning spouse is a beneficiary).

- An increase in the annual limit on deductions for contributions to self-employed retirement plans from $7,500 to $15,000.
- Tax exemption of up to $1,000 ($2,000 for a married couple) of interest income on certain 1-year savings certificates issued by depository institutions.
- Repeal, after 1981, of the $200 interest and dividend exclusion ($400 for a joint return) and a return to the $100 per taxpayer dividend exclusion of prior law.
- A restructuring of the tax credit for employer contributions to employee stock ownership plans (ESOPs).
- A permanent $2,500 credit for royalty owners against the windfall profit tax.
- A reduction from 30 percent to 15 percent in the windfall profit tax rate on newly discovered oil, phased in over a 4-year period.
- A 25-percent tax credit for incremental expenditures for wages paid for services performed in conducting research and experimentation.
- An increase in the unified credit against the estate and gift taxes, phased in over a 5-year period, so that no tax will be imposed on transfers of $600,000 or less.
- Repeal of the existing limits on the marital deduction in the estate and gift taxes.
- An increase in the gift tax exclusion for gifts in any single year to any individual person from $3,000 to $10,000.
- Technical changes in the rules relating to current use valuation of farms and small businesses.
- An expansion of the exclusion for income earned abroad to the first $50,000 of earned income plus one-half of the next $50,000, plus an exclusion for excess housing costs.
- A significant tightening of the rules to prevent the use of commodity tax straddles and similar devices to defer taxes and convert ordinary income and short-term capital gains into long-term capital gains.
- Restoration of capital gains treatment for incentive stock options.
- Sixty-month amortization for motor carriers for the adjusted basis of their operating rights.
- Incentives for corporate contributions of research equipment to colleges.

B. Summary of Provisions

Individual Income Tax Reductions

Across-the-board tax rate cut

The bill includes a multi-stage, across-the-board reduction in individual income tax rates. The reduction in tax rates is approximately 1 percent in 1981, 10 percent in 1982, 19 percent in 1983 and 23 percent in 1984 and future years.

These reductions in tax liability will be accompanied by a series of reductions in taxes withheld from workers' paychecks. The withholding reductions will be at a rate of 5 percent on October 1, 1981, a further 10 percent on July 1, 1982, and a final 10 percent on July 1, 1983.

The revenue loss from these tax rate reductions will be $24.6 billion in fiscal year 1982, $63.1 billion in 1983, and $103.0 billion in 1984.

50-percent maximum rate on investment income

The bill reduces the top tax rate on all income to 50 percent for 1982 and subsequent years. This establishes a maximum rate on long-term capital gains of 20 percent because 40 percent of long-term capital gains is included in income and will be taxed at no more than the 50-percent rate. The top rate under the alternative minimum tax also will be reduced to 20 percent, starting in 1982. In addition, there will be a special 20-percent alternative tax rate on long-term capital gains, under both the regular income tax and the alternative minimum tax, for sales and exchanges between June 10, 1981, and January 1, 1982.

The revenue loss, on a static basis, is expected to be $1.5 billion in fiscal year 1982 and $2.6 billion in 1983; however, the committee expects that the expansion of the tax base resulting from these changes will offset much, and possibly all, of this static revenue effect.

Deduction for two-earner married couples

In order to reduce the marriage tax penalty and to provide an additional work incentive, the bill provides a new deduction for married couples equal to a percentage of the first $30,000 of the earnings of the spouse with the lesser earnings. This deduction will be available both to itemizers and nonitemizers. For 1982, the deduction will be 5 percent (a maximum deduction of $1,500). For 1983 and subsequent years, the deduction will be 10 percent (a maximum deduction of $3,000).

Together with the across-the-board rate cuts, the deduction will reduce marriage tax penalties for most taxpayers subject to the marriage penalty by at least 50 percent.

The marriage penalty deduction will reduce revenue by $0.4 billion in fiscal year 1982, $4.4 billion in 1983, and $9.1 billion in 1984.

Tax Incentives for Savings

Tax-exempt savings certificates

The bill provides an exclusion for interest on savings certificates which meet certain conditions. There is a lifetime limit on the amount

of interest which can qualify for the exclusion of $1,000 for single returns and $2,000 for joint returns. For a certificate to qualify for the exemption, it must have a 1-year maturity, have a yield of 70 percent of the 1-year Treasury bill rate, and be issued by a depository institution between September 30, 1981, and October 1, 1982.

This exemption will reduce revenues by $0.4 billion in fiscal year 1982, $1.7 billion in 1983, and $1.0 billion in 1984.

Interest and dividend exclusion

Under present law, there is an exclusion for the first $200 of interest and dividends ($400 for joint returns) for the years 1981 and 1982. Under present law, the provision reverts, in 1983, to the prior law dividend exclusion for the first $100 of dividends received by any taxpayer. The bill provides that the reversion to prior law will occur in 1982, instead of 1983.

This change will increase revenues by $0.6 billion in fiscal year 1982 and $1.9 billion in 1983.

Individual retirement accounts

The bill increases the limits on deductible contributions to individual retirement accounts (IRAs). The current limit of 15 percent of compensation or $1,500, whichever is less, will be replaced by a new limit equal to the lesser of 100 percent of compensation or $2,000. The limits on spousal IRAs (IRAs where a nonearning spouse is a beneficiary) will be raised from $1,750 to $2,250.

In addition, active participants in employer-provided retirement plans, who are now ineligible for the tax incentives from IRAs, will be able to make deductible contributions to IRAs. However, the limit on deductible contributions for these active participants will be $1,500 for a regular IRA and $1,625 for a spousal IRA. Voluntary contributions to employer sponsored plans will be eligible for this deduction. subject to the $1,500 and $1,625 limits.

These IRA provisions will reduce revenues by $0.2 billion in fiscal year 1982, $1.1 billion in 1983, and $1.5 billion in 1984.

Retirement savings for the self-employed

The bill increases the annual limit on deductible contributions to self-employed retirement plans (commonly called Keogh or H.R. 10 plans) from $7,500 to $15,000.

Employee stock ownership plans

The bill revises the provisions which provide a tax credit for contributions to employee stock ownership plans (commonly known as ESOPs). The existing investment tax credit for contributions to ESOPs will be repealed after 1982. Beginning January 1, 1983, a tax credit will be allowed based upon a percentage of the employer's payroll. This percentage will be one-half of one percent in 1983, three-fourths of one percent in 1984, and one percent in 1985 and future years. The bill also makes a number of other modifications designed to encourage the use of ESOPs.

These changes will reduce revenues by $0.8 billion in fiscal year 1984, $2.0 billion in 1985, and $2.8 billion in 1986.

Capital Formation Tax Incentives

Depreciation and investment tax credit revisions

The bill completely revises the Federal income tax treatment of depreciation and makes revisions in the investment tax credit. The committee's Accelerated Cost Recovery System (ACRS) generally provides much faster recovery of the costs of capital expenditures than occurs under existing law. The changes made by the bill will encourage investment, which will improve productivity, and will simplify the tax law and tax administration.

Personal property

Tangible personal property is assigned to one of four classes with recovery periods of 3, 5, 10 or 15 years. The 3-year class consists of autos, light trucks, equipment used in research and experimentation, and other assets with a current guideline life under the ADR system of 4 years or less. The 10-year class consists of public utility property with an ADR guideline life greater than 18 and less than 25.5 years and railroad tank cars. The 15-year class consists of public utility property with an ADR guideline life above 25 years. All other tangible personal property eligible for ACRS is included in the 5-year class. The 5-year class includes single purpose agricultural structures and petroleum product storage facilities.

An accelerated method of cost recovery is provided for each of the four classes. Before 1985, these methods provide benefits approximating the 150-percent declining balance method for the early years of the recovery period with a switch to the straight-line method for the remainder of the recovery period (adjusted to take account of a half-year convention). In 1985, cost recovery is accelerated further and provides benefits approximating the 175-percent declining balance method for the first year of the recovery period with a switch to the sum-of-the-years-digits method for the remaining years. After 1985, the permanent cost recovery schedules take effect, and these provide benefits approximating the 200-percent declining balance method for the first year of the recovery period with a switch to the sum-of-the-years-digits method for the remaining years.

The investment tax credit is 6 percent for eligible property in the 3-year class and 10 percent for all other eligible property.

Businesses are allowed to expense (i.e., write off immediately) up to $5,000 of investment in 1982 and 1983, $7,500 in 1984 and 1985, and $10,000 after 1985. No regular investment credit is allowed for this expensed property.

Real property

Real property is generally written off over a 15-year period. Taxpayers will use an accelerated method based on the use of the 200-percent declining balance method in the early years of the recovery period with a switch to the straight-line method in the remaining years. A taxpayer may, however, elect a straight-line method. Taxpayers will no longer be allowed to depreciate components separately but must use a composite method of cost recovery for the entire structure.

When a taxpayer disposes of nonresidential property for which the accelerated method of depreciation has been used, gain is treated as ordinary income to the extent of all prior cost recovery deductions. For residential real property, however, the gain is treated as ordinary

income only to the extent of the excess of accelerated over straight-line cost recovery. There is no ordinary income recapture in the case of dispositions of real estate for which straight-line depreciation has been elected.

Other rules

As part of its complete restructuring of capital cost recovery, the bill provides a number of special rules. To provide flexibility in the use of depreciation deductions, taxpayers are allowed to make a number of elections to use longer recovery periods and straight-line methods of depreciation. Rules are also provided for the computation of earnings and profits, depreciation on assets used predominantly outside the United States and the minimum tax. Rules under which leasing transactions are recognized as such for tax purposes are considerably liberalized.

At-risk rules

The bill provides an "at-risk" rule for the investment tax credit. Under this rule, the credit cannot be claimed to the extent an asset is financed with debt for which the taxpayer is not personally liable. However, exceptions are provided for debt provided by certain kinds of third-party lenders, such as financial institutions.

Effective date

ACRS will be effective for property placed in service after December 31, 1980. However, rules are provided to prevent related parties from making used property eligible for ACRS through paper transactions.

Revenue effect

ACRS will reduce revenues by $9.8 billion in fiscal year 1982, $17.6 billion in 1983 and $27.0 billion in 1984.

Tax credit for rehabilitation expenditures

The bill replaces the present 10-percent credit for expenditures to rehabilitate industrial and commercial buildings and the present 5-year amortization for expenditures to rehabilitate certified historic structures with a new tax credit, effective for 1982 and future years. The new credit is 15 percent of expenditures to rehabilitate industrial and commercial buildings 30 to 39 years old, 20 percent of expenditures to rehabilitate such buildings that are at least 40 years old, and 25 percent of expenditures related to certified rehabilitations of both residential and nonresidential certified historic structures. In addition, taxpayers who make noncertified rehabilitations of certified historic structures are limited to straight-line depreciation.

The revenue loss is expected to be $0.1 billion in fiscal year 1982, $0.2 billion in 1983, and $0.2 billion in 1984.

Tax credit for research and experimental wage expenditures

To encourage research and experimentation by industry, the bill provides a 25-percent income tax credit for wages paid or incurred for services performed in conducting research and experimentation. The credit only applies to the extent these expenditures exceed those in a 3-year moving base period. Qualified expenditures include reimbursements to another person (such as a research firm or university) for wages paid for services performed in conducting research and experi-

mentation on behalf of the taxpayer. Rules are provided to prevent the use of these tax credits for tax shelter purposes.

The research and experimentation credit is effective for wages paid or incurred after June 30, 1981.

The revenue loss from the credit is expected to be $0.3 billion in fiscal year 1982, $0.6 billion in 1983, and $0.7 billion in 1984.

Estate and Gift Taxes

The committee bill provides a major reduction in estate and gift taxes, which will greatly alleviate the burden of these taxes on small and medium-sized estates and will eliminate the tax entirely for gifts and bequests between spouses. These changes will reduce the burden of this tax by $1.7 billion in fiscal year 1983, $2.6 billion in 1984, and $3.7 billion in 1985.

Increase in unified credit

The bill increases the amount of the tax credit against the estate and gift taxes from $47,000 to $192,800 over a 5-year period. Thus, the level of transfers at which the estate and gift taxes begin increases from the present $175,625 to $225,000 in 1982, $275,000 in 1983, $350,000 in 1984, $450,000 in 1985, and $600,000 in 1986 and subsequent years.

Unlimited marital deduction

The bill provides an unlimited marital deduction for both the estate and gift taxes. As a result, no transfer tax will be imposed on transfers between spouses regardless of how large those transfers are. Transfers of community property qualify for the unlimited marital deduction.

Annual gift tax exclusion

The bill increases from $3,000 to $10,000 the maximum amount which a taxpayer can give to any individual donee each year without paying gift tax. Thus, under the bill, a husband and wife may jointly transfer up to $20,000 per donee each year without being subject to gift tax.

Current use valuation

Present law provides a reduction in the value of farms and small businesses for estate tax purposes, called current use valuation. The bill provides a number of technical modifications to these provisions to make them simpler and easier to use.

Exclusion for Income Earned Abroad

The bill provides major tax reductions for U.S. citizens and residents who work abroad. There is an exclusion for the first $50,000 of income earned abroad plus half of the next $50,000. The bill also provides a separate exclusion for housing expenses in excess of 16 percent of the salary of a GS–14 U.S. Government employee ($6,059 at the current salary level). No credit or deduction attributable to the excluded income is allowed. If a taxpayer does not elect these exclusions, the foreign earnings are taxable, and the ordinary foreign tax credit and deduction are available.

The required period of physical presence in the foreign country which is needed to qualify for the exclusion is shortened to 11 out of 12 consecutive months, instead of the present 17 out of 18 consecutive months.

The new provisions are effective for 1982 and subsequent years and replace the present exclusion for employees of charities and employees in hardship areas, as well as the current deductions for certain identified expenses that relate to the excess cost of living overseas.

Revenue losses from these changes are $0.3 billion in fiscal year 1982, and $0.5 billion in 1983.

Commodity Tax Straddles

A major tax abuse which has come to the attention of the committee is the use of commodity straddles and similar transactions to defer income and to convert ordinary income and short-term capital gains into long-term capital gains. The committee bill changes the law to curtail these abuses.

Mark-to-market.—Under the bill, regulated futures contracts are marked to market at the earlier of disposition or the end of the tax year. Under this rule, gains and losses in a taxpayer's futures account are treated as recognized at the close of the year. Net gains on regulated futures contracts are treated as if 40 percent of the gain were short-term gain and 60 percent of the gain were long-term gain, thus providing a maximum tax rate of 32 percent on gains on regulated futures contracts after 1981. Furthermore, the bill provides a 3-year capital loss carryback for losses on regulated futures contracts. These losses can be deducted against gains from regulated futures contracts in the three prior years.

Loss deferral.—In the case of straddles which do not involve positions in regulated futures contracts, losses are deferred to the extent there are unrealized gains in offsetting positions. However, in the case of straddles which consist of one or more positions in regulated futures contracts, the taxpayer may elect either to have all positions marked to market, or alternatively, have the leg that is a regulated futures contract exempted from the mark-to-market rule and treated, along with the other positions making up the straddle, under the general loss deferral rule. The bill also authorizes regulations extending present law wash-sale and short-sale principles to straddle positions.

Capitalization of interest and carrying charges.—The bill requires the taxpayers to capitalize interest and carrying charges for certain "cash and carry" straddles.

Hedging exception.—The bill exempts hedging transactions from the mark-to-market, loss deferral and capitalization rules.

Treasury bills.—Treasury bills are treated as capital assets. The amount of ordinary interest income assumed to be earned in connection with the Treasury bill is based on a linear amortization of the difference between the taxpayer's basis and the price at which the bills are to be redeemed during the period which the taxpayer held the Treasury bill.

Dealer identification of securities.—Broker-dealers are required to identify securities held for investment on the day the securities are acquired.

Sale or exchange.—The bill provides that certain dispositions of capital assets which produce capital gain or loss on their sale or exchange are treated as resulting in capital gain or loss without regard to whether a disposition is a sale or exchange.

Effective date.—The bill will generally be effective for property acquired and positions entered into after June 23, 1981.

Revenue effect.—These provisions will increase revenues by $1.4 billion in fiscal year 1982.

Windfall Profit Tax

Royalty owner credit

The bill includes a permanent credit for the first $2,500 of windfall profit tax paid by qualified royalty owners each year. In addition, some technical amendments are made which will permit royalty owners to receive the benefit of these credits during the year instead of having to claim a tax refund after the close of the year.

The revenue loss is $0.8 billion in fiscal year 1982, $0.7 billion in fiscal year 1983 and $0.6 billion in 1984.

Reduced tax on newly discovered oil

The bill reduces the tax rate on newly discovered oil from the present 30 percent to 25 percent in 1983 and 1984, 20 percent in 1985, and 15 percent in 1986 and subsequent years.

The revenue loss is $0.2 billion in fiscal year 1983, $0.4 billion in 1984 and $1.5 billion in 1986.

Small Business Provisions

Incentive stock options

The bill creates a special class of stock options called "incentive stock options." Employers are denied a business deduction relating to the grant of these options. However, an employee receiving such an option is taxed only when he sells the stock, and the gain on the sale is taxed at capital gains rates.

Subchapter S corporations

The bill increases the maximum number of shareholders for a subchapter S corporation from 15 to 25 and permits certain trusts to be shareholders of such corporations.

Accumulated earnings credit

The bill increases the credit against the accumulated earnings tax from $150,000 to $250,000.

Investment credit for used property

The bill repeals the existing $100,000 limitation on the amount of used property eligible for the investment credit. There will, however, be recapture of previously claimed credits based on the proceeds from the sale or disposition of the asset, rather than the period of time the property was held by the taxpayer.

Other Provisions

Deduction for motor carrier operating rights

The bill allows motor carriers to amortize over a 60-month period the adjusted basis of all motor carrier operating rights held on July 1, 1980.

Corporate contributions of research equipment to colleges

Present law limits the amount deductible for charitable contributions of property if the sale of that property would generate ordinary income. The bill provides a limited exception to this rule for contributions by a corporation of new tangible personal property which is manufactured by the corporate donor and is to be used by the donee college or university for research purposes.

II. GENERAL REASONS FOR THE BILL

The committee believes that a program of significant multi-year tax reductions is needed to ensure economic growth in the years ahead. The committee's tax reduction program will help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy, lower personal tax burdens, and restrain the growth of the Federal Government. Lower tax burdens on individuals and businesses, maintained over a period of years, will help restore certainty to economic decision-making and provide a sound basis for a sustained economic recovery. The committee has chosen a program of broadly-based tax cuts that restores incentives to work, produce, save, and invest, consistent with the goal of eliminating the Federal budget deficit by 1984.

The committee is concerned that the performance of the economy has fallen far below its potential and that this condition will continue if there is no change in policy. The real growth of the economy, which had slowed in 1978 and again in 1979, came to a halt in 1980. Inflation and interest rates rose to exceptional levels and remain high. The unemployment rate rose sharply in 1980 and remains unacceptably high, while rates of productivity and savings have declined or stagnated. At the same time, Federal budget receipts have grown to be a larger percentage of the income generated by the American economy than at any other time in the postwar period. Without significant tax cuts, Federal taxes would continue to rise to 22.8 percent of the gross national product by 1984. The committee believes that this level of taxation is a significant impediment to economic progress and that an extensive program of tax cuts is required at this time.

The committee believes that a program of multi-year tax cuts will help check the growth of Federal expenditures. Federal spending has grown from 19.5 percent of gross national product in fiscal year 1974 to 22.6 percent in fiscal year 1980. This trend must be reversed. Through increased expenditures, the Federal Government has too often intruded into decisions on the allocation of resources. Such intrusions have caused inefficiencies in the workings of the economy, misallocation of resources, uncertainty and instability. As a result, the free enterprise system has fallen short of its potential for economic growth. The committee believes that its program of tax reductions will increase the likelihood that Federal spending will be restrained over an extended period of time, and will speed economic recovery by reducing governmental interference in the workings of a free economy.

Individual Income Tax Reductions

The interaction of the progressive income tax rate structure with the inflation of the past several years has caused a significant increase in individual income taxes, far in excess of the tax reduction which

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was enacted in 1978. The committee believes that excessively high income taxes give households too little control (and the Federal Government too much control) over the disposition of their earnings. The proportion of household income that is paid in individual income tax is now greater than at any other time in the last two decades. Without a change in policy, this proportion would automatically rise in future years due to the interaction of inflation and the fixed dollar amounts in the present tax rate schedules. The committee believes that these automatic increases should be forestalled by multi-year tax cuts.

A second reason for individual tax reductions is to mitigate the adverse effects of high marginal tax rates on productivity and savings. A high marginal tax rate—that is, the tax rate applicable to the last dollar of income—discourages additional work effort and encourages tax avoidance by diverting people from more productive activities that are fully taxable to less productive activities that are not fully taxable or that generate tax losses which can be used to shelter other income from tax. Marginal income tax rates are now higher than they have been at any other time during the last two decades. Today, more than half of all income is received by taxpayers whose marginal income tax rate exceeds 30 percent. Moreover, without a change in policy, inflation would cause marginal tax rates to increase automatically in future years. The committee believes that these marginal income tax rates should be lowered for all taxpayers by multi-year cuts in tax rates.

Third, tax changes are needed to reduce the tax penalty which results when two persons with relatively equal incomes marry each other. Imposing substantial tax penalties on marriage is undesirable because such penalties imply a lack of concern on the part of the government for the family. These penalties also discourage work effort by second-earners and undermine respect for the tax system itself as an even-handed way to raise revenue. Accordingly, the bill is designed to achieve significant reductions in this marriage penalty.

The committee concludes that the appropriate size of the income tax reduction for individuals is $4.0 billion for calendar year 1981, $41.4 billion for calendar year 1982, $84.8 billion for calendar year 1983 and $119.3 billion for calendar year 1984. These amounts represent significant progress toward the goals of tax reduction, yet are consistent with controlling the budget and eliminating the deficit in 1984.

Capital Formation Tax Reductions

Tax reductions are urgently needed to stimulate capital formation. The present tax system creates significant disincentives to investment. Business investment in new plant and equipment is crucial for increasing productivity, which will hold down the rate of inflation and improve the nation's competitiveness in international trade. Yet, investment spending in excess of what is needed to replace worn-out parts of the existing industrial base has been too small in recent years, and an increasing share of that spending has been for satisfaction of governmentally mandated requirements and does not necessarily augment capacity to produce.

In its hearings on tax reduction, the committee heard numerous witnesses testify that a restructuring of depreciation allowances for tax purposes would be an effective way of stimulating capital formation. Inflation reduces the tax savings from depreciation deductions because the value of the dollar is less when these deductions are claimed than it was when the investment was originally made. As a result, the current system of depreciation reduces the incentive to invest. The committee agrees that a new system of capital cost recovery is required and the bill, therefore, provides for more accelerated depreciation of plant, equipment, and rental housing. This will provide incentives for investment spending and will contribute immediately to cash flow for the financing of such spending. In addition, the new system is designed to simplify compliance by taxpayers and administration by the Internal Revenue Service.

The committee is concerned that the nation's lead in research and development has been diminished in recent years. From research and development come technological advances that are essential to increased productivity and competitiveness. The committee believes that a major new tax incentive is needed to encourage additional research and development.

The committee believes that the tax system should be modified to promote greater personal savings, so that the rebuilding of the economy can occur with less risk of inflation and so that individuals can more easily accumulate their own resources for retirement. The bill, therefore, provides incentives for individuals to make greater contributions to private retirement accounts and to a new type of savings account. It extends tax incentives for individual retirement accounts to a much broader class of taxpayers. The bill also contains incentives for the wider use of employee stock ownership plans, which encourage employees to invest in the stock of their employer and to increase their productivity. The reduction in the top income tax rate to 50 percent in 1982 will also encourage saving and direct saving away from tax shelter investments.

The committee believes that additional incentives are needed to maintain and increase the viability of small businesses. Small businesses are important sources of employment, innovation and competition, but are especially vulnerable during periods of high inflation, high interest rates and economic stagnation. The committee bill therefore provides for significant reductions in estate and gift taxes, the expensing of relatively small amounts of investment and other measures targeted to small businesses.

A substantial percentage of the tax reductions in the committee bill are specifically targeted toward improving capital formation. The committee believes these tax cuts, in combination with individual income tax reductions, constitute a redirection of the Federal tax system that will restore the vitality of the national economy.

III. REVENUE EFFECTS OF THE BILL

The revenue effects of the tax provisions of the bill, as reported by the Senate Finance Committee, are presented in three tables. Table 1 summarizes the revenue effects of the bill and shows the revenue figures by title of the bill for fiscal years and calendar years 1981 through 1986. Table 2 depicts the revenue effects on fiscal year budget receipts, while Table 3 shows these effects on calendar year tax liabilities. The revenue estimates in Tables 2 and 3 are shown by provision and are summarized by title.

As shown in Table 1, the committee bill provides a tax reduction of $1.5 billion in fiscal year 1981, $37.0 billion in fiscal year 1982, $93.1 billion in fiscal year 1983, and $224.2 in fiscal year 1986.

On the calendar year basis, the tax reduction is $9.1 billion in 1981. $56.8 billion in 1982, $115.8 billion in 1983, and $243.3 billion in 1986.

In many cases the revenue estimates do not include assumptions about the extent to which taxpayers change their behavior in response to tax changes. However, responses by taxpayers often can be expected to increase the tax base and offset some or all of the revenue loss from the reduction in taxes. For example, the reduction in the top individual income tax rate from 70 percent to 50 percent is expected to encourage additional sales of capital assets, reduce use of tax shelters and a number of other changes in behavior which will expand the amount of taxable income, i.e., the tax base. The committee believes that there is a good chance that these "feedback effects" will expand the tax base enough to offset the revenue loss from the reduction in the top rate. However, because it is very difficult to make precise scientific estimates of these feedback effects, the revenue estimates of this provision of the bill do not take feedback effects into account.

Table 1.—Summary Revenue Effects of the Economic Recovery Tax Act of 1981, as Reported by Senate Finance Committee, 1981–86

(Millions of dollars)

	Fiscal year receipts—					
	1981	1982	1983	1984	1985	1986
Title I: Individual income tax provisions	−39	−26, 844	−70, 624	−114, 117	−134, 187	−157, 085
Title II: Business tax incentive provisions	−1, 568	−11, 249	−19, 552	−29, 283	−40, 957	−57, 174
Title III: Savings tax provisions		−98	−1, 142	−3, 505	−4, 091	−5, 075
Title IV: Estate and gift tax provisions		−137	−1, 735	−2, 622	−3, 700	−4, 827
Title V: Commodity tax straddles provisions	142	1, 351	([1])	([1])	([1])	([1])
Total revenue effect	**−1, 465**	**−36, 977**	**−93, 053**	**−149, 527**	**−182, 935**	**−224, 161**

	Calendar year liabilities—					
	1981	1982	1983	1984	1985	1986
Title I: Individual income tax provisions	−4, 036	−41, 399	−84, 825	−119, 309	−140, 595	−164, 748
Title II: Business tax incentive provisions	−6, 457	−14, 093	−25, 278	−34, 167	−48, 406	−66, 921
Title III: Savings tax provisions	−20	−331	−3, 053	−3, 350	−4, 775	−5, 486
Title IV: Estate and gift tax provisions		−1, 737	−2, 626	−3, 704	−4, 836	−6, 140
Title V: Commodity tax straddles provisions	1, 421	722	([1])	([1])	([1])	([1])
Total revenue effect	**−9, 092**	**−56, 838**	**−115, 782**	**−160, 530**	**−198, 612**	**−243, 295**

[1] Revenue effects for these years will depend upon judicial decisions.

Table 2.—Estimated Revenue Effects of the Economic Recovery Tax Act of 1981 as Reported by Senate Finance Committee, Fiscal Years 1981–86

(Millions of dollars)

Provision	Fiscal year receipts					
	1981	1982	1983	1984	1985	1986
Title I—Individual Income Tax Provisions						
Subtitle A—Individual tax reductions:						
1. Rate cuts [1]	------	−25, 793	−65, 703	−104, 512	−122, 652	−143, 832
2. 20% rate on capital gain for portion of 1981	−39	−355	------	------	------	------
3. Deduction for two-earner married couples	------	−419	−4, 418	−9, 090	−10, 973	−12, 624
Subtitle B—Changes in taxation of foreign earned income	------	−277	−503	−515	−562	−629
Total, individual income tax provisions	−39	−26, 844	−70, 624	−114, 117	−134, 187	−157, 085
Title II—Business Tax Incentive Provisions						
Subtitle A—Cost recovery provisions [3]	−1, 496	−9, 816	−17, 586	−26, 968	−38, 096	−53, 543
Subtitle B—Investment tax credit provisions:						
1. Increase in investment credit for rehabilitation expenditures	------	−71	−175	−211	−277	−386
2. Removal of limit on investment credit for used property and changes in recapture rules	−11	−88	−208	−303	−358	−353

Subtitle C—Research and experimentation incentives:						
1. Credit for research and experimental wage expenditures	−40	−329	−602	−736	−748	−724
2. Charitable contributions of certain property for research or experimentation	(2)	(2)	(2)	(2)	(2)	(2)
Subtitle D—Small business provisions:[4]						
1. Accumulated earnings credit	------	(2)	−33	−36	−40	−44
2. Subchapter S shareholders	------	(2)	(2)	(2)	(2)	(2)
Subtitle E—Windfall profit tax:						
1. Credit for royalty owners	------	−824	−660	−576	−586	−593
2. Reduced tax on newly-discovered oil	------	------	−217	−382	−809	−1, 534
Subtitle F—Other provisions:						
1. Incentive stock options	(2)	(2)	(2)	(2)	11	21
2. Motor carrier operating rights	[5] −21	[5] −121	−71	−71	−54	−18
Total, business tax incentive provisions	−1, 568	−11, 249	−19, 552	−29, 283	−40, 957	−57, 174
Title III—Savings Tax Provisions						
Subtitle A—Interest exclusion:						
1. Exclusion of interest on certain savings certificates [3]	------	−397	−1, 722	−991	------	------
2. Repeal of partial exclusion of interest [6]	------	556	1, 916	------	------	------
Subtitle B—Retirement savings:						
1. Individual retirement savings [6]	------	−201	−1, 118	−1, 520	−1, 897	−2, 124
2. Self-employed plans [6]	------	−56	−157	−173	−183	−201
Subtitle C—ESOPs	------	------	−61	−821	−2, 011	−2, 750
Total, savings tax provisions	------	−98	−1, 142	−3, 505	−4, 091	−5, 075

See footnotes at the end of the table.

Table 2.—Estimated Revenue Effects of the Economic Recovery Tax Act of 1981 as Reported by Senate Finance Committee, Fiscal Years 1981–86—Continued

(Millions of dollars)

Provision	Fiscal year receipts					
	1981	1982	1983	1984	1985	1986
Title IV—Estate and Gift Tax Provisions						
1. Increase in unified credit	------	(2)	−1,077	−1,981	−3,084	−4,241
2. Martial deduction	------	(2)	−259	−257	−250	−242
3. Gift tax exclusion	------	−137	−227	−223	−216	−205
4. Current use valuation	------	(2)	−86	−84	−83	−81
5. Transfers within 3 years of decedent's death	------	(2)	−65	−58	−50	−44
6. Extensions of time of payment	------	(2)	−21	−19	−17	−14
7. Disclaimers	------	(2)	(2)	(2)	(2)	(2)
Total, estate and gift tax provisions	------	−137	−1,735	−2,622	−3,700	−4,827
Title V—Commodity Tax Straddles	142	1,351	(7)	(7)	(7)	(7)
Total Revenue Effect	**−1,465**	**−36,977**	**−93,053**	**−149,527**	**−182,935**	**−224,161**

[1] These figures include the increase in outlays attributable to the earned income credit which results from reduction in tax rates. These outlays are. $4 million in fiscal year 1982, $31 million in 1983, $44 million in 1984, $41 million in 1985, and $38 million in 1986.

[2] Loss of less than $5 million.

[3] Includes sec. 211 of subtitle B (shorter period requirements for investment credit).

[4] The revenue estimates for the provision which allows expensing of certain depreciable assets are not shown as a separate line item under this subtitle because they have been included in the figures covering subtitle A, cost recovery provisions. This provision would reduce fiscal year receipts by $483 million in 1982, $903 million in 1983, $699 million in 1984, $559 million in 1985, and $165 million in 1986.

[5] Includes a portion of the $36 million reduction in tax liabilities for calendar year 1980.

[6] These estimates were made using the rate schedule proposed by the bill. This approach results in a lower revenue loss than one that would have been obtained if the present law rates had been used.

[7] Estimates for these years will depend upon judicial decisions.

Table 3.—Estimated Revenue Effects of the Economic Recovery Tax Act of 1981 as Reported by Senate Finance Committee, Calendar Years 1981–86

(Millions of dollars)

Provision	Calendar year liabilities					
	1981	1982	1983	1984	1985	1986
Title I—Individual Income Tax Provisions						
Subtitle A—Individual tax reductions:						
1. Rate cuts [1]	−3,642	−37,354	−75,820	−108,580	−127,868	−149,756
2. 20% rate on capital gain for portion of 1981	−394					
3. Deduction for two-earner married couples		−3,541	−8,477	−10,189	−12,137	−14,332
Subtitle B—Changes in taxation of foreign earned income		−504	−528	−540	−590	−660
Total, individual income tax provisions	−4,036	−41,399	−84,825	−119,309	−140,595	−164,748
Title II—Business Tax Incentive Provisions						
Subtitle A—Cost recovery provisions [3]	−5,669	−12,582	−23,082	−31,707	−45,353	−63,012
Subtitle B—Investment tax credit provisions:						
1. Increase in investment credit for rehabilitation expenditures		−172	−193	−239	−331	−464
2. Removal of limit on investment credit for used property and changes in recapture rules	−70	−193	−293	−358	−356	−336

See footnotes at the end of the table.

Table 3.—Estimated Revenue Effects of the Economic Recovery Tax Act of 1981 as Reported by Senate Finance Committee, Calendar Years 1981–86—Continued

(Millions of dollars)

Provision	Calendar year liabilities					
	1981	1982	1983	1984	1985	1986
Subtitle C—Research and experimentation incentives:						
1. Credit for research and experimental wage expenditures	−133	−495	−716	−766	−733	−713
2. Charitable contributions of certain property for research or experimentation	([2])	([2])	([2])	([2])	([2])	([2])
Subtitle D—Small business provisions: [4]						
1. Accumulated earnings credit	------	−33	−36	−40	−44	−48
2. Subchapter S shareholders	------	([2])	([2])	([2])	([2])	([2])
Subtitle E—Windfall profit tax:						
1. Credit for royalty owners	−514	−547	−568	−582	−588	−594
2. Reduced tax on newly-discovered oil	------	------	−319	−404	−980	−1,777
Subtitle F—Other provisions:						
1. Incentive stock options	([2])	([2])	([2])	([2])	15	23
2. Motor carrier operating rights	−71	−71	−71	−71	−36	([2])
Total, business tax incentive provisions	**−6,457**	**−14,093**	**−25,278**	**−34,167**	**−48,406**	**−66,921**
Title III—Savings Tax Provisions						
Subtitle A—Interest exclusion:						
1. Exclusion of interest on certain savings certificates [5]	−20	−1,675	−1,415	------	------	------
2. Repeal of partial exclusion of interest [5]	------	2,472	------	------	------	------

Subtitle B—Retirement savings.						
1. Individual retirement savings [5]	------	−980	−1, 345	−1, 649	−2, 027	−2, 285
2. Self-employed plans [5]	------	−148	−171	−177	−194	−214
Subtitle C—ESOP's	------	------	−122	−1, 524	−2, 554	−2, 987
Total, savings tax provisions	−20	−331	−3, 053	−3, 350	−4, 775	−5, 486
Title IV—Estate and Gift Tax Provisions						
1. Increase in unified credit	------	−1, 077	−1, 981	−3, 084	−4, 241	−5, 591
2. Marital deduction	------	−259	−257	−250	−242	−226
3. Gift tax exclusion	------	−229	−227	−220	−214	−199
4. Current use valuation	------	−86	−84	−83	−81	−75
5. Transfers within 3 years of decedent's death	------	−65	−58	−50	−44	−37
6. Extensions of time of payment	------	−21	−19	−17	−14	−12
7. Disclaimers	------	([2])	([2])	([2])	([2])	([2])
Total, estate and gift tax provisions	------	−1, 737	−2, 626	−3, 704	−4, 836	−6, 140
Title V—Commodity Tax Straddles	1, 421	722	([6])	([6])	([6])	([6])
Total Revenue Effect	**−9, 092**	**−56, 838**	**−115, 782**	**−160, 530**	**−198, 612**	**−243, 295**

[1] These figures include the increase in outlays attributable to the earned income credit which results from reduction in tax rates. These outlays are: $3 million in calendar year 1981, $31 million in 1982, $44 million in 1983, $41 million in 1984, $38 million in 1985, and $35 million in 1986.

[2] Loss of less than $5 million.

[3] Includes sec. 211 of subtitle B (shorter period requirements for investment credit).

[4] The revenue estimates for the provision which allows expensing of certain depreciable assets are not shown as a separate line item under this subtitle because they have been included in the figures covering subtitle A, cost recovery provisions. This provision would reduce calendar year liabilities by $1,104 million in 1982, $645 million in 1983, $765 million in 1984, $301 million in 1985, and less than $5 million in 1986.

[5] These estimates were made using the rate schedule proposed by the bill. This approach results in a lower revenue loss than one that would have been obtained if the present law rates had been used.

[6] Estimates for these years will depend upon judicial decisions.

IV. EXPLANATION OF THE BILL

TITLE I.—INDIVIDUAL INCOME TAX PROVISIONS

A. Individual Income Tax Reductions

1. Reductions in tax rates and alternative minimum tax (capital gains) and repeal of maximum tax (secs. 101 and 102 of the bill and secs. 1, 55, 541, 1348, and 6428 of the Code)

Present Law

Tax rates

Under present law, individual income tax rates begin at 14 percent on taxable income in excess of $3,400 on a joint return and $2,300 on a single return. There is no tax on taxable income below these amounts. Individual income tax rates range up to 70 percent on taxable income in excess of $215,400 for joint returns and $108,300 for single returns. The existing marginal tax rates applying to married couples filing joint returns are shown in table 5.

Present law also imposes a 70-percent tax on the undistributed income of personal holding companies. In general, personal holding companies are closely held corporations the income of which consists largely of passive investment income.

Maximum tax

Under present law, a maximum tax rate of 50 percent generally applies to personal service (earned) income.[1] Personal service income, for purposes of the maximum tax, includes items such as wages, salaries, professional fees, and amounts received from pensions or annuities. The maximum tax applies to single individuals with taxable personal service income above $41,500 and married couples with taxable personal service income above $60,000, since these are the levels at which present law tax rates exceed 50 percent.

Alternative minimum tax (capital gains)

Under present law, noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain for the taxable year. (Net capital gain is the excess of net long-term capital gain

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[1] The actual marginal tax rate on earned income may exceed 50 percent, under present law, even for those individuals whose tax liability is calculated using the maximum tax. This occurs because the tax liability on unearned income is calculated by "stacking" unearned after earned income, so that each additional dollar of earned income may push a taxpayer's unearned income into higher tax brackets. Moreover, because itemized deductions are, in effect, allocated on a pro rata basis between earned income and other income, each dollar of earned income causes an additional amount of itemized deductions to be allocated to earned income. Thus, an additional dollar of earned income causes a larger portion of itemized deductions to be deducted against income that would be taxed at a 50-percent rate rather than at the higher rates applicable to other income.

over net short-term capital loss.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a taxpayer's net capital gain is 28 percent (70-percent top tax rate on the 40-percent includible capital gain).

Present law also imposes an alternative minimum tax (sec. 55) on noncorporate taxpayers in certain circumstances. This tax is payable by an individual to the extent that it exceeds the individual's regular income tax, including the "add-on" minimum tax (sec. 56). The alternative minimum tax is based on the sum of the taxpayer's gross income, reduced by allowed deductions, and increased by two tax preference items: (1) "excess" itemized deductions and (2) the capital gains deduction. The alternative minimum tax rate is 10 percent for amounts from $20,000 to $60,000, 20 percent for amounts from $60,000 to $100,000, and 25 percent for amounts over $100,000.

Reasons for Change

The committee bill provides for the reduction of individual income taxes by including one of the key recommendations of the President's economic recovery program—a three-year sequence of across-the-board reductions in marginal tax rates. When the last phase of reductions is reflected in withholding in July 1983, and in tax liability calculations for calendar year 1984, marginal rates and tax burdens will be approximately 23 percent less than what they would have been under current law.

The committee believes that these marginal rate reductions will accomplish two important goals of the economic recovery program. First, they provide equitable across-the-board relief from the excessive and steadily growing tax burden that is imposed under current law. Second, they reduce the distortions, inefficiencies and disincentives that result from the current high level of marginal tax rates.

The average income tax burden, as a percentage of income, is now higher than at any time during the last twenty years. A cornerstone of the economic recovery program is the reduction of the role the Federal government plays in the lives of American citizens. Other legislative action, such as the reconciliation bill, will provide substantial reductions in government spending programs; the committee bill returns to taxpayers the substantial resources that otherwise would have been absorbed by these programs. The tax rate reductions are provided in an across-the-board manner, in order to assure that all taxpayers share the relief in proportion to what their tax liability would have been had the shrinkage in the government's role not taken place. (See Table 4 for figures on the distribution of the tax cut by income class.)[2] The 23-percent reduction will be phased in over three years, in a manner that will have a steady, predictable impact on the economy and that is consistent with the goal of a balanced budget in fiscal year 1984.

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[2] The highest income group receives a 1984 tax reduction, as a percentage of current tax liability, which is lower than average because a large portion of the income received by this group—personal service income—is already subject to a maximum tax rate of 50 percent. The lowest income group receives a higher than average reduction because its tax liability has already been reduced substantially by the earned income credit; thus, a 23-percent reduction in tax liability before credits may lead to a substantially larger percentage reduction in tax liability after credits.

Table 4.—Distribution of Aggregate Revenue Loss Relative to Present Law From Individual Income Tax Rate Reductions and Deduction for Two-Earner Couples in Effect in 1982, 1983 and 1984 [1]

[Millions of dollars, 1981 income levels]

Expanded income class [2]	Present law tax liability [3]	1982 total reductions	1983 total reductions	1984 reductions: Rate reductions	1984 reductions: Deduction for two-earner couples	1984 reductions: Total	1984 reductions: Total as percent of present law liability
Under $5,000	−157 (−0.1)	−69 (0.2)	−109 (0.2)	−114 (0.2)	0 (0.0)	−114 (0.2)	[4]
$5,000–$10,000	6,381 (2.2)	−937 (2.7)	−1,479 (2.5)	−1,718 (2.6)	−13 (0.2)	−1,731 (2.4)	27.1
$10,000–$15,000	16,317 (5.7)	−1,925 (5.6)	−3,287 (5.4)	−3,812 (5.8)	−88 (1.5)	−3,900 (5.4)	23.9
$15,000–$20,000	22,927 (8.0)	−2,651 (7.7)	−4,675 (7.7)	−5,407 (8.2)	−218 (3.7)	−5,625 (7.8)	24.5
$20,000–$30,000	58,558 (20.4)	−6,715 (19.4)	−12,349 (20.5)	−13,744 (20.8)	−1,149 (19.5)	−14,893 (20.7)	25.4
$30,000–$50,000	85,706 (29.9)	−10,183 (29.4)	−18,923 (31.4)	−19,695 (29.9)	−2,825 (48.0)	−22,520 (31.3)	26.3
$50,000–$100,000	51,631 (18.0)	−5,900 (17.1)	−11,002 (18.2)	−12,033 (18.2)	−1,222 (20.8)	−13,255 (18.4)	25.7
$100,000–$200,000	24,125 (8.4)	−2,639 (7.6)	−4,437 (7.4)	−5,116 (7.8)	−280 (4.8)	−5,396 (7.5)	22.4
Over $200,000	21,110 (7.4)	−3,583 (10.4)	−4,080 (6.8)	−4,328 (6.6)	−85 (1.4)	−4,413 (6.1)	20.9
Total	286,659 (100.0)	−34,603 (100.0)	−60,341 (100.0)	−65,966 (100.0)	−5,881 (100.0)	−71,847 (100.0)	25.1

[1] Percentage distribution of revenue loss in parentheses.

[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income.

[3] Includes outlay portion of the earned income credit.

[4] Not meaningful because this income class does not have positive tax liability.

The committee believes that the 23-percent reduction in marginal rates, itself, will play a crucial role in economic recovery. An individual's marginal tax rate is the rate applicable to the last dollar of income received or to the next dollar of income to be received. For an individual with a 30-percent marginal rate, for example, the return from additional work effort and saving is reduced by 30 percent. Thus, the marginal tax rate substantially affects the return from additional work effort and additional saving. Because average marginal tax rates are at their highest point in recent history, they are an important cause of the economic distortion and inefficiency currently induced by the individual income tax. The committee bill will reduce this tax-induced distortion.

With respect to work effort, the committee believes that the reduction in marginal rates, and the resulting increase in the reward for additional work effort, will lead to increased willingness to work full-time rather than part-time, greater acceptance of overtime assignments, less absenteeism, and more individuals in the labor force. Further, lower marginal rates should reduce the proportion of compensation which, partly or fully for tax reasons, employees now demand in the form of tax-free fringe benefits, and should improve voluntary compliance with the income tax.

The committee also believes that the increase, resulting from marginal rate reductions, in the after-tax return to saving will significantly increase personal saving, thus insuring adequate financing for the additional investment encouraged by other provisions of this bill. The urgency with which the committee views this need is reflected in its decision to reduce the highest marginal rate by 20 percentage points on January 1, 1982, rather than to phase in this change, as is the case with other rate reductions. Because the law already provides a special maximum tax rate on earned income, this change is intended to eliminate a substantial disincentive to investment. In addition to providing a stimulus for additional saving, the marginal rate reductions will encourage the expansion of many small business activities by increasing the after-tax return to those activities. Moreover, by increasing the after-tax cost of borrowing, marginal rate reductions will reduce the incentive for borrowing (or dissaving) that results from the present law deduction for interest. Further, individuals will be less inclined to shift their investments from highly taxed, productive activities, to lightly taxed, less productive investments such as tax shelters and precious metals. Finally, lower marginal rates will reduce the "lock-in" effect of the present treatment of capital gains, thus increasing the likelihood that capital assets always will be employed in their most efficient uses.

Explanation of Provisions

a. Reduction in tax rates

The committee bill reduces individual income tax rates in every tax bracket. By 1984, all tax rates in current tax rate schedules are reduced by approximately 23 percent. Moreover, the highest marginal tax rate is reduced from 70 percent to 50 percent as of January 1, 1982; this 50-percent maximum rate is applied in all years to the rate schedules which would have resulted from the across-the-board reductions by themselves. Thus, when the committee's tax rate cuts are phased in fully, tax rates will range from 11 percent to 50

percent instead of the present law range of 14 percent to 70 percent. The committee bill implements the "5–10–10" proposal put forward by the President.

The committee bill reduces individual income tax liability in four stages. For calendar year 1981, there is a tax credit against regular tax equal to 1¼ percent of regular tax liability before other credits. This credit corresponds to a 5-percent reduction in withholding, effective on October 1, 1981. The Secretary is required to incorporate this credit in the section 3 tax tables for 1981 and has the authority to modify the applicable rate schedules of section 1 to reflect the credit or to prescribe other tables which reflect the amount of credit for different levels of tax or taxable income. In calendar year 1982, there are across-the-board rate reductions averaging about 10 percent below present law. For 1983, there are additional across-the-board rate reductions of 10 percent, resulting in rates about 19 percent below present law. (The two 10-percent rate reductions lead to a 19-percent, rather than a 20-percent reduction because the second 10-percent reduction is applied to the rates in effect after the first 10-percent reduction.) Finally, in 1984, the permanent rate schedules, incorporating further reductions of 5 percent and total across-the-board reductions of about 23 percent below present law, take effect. The marginal tax rates proposed under the committee bill for married couples filing joint returns are shown in table 5, below.

To conform the tax on undistributed personal holding company income to the reduction in the maximum individual income tax rate from 70 percent to 50 percent, the bill reduces the tax rate on such income to 50 percent.

Table 5.—Tax Rate Schedules Under Present Law and the Committee Bill for 1982, 1983, and 1984 (Joint Returns)

[In percent]

Taxable income bracket	Present law	Committee bill		
		1982	1983	1984 and subsequent years
0 to $3,400	0	0	0	0
$3,400 to $5,500	14	12	11	11
$5,500 to $7,600	16	14	13	12
$7,600 to $11,900	18	16	15	14
$11,900 to $16,000	21	19	17	16
$16,000 to $20,200	24	22	19	18
$20,200 to $24,600	28	25	23	22
$24,600 to $29,900	32	29	26	25
$29,900 to $35,200	37	33	30	28
$35,200 to $45,800	43	39	35	33
$45,800 to $60,000	49	44	40	38
$60,000 to $85,600	54	49	44	42
$85,600 to $109,400	59	50	48	45
$109,400 to $162,400	64	50	50	49
$162,400 to $215,400	68	50	50	50
$215,400 and over	70	50	50	50

b. Reduction in alternative minimum tax (capital gains)

As a result of reducing the maximum regular tax rate from 70 percent to 50 percent, the committee bill reduces the maximum rate of tax on net capital gains from 28 percent to 20 percent, even though the deduction for net capital gains is not increased. This 20-percent capital gain rate results from applying the highest tax rate under the bill (50 percent) to the 40 percent of net capital gain that is includible in gross income.

In order to conform the alternative minimum tax to the reduction in the maximum regular tax on net capital gains, the bill reduces the top alternative minimum tax rate from 25 percent to 20 percent. Thus, under the committee bill, the alternative minimum tax rate is 10 percent for amounts from $20,000 to $60,000 and 20 percent for amounts in excess of $60,000.

c. Special rules for net capital gains in 1981

Because the committee does not want to encourage individuals to postpone the disposition of capital assets until 1982 in order to take advantage of the effect that the 50-percent maximum tax rate will have on the taxation of net capital gains, the committee bill provides a special alternative tax so that a maximum 20-percent rate on net capital gains will apply to sales or exchanges occurring after June 10, 1981.

Specifically, an individual who has net capital gains in 1981 will pay a tax equal to the lesser of: (1) the sum of the regular tax on all taxable income other than 40 percent of the qualified net capital gain, and a tax at the rate of 20 percent on the qualified net capital gain, or (2) the regular tax on all taxable income (including 40 percent of qualified net capital gain). Qualified net capital gain is the lesser of the net capital gain for the taxable year or the net capital gain for the taxable year taking into account only gain or loss from sales or exchanges occurring after June 10, 1981. Thus, qualified net capital gain does not take account of taxable receipts after June 10, 1981, of proceeds of transactions which occurred prior to that date. Likewise, with respect to the alternative minimum tax, an individual's tax is limited to the sum of the alternative minimum tax on alternative minimum taxable income other than qualified net capital gain, and a 20-percent tax on qualified net capital gain. Credits other than the foreign tax credit are not allowed against the qualified net capital gain portion of the minimum tax.

d. Withholding changes

Under the committee bill, three changes in income tax withholding rates are scheduled. An initial 5-percent reduction in income tax withholding rates takes effect on October 1, 1981. There is a further 10-percent reduction on July 1, 1982, amounting to a cumulative reduction of 14½ percent. (The cumulative reduction is less than 15 percent because the 10-percent reduction applies to the withholding rates in effect after the initial 5-percent reduction.) There is a final 10-percent reduction on July 1, 1983, for a total cumulative reduction of 23 percent.

In addition to the withholding changes made to reflect the tax reductions provided by the committee bill, the bill makes several other with-

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holding changes to give the Secretary authority to issue regulations which would permit workers to adjust their withholding to more closely match their tax liability. The bill makes clear that the maximum number of withholding exemptions to be claimed by an individual will be determined pursuant to Treasury regulations. The bill also allows the Secretary to prescribe that more than one additional withholding exemption may be allowed to taxpayers who may claim a zero bracket (special withholding) allowance because they are neither married with a spouse receiving wages nor working for more than one employer (present law allows only one additional exemption to such taxpayers). Moreover, the Secretary is authorized to provide by regulations that employees may have withholding either increased or reduced at their request (present law provides only for increases) and that an employee could achieve such increased or decreased withholding without the employer's consent. (Present law requires both the employer and employee to agree to increased withholding). Finally, the bill makes it clear that additional withholding allowances for anticipated excess itemized deductions and tax credits can be claimed only in accordance with Treasury regulations and gives the Treasury statutory authority to provide additional withholding allowances for any additional items specified in Treasury regulations.

e. Elimination of maximum tax

Under the committee bill, the highest marginal tax rate on all types of income is reduced to 50 percent, as of January 1, 1982. Therefore, the maximum tax rate on personal service income, which would become redundant, is repealed by the bill, as of January 1, 1982.

Effective Dates

The calendar year 1981 rate reduction credit is effective for taxable years beginning in 1981. The general rate reductions, repeal of the maximum tax on earned income, reduction of the alternative minimum tax, and reduction of the personal holding company tax are effective for taxable years beginning after December 31, 1981. Two additional rate reductions would be effective for taxable years beginning after December 31, 1981, and 1982, respectively. The withholding provisions are applicable to remuneration paid after September 30, 1981. The reduction in the maximum tax rate for net capital gains (including the related limitation on the alternative minimum tax) is effective for sales or exchanges occurring after June 10, 1981.

For fiscal year taxpayers, the rate changes would be effective for the portion of the taxable year after December 31 of the year (sec. 21).

Revenue Effect

The reduction in tax liability from these changes is expected to be $4,036 million in calendar year 1981 and $37,354 million in calendar year 1982, with reduction in receipts of $26,148 million in fiscal year 1982 and $65,703 million in fiscal year 1983. These figures include the increase in outlays attributable to the earned income credit; this increase occurs because of the reduction in tax rates. (To the extent that the earned income credit exceeds tax liability, it is treated as an outlay under budget procedures.)

2. Deduction for two-earner married couples (sec. 103 of the bill and secs. 62, 85, 105, 3402 and new sec. 221 of the Code)

Present Law

Under present law, a married couple generally is treated as one tax unit which must pay tax on its total taxable income. Although couples may elect to file separate returns, the law is structured so that filing separate returns almost always results in a higher tax than filing joint returns. In addition, different tax rate schedules apply to single persons and to single heads of households. Along with other provisions of the law, these rate schedules give rise to a "marriage penalty" when persons with relatively equal incomes marry each other and a "marriage bonus" when persons with relatively unequal incomes marry each other. In general, if two persons' combined income is allocated between them more evenly than 80%-20%, their combined income tax liability will increase when they marry.

Reasons for Change

The committee is concerned about the marriage tax penalty, and has decided that a suitable response to this problem is to allow married couples a new deduction equal to a percentage of the earnings of the spouse with lower earnings.

Any attempt to rectify the marriage penalty involves the reconciliation of several competing objectives of tax policy. For many years, an accepted goal has been the equal taxation of married couples with equal incomes. This has been viewed as appropriate because married couples frequently pool their income and consume as a unit, and, thus, it has been thought that married couples should pay the same amount of tax regardless of how the income is divided between them. This result generally is achieved under current law.

The committee believes that alleviation of the marriage penalty is now necessary because large tax penalties on marriage undermine respect for the family, by affected individuals, and for the tax system itself. To do this, the committee was obliged to make a distinction between one-earner and two-earner married couples. The simplest way to alleviate the marriage penalty is to allow a percentage of the earned income of the spouse with the lower earnings to be, in effect, free from income tax.

The provision also will alleviate another effect of the current system on all married couples—high marginal tax rates on the second earner's income. Recent studies have shown that these high marginal rates have a significant adverse effect on second earners' decisions to seek paying jobs. The 10-percent reduction in marginal tax rates for second earners provided by the new deduction will reduce this work disincentive. In addition, some contend that two-earner couples are less able to pay income tax than one-earner couples with the same amount of income because the former have more expenses resulting from earning income, as well as less free time. Under this theory, the new

deduction will improve equity by reducing the tax burden of two-earner couples compared to one-earner couples.

The second-earner deduction will reduce the marriage penalty and improve work incentives for second earners without abandoning the basic principle of joint returns. Allowing married couples to file separate returns as single taxpayers would be very complex because of the necessity for rules allocating income and deductions between the spouses. If separate filing were optional, many couples would be burdened by having to compute tax liability under both options (separately and jointly) in order to determine which method minimizes their liability. Further, separate filing would provide tax reductions with respect to all types of income received by married couples, while the committee believes that relief is essential for wages and salaries received by second earners. Also, separate filing would reduce taxes only for couples affected by the marriage penalty, while the committee believes there should be a reduction for all two-earner married couples.

The substantial reductions in the marriage penalty resulting from both this new deduction and the overall reductions in marginal rates provided by the committee bill are shown in table 6. This new deduction is a major step towards the goal of eliminating the marriage penalty completely.

Explanation of Provision

With certain exceptions, two-earner married couples who file a joint return will be allowed a deduction from gross income in arriving at adjusted gross income. Taxpayers may claim this deduction even if they do not itemize their personal deductions. The deduction will equal 10 percent (5 percent for taxable years beginning in 1982) of the lesser of $30,000 or the qualified earned income of the spouse with the lower qualified earned income. Thus, the maximum deduction will be $1,500 for taxable years beginning in 1982 and $3,000 for subsequent taxable years. If the qualified earned income of each spouse for the taxable year is the same, then the deduction may be computed using the qualified earned income of either one of the spouses.

In general, qualified earned income is earned income within the meaning of section 401(c)(2)(C) or section 911(d)(2) (as redesignated by the bill) less specified deductions allowable under section 62 that are properly allocable to or chargeable against such earned income in determining qualified earned income. Qualified earned income will be determined without regard to the 30-percent limitation on compensation from a trade or business in which both personal services and capital are material income-producing factors. Qualified earned income is not intended to include unemployment compensation paid under a government program.

Under the bill, qualified earned income does not include any amount that is not includible in gross income, because untaxed income does not give rise to a work disincentive or a marriage penalty. In addition, the qualified earned income of each spouse will be computed without regard to any community property laws; that is, earned income will be attributed to the spouse who renders the services for which the earned income is received.

Pensions, annuities, individual retirement plan distributions and deferred compensation are excluded from qualified earned income. In

general, deferred compensation is any amount received after the close of the taxable year following the taxable year in which the services to which the amount is attributable are performed. Pensions and annuities are excluded because these amounts are composed largely of investment income (e.g., interest on plan contributions) that has accumulated tax-free. This exclusion is also necessary to focus the benefits of this deduction on individuals currently earning income and to avoid a windfall for those whose work took place in past years. The exclusion of pensions and annuities is consistent with the definitions applicable to the earned income credit. Distributions from individual retirement plans have been excluded to maintain parity with qualified plans. Other forms of deferred compensation are excluded from qualified earned income for similar reasons.

Wages exempt from certain social security taxes because an individual is in the employ of his or her spouse also are excluded from qualified earned income. These amounts are excluded because the existing exemption of these wages from social security tax already provides substantial relief to these second earners and because, otherwise, there could be opportunities to shift earned income between spouses and attribute an inaccurate or unreasonable amount of earned income to the second earner.

Certain items deductible under section 62 must be deducted in computing qualified earned income. These items are: (1) deductions attributable to a trade or business from which earned income is derived, except that if some of the gross income from a trade or business does not constitute earned income, only a proportional share of the deductions attributable to such trade or business must be deducted (section 62(1)); (2) deductions consisting of expenses paid or incurred in connection with the performance of services as an employee (section 62(2)); (3) deductions for contributions by a self-employed person to a qualified retirement plan (section 62(7)); (4) certain deductions relating to pension plans of subchapter S corporations (section 62(9)); (5) contributions to an individual retirement plan (section 62(10)); and (6) deductions for certain required repayments of supplemental unemployment compensation benefits (section 62(15)).

Table 6.—Marriage Tax Penalty for Two-Earner Couples Under Present Law and Committee Bill

Income of husband	Income of wife				
	$10,000	$20,000	$30,000	$50,000	$100,000
$10,000					
Present law	$103	$185	$157	−$134	−$241
Committee bill	−121	−84	−146	−512	−2, 360
$20,000					
Present law	185	822	1, 350	1, 701	1, 671
Committee bill	−84	90	388	557	−837
$30,000					
Present law	157	1, 350	2, 166	2, 901	2, 918
Committee bill	−146	388	606	1, 110	185
$50,000					
Present law	−134	1, 701	2, 901	3, 760	3, 777
Committee bill	−512	557	1, 110	2, 290	2, 007
$100,000					
Present law	−241	1, 671	2, 918	3, 777	3, 794
Committee bill	−2, 360	−837	185	2, 007	3, 390

NOTES:

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 23 percent of adjusted gross income and are allocated between spouses in proportion to income.

Committee bill computations assume the rate schedules and two-earner couple deduction in effect in 1984 and thereafter.

The bill includes conforming amendments specifying that the amounts of unemployment compensation and disability income included in adjusted gross income are to be computed without regard to this deduction. Then, the deduction is to be computed excluding from qualified earned income amounts of disability (or other) income not included in gross income.

The bill also provides that no deduction is allowable if either spouse claims, on the couple's joint return for the taxable year, the benefits of section 911 (relating to income earned by individuals in certain camps outside the United States) or section 931 (relating to income from sources within possessions of the United States). Couples benefiting from these provisions are excluded from the new deduction because of the substantial relief provided elsewhere in the bill for income earned abroad and the complexity of coordinating the new deduction with these provisions. This is consistent with the eligibility rules for the earned income credit.

Finally, a married couple will be allowed to take this deduction into account in determining withholding allowances under section 3402(m).

Effective Date

The provision is effective for taxable years beginning after December 31, 1981.

Revenue Effect

The reduction in tax liability from these changes is expected to be $3,541 million in calendar year 1982 and $8,477 million in calendar year 1983, with a reduction in receipts of $419 million in fiscal year 1982 and $4,418 million in fiscal year 1983.

B. Foreign Earned Income Exclusion

(Secs. 111–115 of the bill and secs. 911 and 913 of the Code)

Present Law

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents generally are taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to $20,000 of earned income a year if they were present in a foreign country for 510 days (approximately 17 months) out of a period of 18 consecutive months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to $25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the $20,000 (or $25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to $15,000 per year. However, the Act would have retained a $20,000 exclusion for employees of domestic charitable organizations. In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion, for years beginning after December 31, 1977, with a new deduction for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion, for years beginning after December 31, 1977, with a new deduction for the excess costs of working overseas. The basic eligibility requirements for the deduction generally are the same as for the prior earned income exclusion.

The excess living cost deduction (sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS–14, step 1, regardless of the

taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount (generally one-sixth of his net earned income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special $5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these rules, present law permits employees who reside in camps in hardship areas to elect to claim a $20,000 earned income exclusion (under sec. 911) in lieu of the excess living cost and hardship area deductions. No foreign tax credit is allowed for foreign taxes attributable to the excluded amount, and deductions attributable to the excludable amount are not allowed. For taxpayers electing the exclusion, the camp is treated as the employer's business premises so that the exclusion for employer-provided meals and lodging also can be claimed (provided the other requirements of sec. 119 are satisfied).

The 1978 Act liberalized the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extended the regular 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence to up to four years in the case of Americans working abroad.

Under certain circumstances, the time limits of the eligibility requirements for the excess living cost deduction or the exclusion may be waived. Three conditions must be met for the waiver to apply. First, the individual actually must have been present in, or a *bona fide* resident of, a foreign country. Second, he must leave the foreign country after August 31, 1978, during a period with respect to which the Treasury Department determines, after consultation with the State Department, that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals. Third, the individual must establish to the satisfaction of the Treasury that he reasonably could have been expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions. If these criteria are met, the taxpayer is treated as having met the foreign residence or presence requirements with respect to the period during which he was resident or present in the foreign country even though the relevant time limitation under existing law has not been met.

Reasons for Change

The committee believes that American business faces increasing competitive pressures abroad, and that, in view of the nation's con-

tinuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive. The tax burdens imposed on these individuals, even under the liberalizations of the Foreign Earned Income Act of 1978, have made it difficult for U.S. businesses to utilize American employees abroad. In many cases, the policy of these businesses is to make their employees whole for any extra tax expenses the employees incur because of overseas transfers. Thus, an extra tax cost to the employees becomes a cost to the business, which cost often must be passed through to customers in the form of higher prices. In intensely competitive industries, such as construction, this leads to higher, and thus often noncompetitive bids for work by American firms. The impact also is felt in other export industries. As a result, some U.S. companies either have cut back their foreign operations or have replaced American citizens in key executive positions with foreign nationals. In many cases, these foreign nationals may purchase goods and services for their companies from their home countries, rather than from the United States because they often are more familiar with those goods and services.

The committee also believes that, the rules of present law are complex. Because the deductions can vary significantly from case to case, it is often difficult for an American to estimate what his tax liability will be if he plans to work overseas. In addition, many Americans employed abroad have found it necessary to use costly professionals to complete their tax returns.

The committee believes that it is necessary to change the tax law to encourage Americans to work abroad to help promote the export of U.S. manufactured goods and services. Reducing the tax burden on Americans working abroad will make American enterprises more competitive in foreign markets. The committee feels that a broad range of activities by Americans abroad benefit the U.S. economy and should be encouraged.

The committee concludes that an appropriate incentive, to replace the present excess foreign living cost deduction and exclusion, is to allow qualifying Americans to elect a substantial exclusion from U.S. tax for their foreign earned income. The committee has, however, placed a specific dollar limitation on the exclusion. This limitation prevents abuse of the exclusion by, for example, highly paid entertainers or athletes who might otherwise move abroad to escape large amounts of U.S. tax on their income. In addition, the committee has provided an exclusion from income measured by excess housing costs, which can be a substantial component of excess foreign living costs.

The committee also believes that the period of foreign presence required to qualify for the exclusions should be shortened, and that the residence or presence period should continue to be waived in certain circumstances where civil unrest prevents individuals from meeting those requirements.

Explanation of Provision

The bill modifies the eligibility standards of present law and replaces the present deduction for excess living costs with an exclusion of a portion of foreign earned income. The *bona fide* residence

test remains in its present form. However, an individual also is eligible for the special provisions if he is present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law). Individuals meeting these requirements generally may elect to exclude foreign earned income attributable to the period of foreign residence or presence at an annual rate of $50,000 plus 50 percent of the next $50,000 (a maximum of $75,000). In the case of a married couple, the exemption is computed separately for each qualifying individual. The definition of earned income is identical to present law.

In addition to the exclusion described above, an individual may elect to exclude a portion of his income based on his housing expenses. This exclusion is equal to the excess of the taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by, or on behalf of, the individual for housing for the individual (and for his spouse and dependents, if they reside with him) in a foreign country. The term includes expenses attributable to the housing, such as utilities and insurance, but does not include interest and taxes, which are separately deductible. If the taxpayer maintains a second household outside the United States for his spouse and dependents who do not reside with him because of adverse living conditions, then the housing expenses of the second household also are eligible for the exclusion. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The base housing amount is 16 percent of the salary of an employee of the United States whose salary grade is step 1 of grade GS-14. Currently, this salary is $37,871 so the current base housing amount would be $6,059.

Deductions and credits attributable to excluded income are not allowed. For example, foreign taxes paid on excluded income may not be credited against U.S. taxes.

As under present law, pensions and annuities, and income from certain trusts are not excludable.

The bill extends the benefits of the exclusion to individuals who are paid by the United States but who are not eligible for any exclusion under section 912 or any other provision of U.S. law. As a general rule, therefore, employees of the Federal Government will not be eligible for the exclusion.

The bill retains with certain modifications the present rule that in the case of an individual who is furnished lodging in a camp located in a foreign country by or on behalf of his employer the camp shall be considered part of the business premises of the employer for purposes of section 119, relating to the exclusion from income of the value of meals and lodging furnished by the employer. To qualify as a camp, the lodging must be furnished for the convenience of the employer because the place at which the services are rendered is in a remote area where satisfactory housing is not otherwise available on the open market. The lodging must also be located, as near as practicable, in the vicinity of the site at which the individual performs the services and must also be in a common area, or enclave, which is not available to the public and which normally accommodates

10 or more employees. This provision differs from present law primarily in that the camp does not have to be in a hardship area and need not constitute substandard lodging.

The bill retains the present rules under which an individual is allowed pro rata benefits in certain cases where civil unrest or similar adverse conditions require an individual to leave the foreign country before meeting the time requirements.

The bill authorizes the Secretary of the Treasury to issue such regulations as may be necessary or appropriate to carry out the purposes of this provision, including regulations providing rules for cases in which both spouses have foreign earned income or file separate returns.

The present rule extending the period within which capital gain on the sale of a principal residence must be rolled over to qualify for exemption from tax is retained.

Finally, the provision of the Foreign Earned Income Act of 1978 requiring the Secretary to report biannually to the Congress on the operation and effects of sections 911 and 912 is changed to require the report after the close of calendar year 1983, and each fourth calendar year thereafter.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $277 million in fiscal year 1982, $503 million in fiscal year 1983, and $629 million in fiscal year 1986.

TITLE II.—BUSINESS TAX INCENTIVE PROVISIONS

A. Cost Recovery Provisions: Depreciation and Investment Tax Credit Revisions

(Secs. 201–211 and 213 of the bill and new sec. 168 and secs. 47, 48, 57, 179, and 312(k) of the Code)

Present Law

Depreciation

Overview

Depreciation is based on the concept that the cost of an asset should be allocated over the period it is used to produce income. In general, property is depreciable if it is (1) used in a trade or business or for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or obsolescence. Land, goodwill, stock, and other assets that do not have a determinable useful life and that do not decline in value predictably are not depreciable. In general, depreciation is limited to the cost or other basis of the property, less a reasonable estimate for salvage value.

Personal property

Useful life.—A principal method used to determine useful lives for personal property is the Asset Depreciation Range (ADR) system. Assets eligible for ADR are grouped into more than 100 classes and a guideline life for each class is determined by the Treasury. Taxpayers may claim a useful life up to 20 percent longer or shorter than the ADR guideline life. For assets not eligible for ADR and for taxpayers who do not elect ADR, useful lives are determined according to the facts and circumstances pertaining to each asset or by agreement between the taxpayer and the IRS.

Method.—Taxpayers are allowed to use the straight-line method of depreciation for all depreciable assets. Under the straight-line method, the recovery of the cost basis of an asset is spread evenly over the asset's useful life. However, the cost basis of most assets also can be recovered using accelerated methods, which allocate a greater share of the deductions to the early years of the asset's useful life. The most generous accelerated methods permitted under present law are the 200-percent declining balance method and the sum of the years-digits (SYD) method.[1]

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[1] Under the 200-percent declining balance method, depreciation is taken at twice the straight-line rate on the capital costs that have not yet been recovered through depreciation deductions. For example, for an asset with a 5-year life, the first year's deduction is 40 percent of the cost, the second year's deduction is 24 percent (40 percent of the remaining 60 percent of cost), and so forth. Taxpayers using the 200-percent declining balance method typically switch to straight-line or SYD at some point during the asset's useful life because the entire cost of an asset is not recovered using a declining balance method.

Under the sum of the years-digits (SYD) method, changing fractions are applied each year to the original cost (or other basis) of the property reduced by estimated salvage value. The numerator of the fraction for a given year is the number of years remaining in the asset's useful life, including the year for which the deduction is being computed and the denominator, which remains constant, is the sum of the numerals representing each of the years of the asset's estimated useful life.

Gain on disposition and recapture.—In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. However, under ADR, the recognition of gain or loss is postponed for assets retired for routine causes (ordinary retirements), while immediate recognition of gain or loss is required on extraordinary retirements. Similar rules also apply to taxpayers who do not use ADR but who maintain item and group accounts.

When personal property is sold, any recognized gain is treated as ordinary income to the extent of any depreciation previously taken ("sec. 1245 recapture"). Any recognized gain that exceeds previously taken depreciation generally is capital gain.

Real property

Useful lives.—Under present law, depreciation of real property may be determined by estimating useful lives under a facts and circumstances test or by using guideline lives prescribed under Revenue Procedure 62–21, as in effect on December 31, 1970. Guideline lives have not been prescribed for real property under the ADR system, except for certain structures, such as gas stations, farm buildings, and theme park structures.

The IRS guideline lives contained in Rev. Proc. 62–21 range from 40 years for apartments to 60 years for warehouses. However, based on a 1975 study by the Treasury Department's Office of Industrial Economics, average lives claimed by taxpayers for new buildings range from 32 years for apartments to 43 years for bank buildings. These averages reflect, in part, the fact that some taxpayers are using component depreciation.

Component depreciation.—Under the component method of depreciation, a taxpayer allocates the cost of a building to its basic component parts and then assigns a separate useful life to each of these components. These components include the basic building shell, wiring, plumbing and heating systems, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property. The component depreciation method may be applied to both new and used property.

The use of component depreciation may substantially reduce the composite life for the entire building if its short-lived components, such as wiring, comprise a large portion of the building's cost as compared to its long-lived components, such as the shell. However, many taxpayers do not use the component method because it is complex and, for used property, requires a competent appraisal. In addition, it is difficult to audit component depreciation and there is no assurance that the lives chosen by the taxpayer for the components would be approved by the Internal Revenue Service or the courts.

Methods.—Allowable methods for real property depend on the use of the property. New residential rental buildings may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the total depreciation allowable during the first two-thirds of the property's useful life does not exceed the amount allowable under the 200-percent declining balance method. A building or structure is considered to be residential rental property for the taxable year only if 80 percent or more of the gross rental income is from the rental

of dwelling units. New nonresidential buildings may be depreciated under the declining balance method at a rate of up to 150 percent of the straight-line rate. Used residential property with an estimated useful life of 20 years or more can be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. Any other used property, either residential or nonresidential, must be depreciated under the straight-line method.

Gain on disposition and recapture.—When real property is sold, any gain is treated as ordinary income to the extent the total depreciation taken exceeds the depreciation that would have been allowable had the straight-line method been used (sec. 1250). Thus, if the straight-line method is used, all gain is capital gain. This rule is more generous than the rule for personal property under which gain is ordinary income to the extent of all depreciation taken (sec. 1245). For subsidized low-income rental housing, the amount of depreciation subject to recapture as ordinary income when the property is sold is phased out by one percentage point for each month after the property has been held for 100 months.

Minimum tax and maximum tax

Under present law, a 15-percent minimum tax is imposed on the amount of a taxpayer's items of tax preference in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the regular income tax in the case of a corporation or one-half of the amount of the regular income tax in the case of an individual.[2]

One of the items of tax preference subject to the minimum tax is accelerated depreciation on leased personal property.[3] The preference is the amount by which the depreciation (or amortization) allowance with respect to an asset for the year exceeds the depreciation deduction that would have been allowable if the property had been depreciated using the straight-line method over its useful life. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a life shorter than the midpoint life, depreciation attributable to the shorter useful life is included in the amount of the preference. Thus, additional ADR depreciation is a preference even if the straight-line method is used. Accelerated depreciation on leased personal property is not a preference item for corporations other than personal holding companies and subchapter S corporations.

Another preference item is accelerated depreciation on real property, i.e., the excess of the depreciation (or amortization) allowable for the year in excess of the depreciation that would have been allowable for the year computed using the straight-line method over the property's useful life. This item is a tax preference for all taxpayers, whether or not the property is leased.

Under present law, the maximum marginal tax rate on taxable income from personal services is 50 percent (sec. 1348). However, the

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[2] This minimum tax is sometimes called the 15-percent "add-on" minimum tax (sec. 56) and is different from the alternative minimum tax, although it has the same general purposes.

[3] For this purpose, the term "personal property" means property which is subject to depreciation recapture under section 1245.

amount of personal service income subject to the maximum tax is reduced, dollar-for-dollar, by the amount of a taxpayer's preference items. Thus, a taxpayer's preference items not only are subject to a separate minimum tax, but also may cause part of a taxpayer's personal service income to be taxed at a marginal rate greater than 50 percent.

Earnings and profits

A dividend is defined under present law as a distribution of property (which includes money) by a corporation to its shareholders out of either current or accumulated earnings and profits. If a distribution exceeds the corporation's earnings and profits, the excess is a "tax-free dividend" (not currently taxable to the shareholder), which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). If a taxpayer's cost basis in stock is reduced to zero, further distributions exceeding earnings and profits are treated as capital gains. Until 1969, earnings and profits generally were computed with reference to the method of depreciation used in computing the corporation's taxable income. A corporation's earnings and profits, therefore, were reduced by the amount of depreciation deducted by the corporation on its return, thereby often allowing tax-free distributions.

Present law provides that a U.S. corporation must compute its earnings and profits using the straight-line method of depreciation or a similar ratable method such as the unit-of-production method. Earnings and profits may be computed using the 20-percent useful life variance permitted under the ADR system. These rules do not apply to foreign corporations if less than 20 percent of gross income for the taxable year is derived from sources within the United States.

Assets used predominantly outside the United States

Property used predominantly outside the United States may be depreciated using the guideline lives under the ADR system, but the 20-percent useful life variance may not be used. Accelerated methods of depreciation generally may be used with respect to such property. The investment tax credit generally is not allowed for such property (sec. 48(a)(2)).

Normalization requirements for public utility property

Under present law, public utilities generally are able to use the same depreciation methods as other taxpayers. However, certain utilities (electric, water, sewage, gas, steam, and telephone companies) generally are permitted to use accelerated depreciation methods and the 20 percent ADR useful life variance only if the current tax reductions that result from using these methods are "normalized" in setting the rates charged to utility customers (sec. 167(l)).

In theory, the rates charged to customers by a public utility are set at a level that permits the utility to earn a fair rate of return on its investment and recover its costs of doing business (including a ratemaking allowance for Federal income taxes plus a ratemaking allowance for depreciation. The straight-line method and relatively long useful lives are generally used to compute the ratemaking allowance for depreciation. Normalization of accelerated depreciation methods generally means that the rates charged to utility customers will not reflect a ratemaking allowance for Federal income taxes based on the use of a depre-

ciation method more accelerated than the depreciation method used to determine the ratemaking allowance for depreciation. Normalization of the 20-percent ADR variance generally means that the rates charged customers will not reflect a ratemaking allowance for Federal income taxes based on useful lives shorter than the ADR guideline life or the useful life used to determine the ratemaking allowance for depreciation, whichever is shorter. Therefore, normalization generally allows the utilities to collect revenues that reflect a ratemaking tax allowance based on straight-line depreciation and ADR midpoint lives.

The use of accelerated methods of depreciation and the ADR useful life variance for Federal income tax purposes, combined with the use of normalization accounting in ratemaking, generally results in an actual Federal income tax expense that is less than the ratemaking tax allowance in the early years of an asset's useful life and more than the ratemaking tax allowance in the later years of an asset's useful life. These "deferred taxes" can be viewed as an interest-free loan to the utility. The utility is able to use this money in lieu of funds that otherwise would have to be obtained by borrowing or raising equity capital.

The normalization rules of the Code do not limit the authority of regulatory bodies to pass through these capital cost savings to utility customers; i.e., the reduction in the costs of acquiring capital can be reflected in the rates charged to utility customers. This may be done either by treating an amount of the utility's capital as cost-free in determining a fair rate of return or by excluding an amount of the utility's assets from the rate base that is permitted to earn a rate of return. In either case, the amount of capital or rate base that is given this ratemaking treatment must not exceed the amount of the deferred taxes.

The use of accelerated methods and short useful lives in ratemaking to compute the allowance for Federal incomes taxes is known as "flow-through" accounting because current tax reductions are immediately reflected in lower rates to customers. The normalization rules in the Code generally do not apply to property that was subject to flow-through accounting before 1970 or similar property placed in service after 1969.

Retirement-replacement-betterment (RRB) property

The railroad industry generally uses what is called the retirement-replacement-betterment (RRB) method of depreciation for rail, ties, and other items in the track accounts such as ballast, fasteners, other materials, and labor costs. This method is used instead of the depreciation methods described in section 167 (b) and (c), which provide for an annual deduction for each item of property.

For assets accounted for under the RRB method, when a new railroad line is laid (an "addition"), the cost (both materials and labor) of the line is capitalized. No depreciation is claimed for this original installation, but a deduction for these original costs may be claimed if this line is retired or abandoned. If the original installation is replaced with components (rail, ties, etc.) of a like kind or quality, the cost of the replacements (both materials and labor) are deducted as a current expense. When the replacement is of an improved quality, the improved portion of the replacement is a "betterment" that is capitalized, and the remainder of the replacement cost is deducted as a current expense.

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Upon the retirement or replacement of rail and other track assets, the salvage value (measured by current fair market value) of the recovered materials is treated as ordinary income.

The regular 10-percent investment credit is allowed for the cost of railroad track material, which includes ties, rails, ballast, and other track material such as bolts. The credit is allowed for costs that are capitalized (additions and betterments) as well as costs that are expensed (replacements) (sec. 48(a)(1)(B)(i) and sec. 48(a)(9)). Some amounts treated as replacement costs under the RRB method (such as the costs of replacing bolts) might be considered repair expenses under a conventional depreciation system and would not be allowed the investment credit.

Additional first-year depreciation

Under present law, there are no special provisions specifically applicable to the depreciation of assets by a small business. Thus, a small business may depreciate its assets over useful lives determined on a facts and circumstances basis or, if elected, over guideline lives prescribed under the ADR system. Depreciation methods are allowable for small business to the same extent allowable for other taxpayers (i.e., straight-line, declining balance, etc.).

Present law, however, does provide a deduction for "bonus" first-year depreciation in an amount not exceeding 20 percent of the cost of eligible property. In general, depreciable property placed in service during a taxable year is eligible under the provision if it is tangible personal property with a useful life of 6 years or more. The cost of the property that may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).[4] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Carryover periods for operating losses

In general, net operating losses and operating losses of certain insurance companies are allowed a 3-year carryback and a 7-year carryover. Certain financial institutions have only a 5-year carryover, but a 10-year carryback. Certain other net operating losses have special carryover periods as follows:

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[4] A controlled group of corporations (with a 50 percent control test) is treated as one taxpayer and thus is entitled to have only $10,000 of eligible property each year to be apportioned among the members of the group as provided by regulations (sec. 179(d) (6) and (7); Treas. Reg. § 1.179–2(c)). Also, a partnership is limited to $10,000 of eligible property per year, and a member of a partnership must aggregate his distributive share of the partnership's eligible property with his distributive share of eligible property from other partnerships and from his direct interest in section 179 property in applying the $10,000 (or $20,000) eligible property limitation (sec. 179(d)(8)).

A trust is not eligible to elect additional first-year depreciation (sec. 179(d)(4)). However, an estate may elect to take an additional first-year depreciation allowance on up to $10,000 of qualifying property. Thus, the maximum deduction available to an estate is $2,000. The amount of the allowance under section 179 apportioned from an estate to an heir, legatee, or devisee shall not be taken into account by such heir, legatee, or devisee in determining the dollar limitations applicable to additional first-year depreciation on his own property (sec. 179(d)(5)).

Taxpayer:	*Carryover period (years)*
Regulated transportation companies	9
Foreign expropriation losses	10
Cuban expropriation losses	20
Real estate investment trusts (REITs)	8
General stock ownership corporations (GSOCs)	10

Investment Tax Credit

Overview

For certain tangible depreciable property with a useful life of 3 years or more, taxpayers may claim an investment tax credit (regular credit) of up to 10 percent of the cost of the property, in addition to their depreciation deductions. An additional investment credit of up to one and one-half percent (ESOP credit) is available if certain requirements concerning the operation of an employee stock ownership plan are met. An energy investment credit is available in addition to the regular and ESOP credits for certain energy property. With certain specific exceptions, buildings and their structural components do not qualify for these credits.

Useful life limitations

A 10-percent regular investment credit is allowed for assets with useful lives of 7 years or more. For assets with useful lives of 5 or 6 years, only two-thirds of the investment is eligible for the investment credit (a credit of 6⅔ percent). For assets with useful lives of 3 or 4 years, only one-third of the investment is eligible for the investment credit (a credit of 3⅓ percent). No credit is allowed for assets with useful lives shorter than 3 years.

Recapture

The credit must be recomputed if the property is disposed of prior to the end of its estimated useful life ("recapture"). The recomputed credit is based on the amount of credit the property would have received if the credit had been based on the actual time the property was held. The difference between the credit allowed and the recomputed credit results in an increase in tax for the year of recapture.

Tax liability limitation

The regular and ESOP investment credits may be used against the first $25,000 of tax liability plus a percentage of the excess. For 1981, the percentage is 80 percent, and for 1982 and subsequent years, the percentage is 90 percent. The energy credit may be used against 100 percent of tax liability. Increases in tax due to recapture of credits are not counted in determining the tax liability limitation (sec. 47(c)).

Used property limitation

Under present law, only $100,000 of used property per year qualifies for the regular investment credit.

At-risk limitation

Present law imposes a limit on the losses from a business or income-producing activity that a taxpayer can currently deduct (sec. 465). The limit generally is the amount of the taxpayer's investment in the activity that is considered at-risk. A taxpayer is considered not

at risk to the extent there is nonrecourse financing. Nonrecourse financing generally means debt the taxpayer is not personally required to repay and for which the taxpayer has not pledged his personal assets. Nonrecourse financing also means debt owed to a creditor who either has an ownership interest in the activity or who is related to the taxpayer (within the meaning of section 267(b)). Amounts invested in an activity are treated as nonrecourse financing if the taxpayer is protected against the loss of such amounts through guarantees, stop-loss agreements or similar arrangements.

The at-risk loss limitation rules apply to most business activities, except real estate, engaged in by individuals, subchapter S corporations, and certain closely held corporations. Certain leasing activities engaged in by closely held corporations are not covered by the at-risk loss limitations.

Under present law, there is no at-risk limit on the investment credit.

Carryover Periods for Certain Credits

In general, unused tax credits, such as the investment credit, alcohol fuels credit, WIN credit, and targeted jobs credit, are allowed a 3-year carryback and a 7-year carryover.

Reasons for Change

The committee believes that present rules for determining depreciation allowances and the investment tax credit need to be replaced because they do not provide the investment stimulus that is essential for economic expansion. The committee also believes that present rules are unnecessarily complicated.

The real value of depreciation deductions allowed under present rules has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology. The committee agrees with numerous witnesses who testified that a substantial restructuring of depreciation deductions and the investment tax credit will be an effective way of stimulating capital formation, increasing productivity and improving the nation's competitiveness in international trade. The committee therefore believes that a new capital cost recovery system is required which provides for the more rapid acceleration of cost recovery deductions and maintains or increases the investment tax credit.

The committee heard copious testimony that the present rules are too complex. These rules require determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently result in unproductive disagreements between taxpayers and the Internal Revenue Service. Current regulations provide numerous elections and exceptions which taxpayers—especially, small businesses—find difficult to master and expensive to apply. The committee believes that a new capital cost recovery system should be structured which de-emphasizes the concept of useful life, minimizes the number of elections and exceptions, and so is easier to comply with and to administer.

Explanation of Provisions

1. Depreciation revisions

a. Overview

The committee bill replaces the present system of depreciation with the Accelerated Cost Recovery System (ACRS). ACRS permits recovery of capital costs for most tangible depreciable property using accelerated methods of cost recovery over predetermined recovery periods generally unrelated to, but shorter than, present law useful lives. The methods of cost recovery and recovery periods are the same for both new and used property.

Under the new system, the cost of eligible personal property is recovered over a 15-year, 10-year, 5-year, or 3-year period depending on the type of property. Most eligible personal property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. Theme park structures, railroad tank cars, and certain long-lived public utility property are in the 10-year class. Certain other long-lived public utility property has a 15-year recovery period. Eligible real property is placed in a separate 15-year real property class. To provide flexibility, certain longer optional recovery periods are provided.

Recovery of costs generally is determined by using a statutory accelerated method. As an option, the taxpayer may choose to recover costs using the straight-line method over either the regular recovery period or the longer recovery periods provided.

The entire cost or other basis of eligible property is recovered under the new system, eliminating the salvage value limitation under present law.

Eligible property includes depreciable property other than (1) property the taxpayer properly elects to amortize (e.g., leasehold improvements or low-income rehabilitation expenditures) and (2) most property the taxpayer properly elects to depreciate under a method not expressed in terms of years (e.g., unit-of-production or income forecast methods). However, railroad property currently depreciated under the retirement-replacement-betterment method is included in ACRS, subject to special transitional rules.

The committee bill provides a provision for the limited expensing of eligible property and special rules relating to cost recovery for foreign assets, normalization requirements for public utility property, and the computation of earnings and profits and of the minimum tax. Special rules also are provided to prevent the "churning" of used property between certain persons solely to obtain the benefits of increased investment incentives under ACRS. In addition, ACRS establishes new rules for determining if the nominal lessor is entitled to recovery deductions and investment credits for certain leased recovery property.

The committee bill also extends the carryover period for certain operating losses.

b. Personal property

Recovery period

Under the committee bill, the capital cost of tangible personal property generally will be recovered over a 15-year, 10-year, 5-year, or 3-year recovery period, depending on the type of property. However, the taxpayer can elect to use either the extended recovery period used to calculate earnings and profits for the property or the extended earnings and profits recovery period for property in the next higher class. (Because there is no class higher than the 15-year class, an optional 45-year period is permitted for 15-year property.) Thus, a taxpayer can elect to use a 45-year or 35-year recovery period for 15-year property, a 35-year or 25-year recovery period for 10-year property, a 25-year or 12-year recovery period for 5-year property, and a 12-year or 5-year recovery period for 3-year property. Theme park structures are included in the 10-year class.

3-year class.—Automobiles, light-duty trucks, and machinery and equipment used in connection with research and experimentation are assigned to the 3-year class. For these purposes, research and experimentation has the same meaning as the term "research or experimental" has in Code section 174. In addition, all other machinery and equipment (such as special tools) with an ADR midpoint life of 4 years or less as of January 1, 1981, are placed in this class.

5-year class.—The 5-year class includes all tangible personal property, including public utility property with a present ADR midpoint of 18 years or less, that is not included in the 15-year, 10-year, or 3-year recovery classes. Single purpose agricultural and horticultural structures and facilities used for the storage of petroleum and its primary products are designated by the bill as section 1245 property and included in the 5-year class. Under regulations prescribed by the Secretary, petroleum and its primary products will have the same meaning as described in the DISC regulations (Treas. Reg. § 1.993–3(g)(3)(i)). Petrochemicals are not considered to be primary products from petroleum. Single purpose agricultural and horticultural structures are the same structures which are eligible for the investment credit under Code section 48(a)(1)(D). The committee intends that no inference should be made as to the treatment under present law of these single purpose structures and petroleum products storage facilities.

The Department of the Treasury has advised the committee that after ACRS is enacted, the class life of telephone central office equipment will be reduced, pursuant to a study by the Office of Industrial Economics, from 20 years to 18 years, effective January 1, 1981. Therefore, such equipment will be classified as 5-year property.

10-year class.—Public utility property with an ADR midpoint life, as of January 1, 1981, of 18.5 to 25 years (other than public utility property used in research and experimentation) and railroad tank cars are placed in the 10-year class. Theme park structures also are included in the 10-year class and, except for eligibility for the investment, are subject to the same rules that apply to 10-year personal property.

15-year class.—Public utility property with an ADR midpoint life, as of January 1, 1981, of more than 25 years (other than public utility

property used in research and experimentation) is placed in the 15-year class. This class will include, for example, electric utility steam production plants, gas utility manufactured gas production plants, water utility property, and telephone distribution plants.

Method

Prescribed method.—The recovery deduction in each year of the recovery period will be determined by applying a statutory percentage to the unadjusted basis of the personal property. In determining the annual deduction, the applicable percentage to be applied to the unadjusted basis of the property will depend on the property's class and the number of years since the property was placed in service by the taxpayer ("recovery year"). No recovery deduction will be allowable in the year of an asset's disposition.

The bill delegates authority to the Secretary to promulgate regulations for determining the amount of a recovery deduction when, after property is placed in service, the basis must be redetermined as, for example, when there has been a reduction or an increase in the purchase price or a reduction in basis under Code section 1017.

For the years 1981–1984, the prescribed accelerated method will approximate the benefit of using the 150-percent declining balance method for the early years of the recovery period with a switch to the straight-line method for the remainder of the recovery period, including the use of a "half-year convention" for the year of acquisition. The recovery percentages for the prescribed accelerated method for 1981–1984 are set forth in the following table.

FOR PROPERTY PLACED IN SERVICE, 1981–84

[Recovery percentage]

	Class of investment			
	3-year	5-year	10-year	15-year public utility property
If the recovery year is:				
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6
Total	100	100	100	100

For 1985, the prescribed accelerated method will approximate the benefit of using the 175-percent declining balance method (and use of the half-year convention for the first year of the recovery period) with a switch to the sum of the years-digits (SYD) method. In 1986 and thereafter, the prescribed accelerated method will approximate the benefit of using the 200-percent declining balance method (and use of the half-year convention for the first year of the recovery period) with a switch to SYD.

The recovery percentages for property placed in service in 1985 and for property placed in service in 1986 and subsequent years are shown in the tables below:

FOR PROPERTY PLACED IN SERVICE IN 1985

[Recovery percentage]

	Class of investment			
	3-year	5-year	10-year	15-year public utility
If the recovery year is:				
1	29	18	9	6
2	47	33	19	12
3	24	25	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				4
13				3
14				2
15				1
Total	100	100	100	100

FOR PROPERTY PLACED IN SERVICE AFTER DECEMBER 31, 1985

[Recovery percentage]

	Class of investment			
	3-year	5-year	10-year	15-year public utility
If the recovery year is:				
1	33	20	10	7
2	45	32	18	12
3	22	24	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				3
13				3
14				2
15				1
Total	100	100	100	100

Optional method.—Taxpayers may use, in lieu of the prescribed accelerated method, a method based on the straight-line method over the regular recovery period for the class, the extended recovery period used in calculating earnings and profits for that class, or the extended recovery period used in calculating earnings and profits for the next higher class (45 years for the 15-year public utility class). Thus, a taxpayer can elect to use the straight-line method over 3 years, 5 years, or 12 years for 3-year property; 5 years, 12 years, or 25 years for 5-year property; 10 years, 25 years, or 35 years for 10-year property; and 15 years, 35 years, or 45 years for 15-year public utility property.

A taxpayer electing to use an optional recovery must elect the same recovery for all property of that class placed in service for the year the election is made. The election will apply to all property in that class and is irrevocable. However, a different election may be made for property in other classes and for property in that class (and other classes) placed in service in a different taxable year.

If the straight-line method is elected, a half-year of cost recovery is allowable for the year the property is placed in service and, if the property is held for the entire recovery period, a half-year of depreciation is allowable for the year following the end of its recovery period. For example, for 5-year property for which the straight-line method and a 5-year recovery period is used, a half-year of cost re-

covery is allowable in the first year, a full year of cost recovery is allowable in each of the next 4 years and a half-year in the 6th year. However, if property is disposed of prior to the end of the recovery period elected by the taxpayer, no cost recovery will be allowable to the taxpayer with respect to the property for the year of disposition.

Disposition of assets and recapture

Gain or loss generally will be recognized on each disposition of an asset, including ordinary or normal retirements, unless other provisions of the Code provide for nonrecognition. However, a special rule is provided to avoid calculation of gain on the disposition of assets from mass asset accounts. In such case, gain is recognized to the extent of the proceeds realized from the disposition of the asset and the unadjusted basis of the property is left in the account until fully recovered in future years.

As under present law, gain recognized on the disposition of assets will be ordinary income to the extent of prior recovery deductions taken ("sec. 1245 recapture"). This section 1245 recapture applies to theme park structures, single purpose agricultural and horticultural structures, and facilities used for the storage of petroleum and its primary products.

c. Real property

Recovery period

All real property (other than theme park structures, which are included in the 10-year class, and certain real property designated as section 1245 property) has a 15-year recovery period. The taxpayer has the option under ACRS to use an extended recovery period of either 35 or 45 years. A substantial improvement is treated as a separate building for this election. (See "Component depreciation eliminated" below). The recovery period for a building, in general, will begin on the first day of the month in which the property is placed in service.

Method

A schedule of accelerated recovery percentages is to be provided by the Secretary for use in computing the annual recovery allowances for real property in the 15-year class. Generally, the recovery percentages will take into account the number of months the property is in service during the year of acquisition and the year of disposition of the property.

Taxpayers may elect to use the straight-line method over the regular recovery period or either of the optional longer recovery periods. As with the schedules of accelerated recovery percentages, the straight-line recovery percentage for the first year will depend on the number of months the property is in service during the year of its acquisition and disposition. Unlike the election for personal property, the half-year convention will not apply to the election for 15-year real property, and the real property election may be made on a property-by-property basis.

Gain on disposition and recapture

If the cost of nonresidential property in the 15-year class is recovered under the prescribed accelerated method, all gain will be ordinary

income to the extent of all recovery allowances previously taken (sec. 1245). However, if the straight-line method is elected, all gain will be capital gain.

For all residential real property, gain will be ordinary income only to the extent the recovery allowed under the prescribed accelerated method exceeds the recovery that would have been allowable if the straight-line method over the 15-year period had been used (sec. 1250). Therefore, if the straight-line method is elected, all gain will be capital gain.

The bill retains the present law rule that phases out recapture at one percentage point per month for subsidized low-income housing after the property has been held 100 months.

Component depreciation eliminated

Composite depreciation is required for the entire structure other than those components the taxpayer properly elects to amortize, (e.g., low-income rehabilitation expenditures). Thus, the same recovery period and method, in general, must be used for each component, such as plumbing, wiring, etc. The recovery period for any component part begins on the first day of the month in which the component is placed in service or, if later, when the building is placed in service.

For purposes of making the election to use an optional recovery period or method, a substantial improvement of a building is treated as a separate building. For example, the taxpayer may use a 15-year period for a substantial improvement even if the rest of the building is depreciable over a 35-year or 45-year period. Also, the taxpayer may use an accelerated method even if the straight-line method were used for the rest of the building. Under the committee bill, an improvement is a substantial improvement if (a) over a 2-year period the amounts added to the capital account for the building are at least 25 percent of the adjusted basis of the building (disregarding adjustments for depreciation or amortization) as of the first day of that period and (b) the improvement is made at least 3 years after the building was placed in service.

A special rule allows a new recovery period and method election for the first component placed in service after 1980 on a building owned before 1981, whether or not it is a substantial improvement.

If the taxpayer were to use accelerated depreciation for a nonresidential building and straight-line depreciation for a substantial improvement to the building (or vice-versa), all gain on a subsequent disposition of the entire building would be first treated as ordinary income to the extent of all recovery allowances taken pursuant to use of the accelerated method (sec. 1245). The remainder of the gain would be capital gain. A similar rule generally applies for components added to a building placed in service before 1981 if accelerated depreciation is taken for the components. This rule that gain on disposition is first treated as ordinary income under the recapture rules will apply even if a portion of a taxpayer's unadjusted basis in the asset is recovered over an extended recovery period.

d. Tax preference for minimum tax and maximum tax

As under present law, accelerated recovery on leased personal property is treated as an item of tax preference subject to the min-

imum tax. The amount of the tax preference for leased personal property is the amount by which the recovery deduction allowed exceeds the amount that would have been allowable if the deduction had been calculated using the half-year convention, no salvage value and the straight-line method over an extended recovery period. The extended recovery period is 5 years for 3-year property, 8 years for 5-year property, 15 years for 10-year property, and 22 years for 15-year public utility property. As under present law, accelerated recovery on leased personal property is not an item of tax preference for corporations other than subchapter S corporations and personal holding companies.

For real property (excluding theme parks which are treated as section 1245 property for purposes of cost recovery under ACRS), the amount of the preference is the excess of the recovery deduction allowed over the deduction which would have been allowable if the deduction had been calculated using no salvage value and the straight-line method over the 15-year recovery period. This amount is a preference item for all taxpayers.

For 1981, minimum tax preferences will continue to reduce the amount of personal service income subject to the 50-percent maximum tax. However, this preference "poison" is eliminated by the committee's bill for taxable years beginning in 1982 when the maximum tax rate on all income will be 50 percent.

e. Earnings and profits

As under present law, the committee bill provides that U.S. corporations will compute earnings and profits using the straight-line recovery method. However, for those corporations that currently make large distributions in relation to earnings and profits, the computation of earnings and profits using the straight-line method over the generally shortened recovery periods under ACRS would greatly increase the incidence of tax-free distributions. The committee bill provides, therefore, that U.S. corporations will compute earnings and profits using straight-line recovery over recovery periods that are longer than the normal recovery periods used to compute recovery allowances for income tax purposes. The extended recovery periods that will be used to compute earnings and profits are as follows:

EXTENDED RECOVERY PERIOD

Type of property:	*Years*
3-year property	5
5-year property	12
10-year property	25
15-year property	35

Under the committee bill, the computation of earnings and profits by foreign corporations that currently are not subject to the special earnings and profits rules of Code section 312(k) are basically unchanged. Earnings and profits for such foreign corporations will be computed in accordance with the rules provided for computing the recovery allowance for foreign assets. See "Foreign assets."

f. Foreign assets

Under the committee bill, the cost of personal property used predominantly outside the United States will be recovered using a re-

covery period equal to the ADR guideline period (midpoint life) for the property as of January 1, 1981. For personal property for which there is no ADR midpoint life as of January 1, 1981, a 12-year recovery period will be used. The applicable recovery percentages will be determined under tables prescribed by the Secretary. These tables will be based on the 200-percent declining balance method for the early years of the recovery period and the straight-line method for the later years. A "half-year" convention will be used and there will be no salvage value limitation. The determination of useful lives using facts and circumstances will not be allowed.

For foreign real property, the recovery period will be 35 years. The applicable percentages for real property also will be determined under tables prescribed by the Secretary, which will be based on the 150-percent declining balance method for the early years of the recovery period and the straight-line method for the later years. There will be no salvage value limitation. Useful life determinations based on facts and circumstances will not be allowed.

To provide flexibility, the straight-line method can be used in lieu of the prescribed accelerated method. In the case of foreign personal property the taxpayer may elect to use the straight-line method over the ADR midpoint, the extended recovery period used to compute earnings and profits for property of the same class, or the earnings and profits period for property of the next higher class, but the period elected may not be shorter than the ADR midpoint. Thus, for a foreign asset that is 3-year property, the taxpayer may elect straight-line recovery over a recovery period of the midpoint life, or if longer, 5 years or 12 years. For all foreign personal property with the same ADR midpoint and same ACRS class, the taxpayer must make any election regarding recovery periods and recovery methods with respect to all such property placed in service in the same taxable year.

For real property, the taxpayer may elect to use the straight-line method over a recovery period of 35 or 45 years. This election may be made on a property-by-property basis.

If an optional straight-line recovery is elected for personal property, the "half-year" convention will apply in the same manner as for domestic property. For foreign real property, recovery in the years of acquisition and disposition will be based on the number of months the property is in service during the year.

Whether an asset is used predominantly outside the United States will be determined under regulations prescribed by the Secretary similar to the rules currently used to determine whether foreign assets are eligible for the investment credit (sec. 48(a)(2)), taking into account all the exceptions set forth in section 48(a)(2)(B).

g. Normalization requirement for public utility property

Under the committee bill, public utility property placed in service after December 31, 1980, is treated as recovery property only if all the tax benefits of ACRS are normalized in setting the rates charged by the utility to customers. If a normalization method of accounting for ACRS benefits is not used in setting rates, a depreciation allowance for the property will be determined under section 167(a), using the same

depreciation method and useful life used to compute the ratemaking depreciation allowance for the property. For this purpose, averaging conventions and salvage value limitations are considered part of the ratemaking depreciation method.

Under the committee bill, the normalization rule for the benefits of using ACRS shortened recovery periods differs from present law. Under present law, the maximum benefit that must be normalized is the benefit of using the 20-percent ADR variance rather than the ADR midpoint life. The further benefit of using the ADR midpoint life instead of a longer ratemaking useful life may be immediately flowed through to customers under present law. Under the committee bill, the total benefit of using the ACRS recovery period rather than the longer ratemaking useful life must be normalized, and none of this benefit may be immediately flowed through to customers.

The committee bill also requires that the statutory "half-year" convention and salvage value rules of ACRS be normalized. Therefore, if for purposes of determining the ratemaking allowance for depreciation, a salvage value limitation rule or a rule relating to first-year depreciation is used, those rules will be used in determining the amount of deferred taxes that result from using ACRS.

As under present law, the committee bill does not restrict the authority of regulatory bodies to treat the deferred taxes as zero-cost capital or as a reduction in rate base in setting rates. However, as under present law, the amount of capital treated as zero-cost capital and the amount of rate base reduction may not exceed the amount of deferred taxes that result from the taxpayer's use of the recovery periods and methods actually used to compute a recovery allowance.

The committee bill does not provide for any continuation of flow-through accounting for property placed in service after December 31, 1980. Thus, public utility property placed in service after December 31, 1980, that is the same type of property as property for which flow-through accounting is currently permitted is subject to the normalization requirement. This is in contrast to present law rules, which permit flowthrough accounting for public utility property placed in service after 1969 if the same type of property was subject to flowthrough accounting in 1969.

As a consequence of the mandatory normalization requirement for all property placed in service after 1980, flow-through treatment of the investment credit permitted under section 46(f)(3) will not be permitted for any property placed in service after 1980.

h. Retirement-replacement-betterment (RRB) property

Under the committee bill, Code section 167(r) permitting the use of the RRB method is repealed as of January 1, 1981. Property placed in service after 1980 that would have been RRB property under present law will be treated as 5-year property under ACRS.

During a 4-year transition period (1981–1984), a special transition rule is provided for such property that would have been expensed under RRB (replacements). Costs of property that would have been capitalized under RRB (additions and betterments) are treated the same as other 5-year property under ACRS. Thus, such costs are subject to the same rules that apply for other eligible property placed in service after 1980.

Replacement property (which would be expensed under RRB) is phased in to ACRS over 5 years. Replacement property placed in service in 1981 will be expensed. Replacement property placed in service in 1982 through 1984 will be recovered over 2, 3, and 4 years, respectively, using a statutory accelerated method based on the 200-percent declining balance method with a switch to the sum of the years-digits method. The recovery percentages for such property during the 4-year transition period are as follows:

	1981	*1982*	*1983*	*1984*
Ownership year:				
1	100	50	33	25
2		50	45	38
3			22	25
4				12

Replacement property placed in service in 1985 and later years is treated the same as other 5-year property under ACRS. (Therefore, replacement property placed in service in 1985 will be depreciated using a statutory method based on the 175-percent declining balance method with a switch to the sum of the years-digits method.)

The adjusted basis of RRB property that exists as of December 31, 1980 (the costs that were capitalized under the RRB method and have not been recovered through retirement) may be recovered over a 5-year period using the following schedule of deductions:

PERCENTAGE OF BASIS DEDUCTIBLE

Year:	*Percent*
1981	40
1982	24
1983	18
1984	12
1985	6

Alternatively, the taxpayer may elect to recover the unrecovered capital costs over a longer period up to 50 years, using a less accelerated schedule of deductions.

Under the committee bill, beginning in 1981, expenditures that are not capitalized (such as repairs) will not be allowed the investment credit permitted for such expenditures under present law. During the transition year 1981, expenditures that would be capitalized if incurred in a later year are considered to have been capitalized, even though they are expensed under the transition recovery rule for 1981.

i. Anti-churning rules

Overview

Special rules are provided to prevent the taxpayer from bringing its property used during 1980 (pre-1981 property) within the system by certain post-1980 transactions (i.e., "churning" transactions). Simi-

lar rules are provided to prevent the taxpayer from taking advantage of the increased recovery percentages available after 1984 for its property used before that time (pre-1985 property).

Pre-1981 property

ACRS will not apply to personal property in use during 1980, unless the property is transferred after 1980 in a transaction in which both the owner and user (if different) change. This rule may not be avoided by selling the churned property more than once after December 31, 1980, unless the user of the property also changes in the same transaction. The requirement that the user must change is designed to prevent lessors of equipment from swapping properties to obtain the benefits of ACRS. Also, ACRS does not apply to personal property leased back to a person that owned or used the property during 1980 or to a person related to that person.

ACRS will not apply to real property if (a) the taxpayer or a person related to the taxpayer owned the property during 1980, (b) the property is leased back to a person that owned the property at any time during 1980 or to a person related to that person, or (c) the property is acquired in certain like-kind exchanges, "rollovers" of low-income housing, involuntary conversions, or repossessions, for property the taxpayer or a related person owned during 1980. The rule in (c) applies only to the extent of the substituted basis of the property received. Thus, ACRS will apply to the extent the taxpayer pays "boot". The taxpayer may not avoid the rule in (c) by transferring the churned property in another like-kind exchange, rollover, etc. Unlike the personal property anti-churning rules, the user need not change for ACRS to apply to real property.

In determining whether the owner or the user of the property has changed under these rules, a person will be considered related to the prior owner or user if the person is related within the meaning of section 267(b) or 707(b)(1) (substituting 10-percent for the 50-percent ownership test), or section 52(a) or (b). A subsidiary is not considered a related person if at least 80 percent of its stock was acquired by the taxpayer by purchase after December 31, 1980, in a transaction described in section 334(b)(2).

For pre-1981 property acquired in a churning transaction (described above), present law governs depreciation of the asset.

For real or personal property used during 1980 and transferred in certain transfers to a corporation or partnership in which the basis is determined by reference to its basis to the transferor (transactions described in section 332, 351, 361, 371, 374, 721, or 731), ACRS will not apply. In that case the Secretary shall provide rules similar to those that apply under section 381(c)(6). Thus, the transferee, in general, must use the same recovery period and method used by the transferor (including use of any optional recovery period or method) the transferor used for the transferred property. This rule will continue to apply to successive transfers of such property to the extent the basis to the transferee includes an amount representing the basis of property used during 1980. Post-1980 additions to such basis, however, such as by the payment of boot, will not be subject to the anti-churning rules.

Finally, broad authority is granted to the Secretary to prescribe regulations to make ineligible for cost recovery under ACRS property

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transferred in a transaction the principal purpose of which is to make property eligible for more generous capital cost recovery.

Pre-1985 property.—Similar anti-churning rules are provided to prevent used property placed in service before 1985 or 1986 from taking advantage of the faster methods of depreciation made available under the committee bill after 1984. For this churned property, the transferee must use the same recovery period and method of depreciation as the transferor.

j. Expensing in lieu of cost recovery

Overview

The committee bill provides that a taxpayer (other than a trust or estate) may elect to treat the cost of qualifying property as an expense that is not chargeable to capital account. The costs for which the election is made will be allowed as a deduction for the taxable year in which the qualifying property is placed in service. The optional expensing provision applies to qualified property placed in service in taxable years beginning after 1981. For taxable years beginning in 1982 and 1983, the dollar limitation on the amount that can be expensed is $5,000 a year ($2,500 in the case of a married individual filing a separate return). For taxable years beginning in 1984 and 1985, the dollar limitation is $7,500 ($3,750 for a married individual filing a separate return). For taxable years beginning in 1986 and later years, the dollar limitation is $10,000 ($5,000 for a married individual filing a separate return).

In general, the property for which an election may be made is personal property eligible to be treated as recovery property, if the property is acquired by purchase for use in a trade or business and is eligible for the investment credit. The trade or business limitation means that the election is not available for property held merely for the producion of income (sec. 212). The requirement that the property be acquired by purchase is the same as the requirement in present section 179 for property eligible for additional first-year depreciation. Generally, this means that acquisitions do not qualify if (1) the property is acquired from a person whose relationship to the taxpayer would result in a disallowance of loss on a transaction between the taxpayers, (2) the property is acquired by one component member of a controlled group from another component member of the same group (using a 50-percent control test), or (3) the basis of the property in the hands of the person acquiring it is determined in whole or in part (a) by reference to the adjusted basis of the property in the hands of the person from whom it was acquired or (b) under the step-up basis rules for property acquired from a decedent.

Existing section 179 is repealed for property placed in service after December 31, 1980. Thus, neither additional first-year depreciation nor expensing is allowed for property placed in service in taxable years beginning in 1981.

Other limitations on eligibility

Under the bill, a controlled group of corporations is subject to limitations similar to those of present section 179. Thus, a controlled group of corporations (with a 50-percent control test) is treated as

one taxpayer and must apportion the annual dollar limitation among the members of the group as provided in regulations.

Similarly, the same type of dollar limitations will apply in the case of partnerships as currently apply under section 179(d)(8). Under the committee bill, as under section 179, both the partnership and each partner are subject to the annual dollar limitation.

Dollar limitations where property is traded in

Present section 179 provides that the cost of property eligible for additional first-year depreciation does not include the portion of the basis of such property that is determined by reference to the basis of property traded in. The same rule is provided in the new expensing provision.

Elections

The bill provides that an election to expense property under this section for any taxable year must specify the items of property to which the election applies and the portion of the cost of each of these items to be deducted currently. The election must be made on an original return (including a late filed original return). In order to provide a degree of certainty, the provisions require that an election to expense property and any specification of items or amounts contained in such an election may not be revoked except with the consent of the Treasury Department.

Treatment of expensed property on disposition

If any portion of the basis of property is expensed under the new provision, the amount expensed is treated as depreciation taken for purposes of the recapture rules of section 1245. Thus, gain recognized on disposition of the property is treated as ordinary income to the extent of amounts expensed and depreciation taken.

In the case of a disposition that is given installment sales treatment under section 453, the committee bill provides that any amounts expensed with respect to the property are immediately recaptured as ordinary income to the extent of the gain realized on the disposition. An amount equal to the amount immediately recaptured under this rule is treated as an addition to the adjusted basis of the property for purposes of determining the amount of basis recovered and gain recognized from each installment.

Relationship with investment tax credit

To the extent that the cost of property is expensed pursuant to this new provision, no investment tax credit is allowable with respect to such cost.

k. Leasing

The committee recognizes that some businesses may not be able to use completely the increased cost recovery allowances and the increased investment credits available for recovery property under ACRS. ACRS will provide the greatest benefit to the economy if ACRS deductions and investment tax credits are more easily distributed throughout the corporate sector. Under present law, three-party financing leases ("leverage" leases) are now widely used to transfer tax benefits to users of property who do not have sufficient tax liability to absorb those

benefits. The committee has decided to facilitate the transfer of ACRS benefits through these types of transactions. Under current administrative practice, however, lease characterization is subject to specific IRS guidelines. Moreover, court decisions have not prescribed clear guidelines as to the appropriate tax characterizations of financing leases. Since the committee has decided that lease characterization should be more available, the committee bill establishes an exception to current judicial and administrative guidelines dealing with leasing transactions.

Under present IRS guidelines, a transaction must meet the following requirements (among others) to qualify for an IRS ruling characterizing the transaction as a lease:

(1) the lessor, at all times, must have a minimum "at risk" investment in the asset of at least 20 percent of its cost;

(2) the lessor must be able to show that the transaction was entered into for profit, apart from the transaction's tax benefits (*i.e.*, without consideration of the tax deductions, allowances, credits, and other tax attributes arising from the transaction);

(3) the lessee must not have a contractual right to purchase the property at less than its fair market value nor may the lessor have a contractual right to cause any party to purchase the asset;

(4) the lessee may not have furnished any part of the purchase price of the asset nor have loaned or guaranteed any indebtedness created in connection with the acquisition of the property by the lessor; and

(5) the use of the property at the end of the lease term by a person other than the lessee must be commercially feasible to the lessor.[6]

The committee bill creates a safe harbor that guarantees that a transaction will be characterized as a lease for the purposes of allowing investment credits and capital cost recovery allowances to the nominal lessor. Lessors will be able to receive cost recovery allowances and investment tax credits with respect to qualified leased property, while it is expected that lessees will receive a very significant portion of the benefits of these tax advantages through reduced rental charges for the property (in the case of finance leases) or cash payments and/or reduced rental charges in the case of sale-leaseback transactions.

To come within the safe harbor, both the lessor and the lessee must affirmatively elect to treat the lessor as the owner of the property. The lessor must be a corporation other than a subchapter S corporation or a closely held corporation described in section 465(a)(1)(C) or a partnership of which all the partners are corporations other than the excepted corporations. At all times during the term of the lease and at the time that the property is first placed in service, the lessor must have a minimum "at risk" investment of not less than 10 percent of the adjusted basis of the property. Finally, the term of the lease (including all extensions thereof) cannot exceed a period equal to the ADR midpoint life of the property.

Only property that is new section 38 property may come within the safe harbor rules. The leased property must be leased within 3 months after its acquisition or, in the case of a sale-leaseback transaction, it

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[6] Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752; Rev. Proc. 76-30, 1976-2 C.B. 647.

must be purchased by the lessor within 3 months of the lessee's acquisition for a purchase price not to exceed the adjusted basis of the property in the hands of the lessee at the time of the lessor's purchase. For these purposes, the time that property is acquired will be the later of the time the property was acquired or the time the property was placed in service (so that, for example, if property takes a substantial period to construct and is not leased until after it has been completed and placed in service, the property would be required to be leased within 3 months after it was completed and placed in service).

If a transaction meets the above requirements, it will not be scrutinized to determine whether the transaction would be, absent this safe-harbor provision, a lease, a sale, a financing, or some other type of transaction. The transaction will be treated as a lease and the parties to the transaction will be treated as lessor and lessee as stipulated in their agreement. The following factors will therefore not be relevant to the characterization of a safe-harbor transaction as a lease: whether or not the lessor's deriving a profit or cash flow from the transaction depends upon the tax benefits of ownership; the fact that the lessee is the nominal owner of the property for state or local law purposes (*e.g.*, has title to the property) and retains the burdens, benefits, and incidents of ownership (such as payment of taxes and maintenance charges with respect to the property); whether or not a person other than the lessee may be able to use the property after the lease term; the fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time; and the fact that the lessee or a related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment).

A lessor may lease a percentage of the property in a safe-harbor transaction, thereby transferring a parallel percentage of the tax benefits associated with the leased portion of the property. All new section 38 property may be leased, regardless of whether or not it is considered separate property under local law. However, the modified leasing rules will not apply to property which is used by the lessee for personal purposes.

If the lessee-user acquires the property and subsequently disposes of it, the lessee-user will be subject to the recapture rules under sections 47 and 1245, as if the lessee had been the owner of the property for the entire term of the lease, except that any credit or depreciation recaptured by the lessor will not be again recaptured by the lessee.

l. Extension of carryover periods for certain operating losses

The committee bill, in general, extends to 10 years the carryover period for net operating losses, operating losses for regulated transportation companies and real estate investment trusts, and operating losses of certain insurance companies. The carryover period for operating losses that receive an 8-year carryover under present law due to the inability of a taxpayer to carry back the losses against any year the taxpayer was a real estate investment trust (REIT) is extended from 8 to 11 years. The carryover period for financial institutions remains at 5 years, and the carryover period for Cuban expropriation losses remains at 20 years.

2. Investment tax credit revisions

a. Petroleum product storage facilities made eligible

Under present law, the investment credit applies to storage facilities used in connection with production activities, such as refining, but not in connection with wholesale or distribution activities. The committee bill extends the investment credit to all facilities used for storage of petroleum or its primary products, even if used in connection with wholesale or distribution activities. Under regulations prescribed by the Secretary, petroleum or its primary products shall have a meaning similar to the meaning given primary products of oil or gas under Treas. Reg. § 1.993–3(a)(3)(i).

b. Useful life limitation replaced

Under the Committee bill, the investment credit initially allowable with respect to an asset is not based on the asset's actual useful life. Rather, the credit is based on the recovery period of the property used in determining the deduction for depreciation. For eligible 5-year and 10-year recovery property, the bill permits full regular, ESOP, and energy credits (e.g., a 10-percent regular credit). For 3-year recovery property, only 60 percent of the investment qualifies for these credits (e.g., a 6-percent regular credit).

c. Recapture

Regular credit

To permit removal of the $100,000 limitation on used property, the present law recapture rules for the regular credit, which are based on the holding period of the property, are replaced with a recapture rule based on the amount realized on the disposition of the property. This rule applies to (1) property first placed in service by any taxpayer after December 31, 1980 and (2) other property disposed of (or ceasing to be qualified property) after December 31, 1990. For property disposed of after December 31, 1980 that is not subject to the proceeds-based recapture rule, the present law recapture rules will apply. Thus, all property in use before 1981 will continue to be subject to the present law recapture rules until 1991.

Under the system, analogous to the depreciation recapture system, the taxpayer will determine the recapture amount by multiplying the amount realized on a sale, exchange, or involuntary conversion (or, for other dispositions or cessations, the fair market value of the property) times the regular credit percentage that would apply to that property if it were placed in service in the year of disposition. However, the recapture amount is limited to an amount equal to the credit allowed to the taxpayer for that property for all prior years. In determining the applicable regular credit percentage for this recapture rule, all property will be treated as recovery property. Thus, the regular percentage applicable for property that would be 5-year recovery property in the

year of disposition will be a full 10-percent. For property that would be 3-year recovery property, the applicable regular credit percentage will be 6-percent.

For example, assume a taxpayer acquired a $1,000 asset qualifying for a full 10-percent regular credit of $100. In a subsequent year, the taxpayer disposed of the asset for $500. If in the year of disposition, the property would be 5-year recovery property, the amount of recapture would be $50, which is 10-percent of the amount realized ($500). The taxpayer would retain a net credit of $50, equal to 10 percent of the taxpayer's net $500 ($1,000 less than $500) investment in the asset. In contrast, under present law the amount of the credit recapture would be more or less than $50, depending on how long the taxpayer held the asset; the amount received on the disposition of the asset would be immaterial.

Energy ESOP, and rehabilitation credits

Although the amount of the energy credit, rehabilitation credit, and ESOP credit initially allowable is determined under the same rules applicable to the regular credit, the proceeds-based recapture rule does not apply to those credits.

Unlike the proceeds-based recapture rule, the recapture amount for these credits will equal the amount of credit that would have been allowed to the taxpayer for that property for all prior years if the credit had been determined using the following percentage of the cost or basis of the property:

If the taxpayer held the property for:	*The percentage to be used is:*
Less than 3 years	100
3 years but less than 5 years	67
5 years but less than 7 years	33
7 or more years	0

For example, if energy property were held for less than 3 years all credit allowed would be subject to recapture. If the property were held 3 or 4 years, two-thirds of the credit would be recaptured, and so on.

A special rule applies for property that would be 3-year recovery property if it were recovery property in the year of disposition. Under this rule, the amount of recapture for property held 3 or 4 years would be one-half of the amount of recapture determined under the general rule above for energy, ESOP, and rehabilitation credits. If property were held 5 years or more, there would be no recapture.

In no case may the recapture amount exceed the credit allowed to the taxpayer for the property for all prior years.

Under a special rule for 3-year property held less than 5 years, the amount of recapture is one-half of the amount of recapture determined under the rule above for energy, ESOP, and rehabilitation credits. If 3-year property is held 5 years or more, there is no recapture.

Recapture tax and tax liability limitation

The bill repeals section 47(c) with respect to proceeds based recapture. Thus, under the bill, an increase in tax due to recapture of

any investment credits may be taken into account in determining the tax liability limitation on the amount of credits allowed for the year of disposition.

d. Used property limitation

The used property limitation, which limits the credit to $100,000 of used property, is repealed for property that is first placed in service by any taxpayer after December 31, 1980, and other property that is acquired after December 31, 1990.

e. At-risk limitation

Under the committee bill, the allowance of investment credits is subject to an "at-risk" limitation. The limitation applies to those business activities that are now subject to section 465, engaged in by individuals, subchapter S corporations, and certain closely held corporations. Thus, real estate activities and certain leasing activities engaged in by closely held corporations are not covered by the limitation.

The committee bill provides that an investment credit will not be allowed with respect to amounts invested in qualifying property to the extent the invested amounts are not "at risk." Generally, amounts are not considered at risk if (1) the taxpayer is protected against the loss of the invested amount, (2) the amount was borrowed and the taxpayer is not personally liable for repayment of the debt, (3) the lender has an interest other than as a creditor or (4) the lender is a related party to the borrower. These rules are the same as those used to determine whether amounts are at risk in an activity for purposes of the loss limitation rules of section 465.

Amounts at risk with respect to qualifying property are only those amounts considered at risk under section 465 that are directly attributable to investment in the property. Cash contributed to the operating expenses of a business is not considered at risk with respect to section 38 property used in the business. Similarly, a loan for the operation of a business, even if recourse, would not be considered at risk with respect to section 38 property.

The calculation of amounts at risk in the case of a partnership will be made by each partner to whom the at risk rules apply.

The committee bill provides an exception to the rules relating to amounts not at risk. Under the exception, amounts borrowed with respect to section 38 property no later than the taxable year the property is placed in service generally will be considered at risk if the amounts are owed to a bank, savings and loan association, credit union, or insurance company regulated under Federal, State, or local law, or are owed to a Federal, State, or local agency or instrumentality, or guaranteed by a Federal, State, or local agency. The exception does not apply where the Federal, State, or local government unit (or instrumentality) is merely acting as a conduit with respect to the loan.

The bank, savings and loan association, or insurance company, etc. cannot be a party related to the borrower. Under a special related party rule, any holder of greater than a 10 percent equity interest in the borrower will be a related party. In addition, the lender is considered related to the borrower if the lender is, for example, the seller or promoter of the taxpayer's interest in the property or is a person related to such seller or promoter. Furthermore, the debt advanced by the borrower cannot be convertible into equity.

In order for debt to qualify under this exception, the lending institution cannot transfer or have an agreement to transfer the debt, to a nonqualified lender during the 12-month period after the date on which the taxpayer borrowed the amount. A transfer of the debt to a nonqualified lender after such 12-month period will not decrease the taxpayer's amount at-risk with respect to the property. The debt may not be secured by property of a party other than the taxpayer.

Debt that falls within the exception will not be subject to the at risk rules and will generate basis for the investment credit as under the existing law. Thus, debt of a limited partnership (whether recourse or nonrecourse) to a qualifying institution will be allocated to the limited partners for these purposes, according to the rules applicable for allocating the investment credit to the limited partners (Treas. Reg. § 1.46–3(f)), even if the limited partners are not personally liable on the debt. Likewise, if a qualifying financial institution has a permissible 9 percent interest in the borrower that would otherwise be an interest other than as a creditor under section 465, the debt will still be taken into account in computing the credit.

A taxpayer's amount at risk with respect to property is increased only through increases in the actual investment in the property, such as by repayment of nonrecourse debt for the property. Repayment must be made with amounts for which the taxpayer is at risk within the meaning of section 465. Repayment of debt from a qualified lender, which is considered to be at risk, will not increase the taxpayer's amount at risk with respect to property. Unless operating profits of a business are used to repay debt with respect to section 38 property, such amounts would not increase at risk amounts for these purposes, even if there would be increases in amounts at risk under section 465. If the amount at risk with respect to property is increased, the credit for the property is redetermined as if the increased amount at risk had been taken into account when the property was first placed in service. Any increase in the credit attributable to the increased amount at risk is considered a credit earned in the taxable year the amount at risk was increased.

Amounts at risk with respect to property are reduced only if the taxpayer's investment in the property decreases. Cash distributions generally will not reduce a taxpayer's amount at risk with respect to property. Amounts at risk with respect to section 38 property will be reduced when recourse debt is converted into nonrecourse debt or when qualified debt is refinanced by the taxpayer and is replaced by debt for which the taxpayer is not at risk.

When an amount at risk with respect to property is reduced the credit for the property is redetermined as if only the reduced amount at risk had been taken into account when the property was first placed in service. Any credit previously earned in excess of the redetermined credit increases the taxpayer's tax liability for the taxable year the amount at risk is reduced. This rule applies to all taxable years following the taxable year the property is placed in service. The investment credit recapture rules will govern recapture upon the disposition (or cessation as qualifying property) of section 38 property.

The committee bill provides that the at-risk limitation on the investment credit will not apply to property placed in service before February 19, 1981, or property placed in service on or after such date

if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981. For purposes of this rule, the Secretary shall prescribe regulations under which property will be considered to have been acquired under a binding contract if it was acquired in a manner that would have qualified the property as pretermination property under section 49(b) (as in effect before its repeal by the Revenue Act of 1978).

3. Extension of carryover periods certain credits

The committee bill, in general, extends to 10 years the carryover period for the WIN, alcohol fuels, new employees, and investment credits.

Effective Dates

The depreciation provisions generally apply to property placed in service after 1980. The rules for extension of the carryover period for operating losses apply for operating losses in taxable years ending after December 31, 1975.

The investment credit provisions generally apply to property placed in service after 1980.

The proceeds-based recapture rule and repeal of section 47(c) applies to (1) property the original use of which begins with the taxpayer after December 31, 1980, or (2) other property disposed of after December 31, 1990. The used property limitation is repealed for (1) property the original use of which begins after December 31, 1980, or (2) other property the taxpayer acquires after December 31, 1990.

The effective dates for extension of the carryover periods for various credits is as follows:

(1) Investment credit and WIN credits—Unused credit years ending after December 31, 1973.

(2) New employee credit—Unused credit years ending after December 31, 1976.

(3) Alcohol fuels credit—Unused credit years ending after September 30, 1980.

Revenue Effects

It is estimated that all the cost recovery provisions of subtitle A together with the increased investment credit provisions would reduce budget receipts by $1,496 million in fiscal year 1981, $9,816 million in 1982, and $53,543 million in 1986.

The provision in the bill removing the limit on investment credit for used property and changing the investment credit recapture rules would reduce budget receipts by $11 million in fiscal year 1981, $88 million in fiscal year 1982, $208 million in 1983, $303 million in 1984, $358 million in 1985, and $353 in 1986.

B.—Tax Credit for Rehabilitation Expenditures

Present Law

Investment tax credit

Overview

Under present law, buildings and their structural components (other than elevators and escalators) generally do not qualify for the investment tax credit. Congress, in 1978, extended the investment credit to rehabilitation expenditures for older nonresidential buildings that are at least 20 years old. Residential buildings do not qualify for the investment credit.

A rehabilitation qualifies only if a major portion of the building is rehabilitated. Also, at least 20 years must elapse between qualifying rehabilitations. In addition, at least 75 percent of the existing external walls of the building must be retained as external walls after rehabilitation. The rehabilitation expenditures must be made for property with a useful life of 5 years or more. No credit is allowed for any expenditure attributable to enlargement of the building.

Rehabilitation expenditures qualifying for the investment credit are treated as new property. Therefore, the expenditures are not subject to the $100,000 used property credit limitation.

Historic structures

If the rehabilitated building is designated as a certified historic structure by the Secretary of the Interior, the rehabilitation must be approved by that Secretary before the investment credit is available. A certified historic structure is defined as a structure that is (1) listed in the National Register of Historic Places, (2) located in a district listed in the National Register and certified as significant to the district, or (3) located in a local or State historic district approved by the Secretary of the Interior and certified as significant to the district.

Depreciation

In addition to the investment credit, and in some cases in lieu of the credit, several special depreciation benefits are available to specified types of rehabilitated buildings. These special depreciation benefits and their relation to the investment credit are summarized by the following table:

CAPITAL COST RECOVERY FOR REHABILITATION EXPENDITURES UNDER PRESENT LAW

Type of property	Depreciation options	Limitations and relation to investment tax credit
Residential real property [1]		
(*a*) Certified historic structures	1. Elect to amortize costs of certified rehabilitation over a 60-month period (sec. 191).	
	2. Elect to use 200-percent declining balance depreciation for the cost basis attributable to both the rehabilitated and nonrehabilitated portions of the building (sec. 167(o)).	200-percent declining balance method unavailable if amortization under section 191 was ever elected by the taxpayer for the same structure.
(*b*) Low-income housing	Elect to amortize cost of rehabilitation expenditures over a 60-month period (sec. 167(k)).	Limited to $20,000 of cost per residential unit.
(*c*) Other depreciable residential property.	No special depreciation benefit.	

Nonresidential real property

(*a*) Certified historic structures----	1. Elect expenditures to amortize cost of rehabilitation over 60-month period (sec. 191).	No investment credit for amortized expenditures.
	2. Elect to use 150-percent declining balance depreciation for the cost basis attributable to both the rehabilitated and nonrehabilitated portions of the building (sec. 167(o)).	150-percent declining balance method unavailable if amortization under section 191 was ever elected by the taxpayer for the same structure. Investment credit (sec. 48(g)) may be claimed in addition to 150-percent declining balance method.
(*b*) Other nonresidential property--	No special depreciation benefit.	10-percent investment tax credit (sec. 48(g)).

[1] Under present law, the investment tax credit is generally unavailable for residential property. (sec. 48(a)(3)).

As a deterrent to demolition or substantial alteration of historic buildings, straight-line depreciation is required for any building constructed or reconstructed at a site that was occupied by a certified historic structure that was demolished or substantially altered (sec. 167(n)). Also, the costs of demolition must be capitalized as part of the cost of the land, and thus are not depreciable (sec. 280B).

Reasons for Change

The tax incentives for capital formation provided in other sections of this bill might have the unintended and undesirable effect of reducing the relative attractiveness of the existing incentives to rehabilitate and modernize older business structures. Investments in new structures and new locations, however, do not necessarily promote economic recovery if they are at the expense of older structures, neighborhoods, and regions. A new structure with new equipment may add little to capital formation or productivity if it simply replaces an existing plant in an older structure in which the new equipment could have been installed. Furthermore, the relocation of business can result in substantial hardship for individuals and communities. Since this hardship does not affect the profitability of the business, it may not have been fully taken into account in the decision to relocate, even though it is an economic detriment to the society as a whole.

The increased credit for rehabilitation expenditures is intended to help revitalize the economic prospects of older locations and prevent the decay and deterioration characteristics of distressed economic areas.

Explanation of Provision

Overview

Under the committee bill, the 10-percent regular investment credit (and the additional energy credit) and certain special depreciation provisions for qualified rehabilitated buildings will be replaced by a three-tier investment credit. The credit is 15 percent for structures at least 30 years old, 20 percent credit for structures at least 40 years old, and 25 percent for certified historic structures. No credit is allowed for rehabilitation of a building less than 30 years old. However, a special rule allows a credit under present law rules for buildings that are more than 20 but less than 30 years old, if the rehabiiltation began before January 1, 1982.

The 15- and 20-percent credits are limited, as under present law, to nonresidential buildings. However, the 25-percent credit for certified historic rehabiiltation is available for both nonresidential and residential buildings. These credits are available only if the taxpayer elects to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. In addition, there must be a substantial rehabilitation of the building to qualify for the credit.

As under existing law, certain expenditures will not qualify for the credit. The costs of acquiring a building or an interest in a building (such as a leasehold interest) or the costs of facilities related to an existing building such as a parking lot will not be considered as qualifying expenditures. In addition, the cost of constructing a new building, or of completing a new building after it has been placed in service,

will not qualify. Construction costs are considered to be for new construction rather than for the rehabilitation of a building if more than 25 percent of the existing external walls of the building are replaced. In addition, any expenditure attributable to an enlargement of a building will not qualify for a credit.

The investment credit recapture rules applicable to the energy and ESOP credits will apply to the rehabilitation credit (see Subtitle A. "2. Investment Credit Revisions").

Qualified rehabilitated building

Expenditures qualify only if they are capitalized and are made for real property with a 15-year recovery period for depreciation under the bill. Expenditures qualify only in connection with a substantial rehabilitation of the building. A building has been substantially rehabilitated if either of two conditions are met.

First, there has been a substantial rehabilitation if the rehabilitation expenditures during the 24-month period ending on the last day of the taxable year exceed the greater of (a) the adjusted basis of the property as of the first day of the 24-month period, or (b) $5,000. This rule will apply in a manner similar to that provided under present law section 167(o)(2) (relating to accelerated methods for substantially rehabilitated certified historic structures).

Second, a rehabilitation is substantial if it meets the requirements under the first alternative by substituting 60 months for 24 months. However, under regulations prescribed by the Secretary, this 60-month alternative will be available only if there is a written set of architectural plans and specifications for all phases of the rehabilitation and a reasonable expectation that all phases of the rehabilitation will be completed. It is intended that the latter rule apply in a manner prescribed by the Secretary in regulations.

Certified historic structure

Under present law, expenditures for a certified historic structure are not eligible for a credit unless the rehabilitation is a certified rehabilitation. Under the committee bill, this rule is extended to buildings located in a registered historic district unless the building is not a certified historic structure and the taxpayer obtains a certification from the Secretary of Interior that the building is not of historic significance to the district.

A certified historic structure is not subject to the rule in the committee bill requiring 30 years to elapse between the year the property was first placed in service and the year rehabilitation begins. However, as is the case for other qualified rehabilitated buildings, there must be a substantial rehabilitation of the building.

Repeal of other special benefits

The committee bill repeals the special 60-month amortization provisions for certified historic structures under section 191. In addition, the special rule permitting use of accelerated methods for substantially rehabilitated certified historic structures is repealed (sec. 167(o)).

Lessees

If a rehabilitation is undertaken by a lessee, the committee bill provides that the lessee is eligible for the investment credit for qualified

rehabilitation expenditures incurred by the lessee but only if, on the date of completion of the rehabilitation, the remaining term of the lease is at least 15 years. This is similar to the rule under current law relating to the availability to lessees of the 5-year amortization of certified rehabilitation expenditures incurred in connection with a certified historic structure. The Secretary of the Treasury will prescribe by regulations rules for applying the substantial rehabilitation requirement to lessees.

Demolition costs

The present law rule (sec. 167(n)) that requires the use of straight-line cost recovery over the uesful life of a building placed in service at the site of a demolished certified historic structure, is amended to require straight-line recovery over 15 years. The composite method of depreciation must be used. The rule in present law requiring demolition costs to be capitalized as part of the cost of the land is retained.

Effective Date

In general, the committee bill applies to expenditures incurred after December 31, 1981, in taxable years ending after that date. However, the bill does not apply to a building if physical work on rehabilitation began before January 1, 1982, and the rehabilitation would not otherwise qualify under the committee bill. For example, if the building is 20 years old, the building will not qualify under the committee bill. However, the present law rules governing rehabilitation expenditures will continue to apply to a rehabilitation that began before 1982 and that qualifies under present law. Thus, if rehabilitation of a 20-year-old building began in 1981, the taxpayer could use the 10-percent credit and accelerated depreciation or, in lieu of the credit and depreciation, 5-year amortization for expenditures incurred in 1982 or thereafter.

Revenue Effect

These changes will reduce revenues by $71 million in fiscal year 1982, $175 million in 1983, and $386 million in 1986.

C. Incentives for Research and Experimentation

1. Credit for research and experimental wage expenditures (sec. 221 of the bill and new Code sec. 44F)

Present Law

Overview

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new consumer product or to improve a production process, normally must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered on a disposition or abandonment of the asset, or through depreciation or amortization deductions over the useful life of the asset. However, Code section 174 permits a taxpayer to elect special accounting methods (described below) for certain research or experimental expenditures which are paid or incurred during the taxable year in connection with the taxpayer's trade or business.

Present law does not provide a tax credit specifically for research or experimental expenditures. However, a taxpayer's investment in machinery and equipment employed in research or experimental activities is eligible for the investment tax credit to the same extent as investments in machinery and equipment employed for business purposes, such as manufacturing, or for current production of income (secs. 38, 46–48).

Section 174 deduction elections

General rule

Under present law, a taxpayer may elect to deduct currently the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business, even if such expenses are treated as capital account charges or deferred expenses on the taxpayer's books or financial statements (Code sec. 174(a); Rev. Rul. 58–78, 1958–1 C.B. 148). For example, a taxpayer may elect to expense the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months (sec. 174(b)).

If expenditures relating to development of a product are not eligible for these elections, or if the taxpayer chooses not to elect either current deduction or amortization for qualifying research costs, such expenditures must be capitalized.[1]

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[1] If the capitalized expenses relate to depreciable property, deductions may be taken in the form of depreciation allowances spread over the property's useful life. If the capitalized expenses relate to nondepreciable property, those costs cannot be recovered until disposition or abandonment of the property.

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Amounts for depreciation

The cost of land and the full cost of depreciable or depletable property are expressly excluded from section 174 elections (sec. 174(c)); that is, the full cost of a research building or of equipment used for research cannot be deducted in one year. Also, the statute excludes from eligibility for section 174 elections expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas (sec. 174(d)).[2]

However, the amounts which can be expensed or amortized under section 174 include amounts for depreciation or depletion with respect to depreciable or depletable property used for research activities (sec. 174(c); Treas. Reg. § 1.174–2(b)). Accordingly, if section 174 expensing is elected, depreciation deductions for research buildings and equipment can be taken to the same extent as for property used for business (e.g., manufacturing) purposes or employed in current income production.

Eligible payments

A taxpayer may elect section 174 expensing or amortization for the costs of research conducted directly by the taxpayer and, in general, for expenses paid or incurred for research conducted on behalf of the taxpayer by another person, such as a research institute, foundation, engineering company, or similar contractor (Treas. Reg. § 1.174–2(a)(2)). However, amounts paid by the taxpayer which are expended by a research entity for land or depreciable property to be used in research carried on for the taxpayer do not qualify for section 174 elections if the taxpayer acquires ownership rights in such property.

Definition of qualifying expenditures

The Code does not specifically define "research or experimental expenditures" eligible for the deduction elections (except to exclude certain costs, as described above). Treasury regulations (§ 1.174–2(a)) define the statutory term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned," and also the costs of obtaining a patent on such property.

The regulations provide that qualifying research and experimental expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, section 174 elections cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, and similar projects.

Reasons for Change

The committee believes that a substantial tax credit for incremental research and experimental wage expenditures will overcome the re-

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[2] However, expenses of developing new methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74–67, 1974–1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under Code sec. 616.

sistance of many businesses to bear the significant costs of staffing which must be incurred in initiating or expanding research programs. While such costs bear characteristics of investment activity, the relationships between the investment and the subsequent earnings often are less directly identifiable, and many businesses are reluctant to allocate scarce investment funds for uncertain rewards.

Research and experimentation are basic activities that must precede (1) the development and application of new techniques and equipment to production and (2) the development and manufacture of new products. The committee believes that its multifaceted approach in the bill, designed to stimulate a higher rate of capital formation and to increase productivity, appropriately includes incentives for greater private activity in research.

In recent years, spending for these purposes has not been adequate. Federal and self-financed expenditures for research and development activities performed by business over the 12-year period 1968–1979 remained at a fairly stable level in real terms, fluctuating between $19 and $22.8 billion in constant dollars. Relative to real gross national product, such expenditures declined from 2.01 percent in 1968 to 1.58 percent in 1975, essentially remaining at that level since then.

Aggregate research and development spending in this country has experienced a similar period of decline. In 1967, total expenditures reached a high of 2.91 percent of GNP before declining over ten years to 2.26 percent in 1977, and then increasing to an estimated 2.30 percent in 1980. If military and space research expenditures are subtracted from the total, the "civilian" research/GNP ratio for the United States is 1.5 percent, compared with 1.9 percent for Japan and 2.3 percent for West Germany. The committee believes that the decline in this country's research and development activities has adversely affected economic growth, productivity gains, and our competitiveness in world markets.

Explanation of Provision

Overview

Under the provision, a nonrefundable income tax credit is allowed for research and experimental[3] wage expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer, but only to the extent such expenditures exceed the average amount of the taxpayer's research wage expenditures in the specified base period. The rate of the credit (new Code sec. 44F) is 25 percent of the incremental research wage expenditure amount.

The credit is available for incremental research wage expenditures for the taxable year whether or not the taxpayer has elected under section 174 to expense or amortize research expenditures.

Trade or business requirement

Under the provision, the credit is to be available only with regard to research expenditures paid or incurred in carrying on a trade or business (within the meaning of Code sec. 162) of the taxpayer. The

[3] Hereinafter, this report uses the word "research" in place of the statutory terms "research and experimental" or "research and experimentation," as the case may be.

credit, therefore, is not available for research expenditures paid or incurred by a taxpayer merely in connection with, but not in carrying on, a trade or business. Similarly, the credit is not available with respect to expenditures paid or incurred by a taxpayer as part of a hobby or a financing arrangement.

The rule that only research expenditures paid or incurred by the taxpayer in carrying on a trade or business can qualify for the credit is a more stringent requirement than that which has been deemed applicable for purposes of section 174 (relating to research expenditures which are paid or incurred "in connection with" the taxpayer's trade or business).

For example, under the trade or business test of new section 44F, the credit generally is not available with regard to a taxpayer's expenditures for "outside" or contract research intended to be transferred by the taxpayer to another in return for license or royalty payments. (Receipt of royalties does not constitute a trade or business under present law, even though expenses attributable to those royalties are deductible from gross income (sec. 62(5)) in arriving at adjusted gross income.) In such a case, the nexus between the research and the transferee's activities generally would be insufficient to support a finding that the taxpayer had incurred the research expenditures in carrying on a trade or business. (Under appropriate circumstances, nevertheless, the nexus might be deemed adequate for purposes of the section 174 deduction elections.) If, however, the taxpayer used the product of the research in the taxpayer's trade or business, as well as licensing use of the product by others, the relationship between the expenditures and the taxpayer's trade or business activities generally would be sufficient for credit purposes.

In addition, under the trade or business test of new section 44F, the credit is not available for research wage expenditures paid or incurred prior to commencing a trade or business.

Definition of qualifying wages

General rule

The provision defines qualifying wage expenditures as (1) wages paid or incurred by the taxpayer for services performed in conducting research, and (2) reimbursement by the taxpayer to another person (such as a research firm or a university) for wages paid or incurred for services performed in conducting research on behalf of the taxpayer.

Under the provision, the term "wages" has the same meaning as provided in section 3401(a) for purposes of employee wage withholding. Thus, amounts of compensation which are not subject to withholding, such as certain fringe benefits, do not enter into the credit computation even though paid for services in performing research. In the case of self-employed individuals and owner-employees, the term "wages" for purposes of the new credit includes earned income of such individuals as defined in section 401(c). These rules apply equally to research wages paid or incurred by the taxpayer to its employees and to wages reimbursed by the taxpayer for research performed by another person on behalf of the taxpayer.

Reimbursement of research wages

If a taxpayer contracts with a research firm, university, or other person for research to be performed on the taxpayer's behalf, the taxpayer on whose behalf the research is conducted may claim the credit to the same extent as if the taxpayer had paid to its own employees the wages which are paid by the research firm, etc. and reimbursed by the taxpayer. In the case of such contract research, only the taxpayer which makes the wage reimbursements and on whose behalf the research is conducted can claim the credit as to those wages; the research firm, university, or other person which conducts the research on behalf of the taxpayer cannot.

The determination of whether and to what extent payments from a taxpayer to another person enter into the credit computation as reimbursement of wages for services performed in conducting research on behalf of the taxpayer depends on all the facts and circumstances of the particular research arrangement. If, therefore, the taxpayer enters into a research contract with a university under which substantial benefits of the research, if any, are to accrue to the taxpayer, such research generally will be considered to be performed on behalf of the taxpayer. For example, where a corporation contracts with a university medical school for basic research to be conducted by the medical school in genetic engineering and retains in the contract exclusive rights to make use of discoveries achieved through the research, such research is to be considered as conducted on behalf of the corporation, whether or not the corporation has the right under the contract to direct or control the research and whether or not the taxpayer, in entering into the contract, expects that a particular business item or other research product will result.

If a taxpayer makes qualifying reimbursements of research wage expenditures, the amounts paid by the taxpayer as such wage reimbursements enter into the credit computation in the taxable year of the taxpayer during which the research firm, etc. pays or incurs the wages being reimbursed, provided that the taxpayer has actually made the reimbursement payments in that taxable year or a prior taxable year. Thus, if any amounts paid by a taxpayer during a particular taxable year to the research entity as wage reimbursements are attributable to research to be conducted after the close of that taxable year, such reimbursements are treated as paid or incurred in the taxable year or years of the taxpayer during which the research services for which wages are reimbursed actually are performed. Reimbursements which are treated as wages paid by the taxpayer during a particular taxable year pursuant to these rules, and hence which count as expenditures for such year entering into the credit computation for such taxable year, also are treated as having been made during that same taxable year for purposes of determining average yearly base period expenditures in later year credit computations.

Amount of wages eligible for credit

As a general rule, wages enter into the credit computation only to the extent paid for that portion of the services performed by an individual for or on behalf of the taxpayer which is performed in con-

ducting research (as described below). For example, if an individual spends part of his or her time during the year conducting research, part of the time engaged in production or marketing activities, and part of the time providing general or administrative services, only the amount of wages actually paid for services performed in conducting research enters into the credit computation. The allocation of wages between conducting research and other services is to be made in a consistent manner, in accordance with Treasury regulations, on the basis of time or other appropriate factors.

If substantially all (for this purpose, at least 80 percent) of the services performed by an individual for or on behalf of the taxpayer during a taxable year are performed in conducting research, then all services of that individual for or on behalf of the taxpayer during the year are treated as performed in conducting research. Thus, if 80 percent of the services performed by an employee for the taxpayer during a taxable year are performed in conducting research, all wages paid by the taxpayer during the taxable year to that individual enter into the credit computation, even though the remaining amount of the individual's services for the taxpayer was not performed in conducting research.

Definition of qualifying services

General requirements

A taxpayer's wage expenditures (for its employees or as wage reimbursements) enter into the credit computation only to the extent that they constitute wages paid or incurred for services performed in conducting research. That is, the wages must be paid for engaging in the actual conduct of research (as in the case of a laboratory scientist engaging in experimentation), must be paid for engaging in the immediate supervision of persons actually conducting research (as in the case of a research scientist who supervises other laboratory scientists, but who may not actually conduct experiments), or must be paid for engaging in the direct support of persons who actually conduct research or who immediately supervise the conduct of research. The "support" category of qualifying services would include, for example, the services of a laboratory assistant in entering research data into a computer as part of the conduct of research, of a secretary in typing reports describing the laboratory research results, of a laboratory worker in cleaning research equipment, of a machinist in machining a part for an experimental model, or of a drilling crew in preparing a test well for purposes of testing a new and innovative method for extracting ores or minerals.[4]

Ineligible wage expenditures

Since only wages paid for services performed in conducting research enter into the credit computation, no amount of wages paid for overhead or for general and administrative services qualifies for the new credit. Thus, no amount of overhead or general and administrative wage expenditures is eligible for the new credit, even if such expenditures relate to the taxpayer's research activities, and even if such ex-

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[4] See Rev. Rul. 74-67, *supra*, note 2.

penditures may qualify for section 174 deduction elections or may be treated as research expenditures for accounting and financial purposes. By way of illustration, expenditures not eligible for the credit include such items as wages paid to payroll personnel for preparing salary checks of laboratory scientists, wages paid for accounting services and wages paid to officers and employees of the taxpayer who are not engaged in the conduct of research although engaged in activities (such as general supervision of the business or raising capital for expansion) which in some manner may be viewed as benefiting research activities.

Definition of qualifying research

General rule

Subject to certain exclusions, the provision adopts the definition of research as used in Code section 174. That is, the term "research and experimental" for purposes of new section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174.[5]

As described above, the term "research or experimental expenditures" as used in Code section 174 means "research and development costs in the experimental or laboratory sense" (Treas. Reg. § 1.174-2 (a)). This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned," and the costs of obtaining a patent on such property.

The credit is not available for expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions, or for the costs of acquiring another person's patent, model, production, or process. Other expenditures which are ineligible for the section 174 deduction elections also are not eligible for the new credit. These ineligible expenditures include expenditures for the acquisition or improvement of land or of certain depreciable or depletable property used in research (sec. 174(c)) and expenditures for the purpose of ascertaining the existence, location, extent, or quality of mineral deposits, including oil and gas (sec. 174(d)).

It is anticipated that the Treasury and the Internal Revenue Service, pursuant to authority to issue interpretive regulations and rulings (Code sec. 7805), will provide additional guidance, not inconsistent with existing regulations, defining qualifying research for purposes of new section 44F and section 174.

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[5] While the definition of research generally is the same for purposes both of the section 174 deduction elections and the new credit, research expenditures which qualify for the section 174 deduction elections may be ineligible for the credit. For example, research wage expenditures may be eligible under section 174 if paid or incurred in connection with the taxpayer's trade or business, but enter into the credit computation only if paid or incurred in carrying on a trade or business of the taxpayer (see discussion above). Also, wage expenditures for research conducted outside the United States may qualify for section 174 deduction elections but do not qualify for the credit.

Exclusions

The provision excludes from the definition of qualifying research, for purposes of the new credit, the following: (1) research conducted outside the United States, (2) research in the social sciences or humanities (including the arts), and (3) research to the extent funded from any grant, contract, or subcontract for research with any agency or instrumentality of Federal, State, or local government.[6]

Computation of allowable credit

General rule

The credit applies to the excess of the taxpayer's research wage expenditures for the taxable year over the average of the taxpayer's yearly research wage expenditures during the base period.

For the taxpayer's first taxable year to which the new credit applies (and which begins in 1980 or 1981), the credit will apply to the amount of research wage expenditures for that year which exceeds the amount of such expenditures in the preceding taxable year. For the taxpayer's second taxable year to which the new credit applies (and which begins in 1981 or 1982), the credit will apply to the amount of research wage expenditures for that year which exceeds the average of such expenditures in the preceding two taxable years. For a subsequent taxable year, the credit will apply to the amount of research wage expenditures for that year which exceeds the average of such expenditures in the preceding three taxable years.

Special base period computation

Because the provision is effective for wages paid or incurred after June 30, 1981, a special rule is provided for computing base period expenditures with respect to the first taxable year of a taxpayer to which the new credit applies if such year ends in 1981 or 1982. In that case, the taxpayer's base period expenditures equal total research wage expenditures for the preceding taxable year multiplied by a fraction, the numerator of which is the number of months between June 30, 1981 and the end of the taxpayer's first taxable year ending after that date, and the denominator of which is the number of months in such entire year.

For example, assume a calendar-year taxpayer has research wage expenditures as follows: $100,000 for 1980, $60,000 for the period January 1, 1981 through June 30, 1981, and $70,000 for the period July 1, 1981 through December 31, 1981. The base period amount would equal $100,000 times 6/12ths, or $50,000; thus, the credit for 1981 would apply to the difference between $70,000 and $50,000. If the taxpayer's

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[6] In the case of government contracts, a research expenditure is considered to be funded from the grant, contract, or subcontract to the extent that the cost is required by, or allocable to, a particular contract or is incurred pursuant to a negotiated advance agreement for the payment of such costs (see, e.g., 32 C.F.R. ¶ 15-205.35(a) (1980), relating to the establishment of a cost ceiling for availability of "independent research and development" costs under the Defense Acquisition Regulations). However, a government contractor's independent research generally would not be considered to be funded from a grant, contract, or subcontract. Nevertheless, the costs of such company-sponsored research generally would be treated as being funded from a government contract to the extent that those costs are reimbursed by a grant, contract, or subcontract in accordance with applicable government contracting accounting rules.

research wage expenditures for 1982 are $150,000, the credit would apply to the difference between (1) that amount and (2) the average of 1980 expenditures ($100,000) and 1981 expenditures ($130,000).

New businesses

If the taxpayer, or a related person whose research expenditures are aggregated with those of the taxpayer (pursuant to the rules discussed below), was not in existence during a base period year, then the taxpayer, or the related person, is treated as having research wage expenditures of zero in such year, for purposes of computing average annual research wage expenditures during the base period.

Short taxable years

If the taxpayer has a short taxable year, research wage expenditures for that year are to be annualized to the extent provided in Treasury regulations.

Pass-through of credit

The provision also provides that under Treasury regulations, rules similar to those used with respect to the targeted jobs credit (Code secs. 52(d) and 52(e)) will apply for purposes of apportioning the credit earned by a subchapter S corporation, or by a trust or estate, to the shareholders or beneficiaries. In the case of partnerships, the credit is to be allocated among the partners as provided in Treasury regulations.

Rules for aggregation of expenditures

General rule

To ensure that the new credit will be allowed only for actual increases in research wage expenditures, the provision includes rules under which research wage expenditures of the taxpayer are aggregated with research wage expenditures of other persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research wage expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Under the provision, all research wage expenditures of all corporations that are members of a "controlled group of corporations" are treated as if made by one taxpayer. For this purpose, the same controlled group test (50-percent control) is used as applies under rules for computing the targeted jobs tax credit (Code sec. 52(a)). Any research credit earned by a controlled group, computed pursuant to this aggregation rule, is to be apportioned among members of the group on the basis of their proportionate share of the increase in aggregate research wage expenditures giving rise to the credit.

The provision also requires aggregation, pursuant to Treasury regulations, of all research wage expenditures of partnerships, proprietorships, and any other trades or businesses (whether or not incorporated) which are under common control with the taxpayer. Any allowable research credit, computed pursuant to this aggregation rule, is to be apportioned, as provided in Treasury regulations, among the persons whose expenditures are aggregated on the basis of their proportionate share of the increase in aggregate research wage expenditures giving rise to the credit. This aggregation and apportionment rule is to be based on principles similar to the principles applicable in the case of a controlled group of corporations.

Example

The following example illustrates the method of apportioning the credit among persons whose research wage expenditures are aggregated pursuant to the rules discussed above.

Assume that a controlled group of four corporations has research wage expenditures during the base period and taxable year as follows:

[In thousands of dollars]

Corporation	Base period (average)	Taxable year	Change
A	$60	$40	($20)
B	10	15	5
C	30	70	40
D	15	25	10

Treating the research wage expenditures of the four corporations as if made by one taxpayer, the total amount of incremental expenditures eligible for the credit is $35,000 ($55,000 increase attributable to B, C, and D, less $20,000 decrease attributable to A). The total amount of credit allowable to members of the group is 25 percent of the incremental amount, or $8,750.

No amount of credit is apportioned to A, since A's research wage expenditures did not increase in the taxable year. The full $8,750 credit would be allocated to B, C, and D, i.e., to those members of the group with increases in their expenditures. This allocation would be made on the basis of the ratio of each such corporation's increase in its research wage expenditures to the sum of increases in such expenditures (counting only members with increases). Inasmuch as the total increase made by those members of the group whose research wage expenditures went up (B, C, and D) was $55,000, B's share of the $8,750 credit is 5/55; C's share is 40/55; and D's share is 10/55.

If, in the example set forth above, A had zero expenditures in the taxable year, the controlled group as a whole would show a decrease rather than an increase in aggregate expenditures. In that case, no amount of credit would be allowable to any member of the group even though B, C, and D actually increased their research wage expenditures in comparison with their own base period expenditures.

Rules for changes in business ownership

General rule

The provision includes special rules for computing the credit where a business changes hands. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research wage expenditures to the appropriate taxpayer. If the provision did not include rules for changes in ownership of a business, a taxpayer who begins business by buying and operating an existing company might be entitled to a credit even if the amount of research wage expenditures were not increased. Also, the sale of a unit

of a business could cause the seller to lose any credit even though research wage expenditures increased in the part of the business that was retained.

Acquisitions

Under the provision, if a taxpayer acquires (after June 30, 1979) any portion of a trade or business, the credit for any year ending after the acquisition is to be computed as if such portion of the business had not changed hands. That is, the acquiring taxpayer's research wage expenditures for periods before the acquisition are to be increased by the amount of research wage expenditures attributable to the portion of the business acquired by the taxpayer.

Dispositions

The provision also includes rules for computing the amount of incremental expenditures if a taxpayer disposes (after June 30, 1979) of any portion of a trade or business in a transaction to which the above acquisition rules apply. In determining the credit allowable to the taxpayer for a taxable year ending after the disposition, the taxpayer's research wage expenditures for periods before the disposition generally are to be decreased by the amount of the taxpayer's research wage expenditures attributable to the portion of the business which has changed hands. (This rule permits a taxpayer which operates two businesses to sell one and nevertheless earn a credit for increased research wage expenditures in the retained business.) This relief is not provided unless the taxpayer furnishes the acquiring person with information needed to compute the credit under the acquisition rules described in the preceding paragraph.

However, the base period expenditures of a taxpayer which so disposes of a portion of a trade or business will be increased if, during any of the three taxable years following the year of disposition, the taxpayer (or a person whose research wage expenditures must be aggregated under the provision with those of the taxpayer) reimburses the acquiring person (or a person whose research expenditures must be aggregated under the provision with those of the acquiring entity) for research on behalf of the taxpayer. In such a case, the amount of research wage expenditures of the taxpayer for the base period for such taxable year shall be increased by the lesser of (1) the amount of decrease (under the rules described in the preceding paragraph) which is allocable to such base period, or (2) the product of the number of years in the base period multiplied by the amount of such reimbursement.

Limitation and carryover

The amount of credit which can be used in a particular taxable year is limited to the taxpayer's income tax liability reduced by certain other nonrefundable credits.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in a subchapter S corporation, the amount of credit which can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in such trade or business or entity) equal to

the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest. Accordingly, if in a particular year an individual taxpayer derives no taxable income from a specific partnership, subchapter S corporation, unincorporated business, or trust or estate, the taxpayer would not be able to utilize in that year any tax credit for incremental research wage expenditures of such entity or business.

If the amount of allowable credit exceeds the applicable limitation, the excess credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward seven years, beginning with the earliest year.[7]

Effective Date

The provision applies to wages paid or incurred after June 30, 1981, in taxable years ending after that date.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $40 million in fiscal year 1981, $329 million in fiscal year 1982, $602 million in fiscal year 1983, and $724 million in fiscal year 1986.

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[7] In conformity with these credit carryover rules, sec. 221(b) of the bill makes technical amendments to Code sec. 55(c)(4), relating to carryover and carryback of certain credits in connection with the alternative minimum tax; sec. 381(c), relating to carryover items of the distributor or transferor corporation in certain corporate acquisitions; sec. 383. relating to special limitations on carryovers of certain credits, etc.; the table of Code sections relating to carryovers; sec. 6511(d)(4)(C), defining credit carrybacks in connection with refund claims; and sec. 6411, relating to quick refunds in respect to tentative carryback adjustments.

Also, sec. 221(c) of the bill makes technical and clerical amendments to Code sec. 6096(b), defining income tax liability for purposes of rules on payments to the Presidential Election Campaign Fund, and to the table of sections relating to allowable income tax credits.

2. Charitable contributions of certain property used for research or experimentation purposes (sec. 222 of the bill and Code sec. 170(e))

Present Law

Overview

Under present law, a corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations, including contributions to colleges and universities for research purposes (Code sec. 170). This charitable deduction is limited to five percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. If the amount contributed exceeds the five-percent limitation, the excess may be carried forward and deducted over five succeeding years, subject to the five-percent limitation in those years.

General reduction rule

In general, the amount of 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 (sec. 170(e)).[1] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally can deduct only the basis in the property, rather than its full fair market value.

Exception

In 1976, an exception to this general reduction rule was enacted for contributions by corporations of certain types of ordinary income property (e.g., medical equipment) donated for the care of the needy, the ill, or infants (sec. 170(e)(3)(A)). In the case of such a qualifying charitable contribution of inventory, the exception generally allows a deduction equal to the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation. However, in no event is a deduction allowed for an amount in excess of twice the basis of the property.

This exception was enacted because the Congress concluded that it was desirable to provide a greater tax incentive than in prior law for contributions of certain types of ordinary income property for the specified category of exempt purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

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[1] In the case of donation of capital-gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

Reasons for Change

The committee believes that an additional incentive is desirable to encourage manufacturers to contribute "state-of-the-art" scientific equipment to colleges and universities for use in research activities.

Academic research and development expenditures have increased in constant dollars by three percent each year since 1974, reversing a spending decline over the prior six years. However, studies indicate that in equipment-intensive research areas such as physics, chemistry, and electrical engineering, the continuing growth of university expenditures has not kept pace with the rising costs of scientific instrumentation.

The general deduction limitation rule, enacted in the Tax Reform Act of 1969, has been effective to prevent situations which led to its enactment, in which individual taxpayers in high marginal tax brackets or corporations could donate to charity substantially appreciated ordinary income property and be better off, after tax, than they would have been had they sold the property and retained all the after-tax proceeds. At the same time, the 1969 rule has resulted in reduced contributions of certain types of property to charitable institutions.

The committee believes that it is desirable to provide a greater tax incentive than in present law for contributions of certain types of new inventory property, manufactured by the donor corporation no more than two years before contribution, which the donee university or college uses in carrying on research activities, including research training. The committee also believes that the deduction so allowed should not be such that the donor corporation could be in a better after-tax situation by donating the property than by selling it.

Explanation of Provision

Overview

The provision provides an additional exception to the rules of present law which generally require an otherwise allowable deduction for charitable contributions of appreciated property to be reduced by the amount which would not be long-term capital gain if the property contributed had been sold at its fair market value at the time of the contribution.

The provision allows a corporation (other than a subchapter S corporation) a larger deduction than under present law for charitable contributions of new tangible personal property which is of an inventory nature (within the meaning of Code sec. 1221(1)), if contributed to an institution of higher education (as defined in secs. 170(b)(1)(A)(ii) and 3304(f)), and if used by the college or university for research purposes.

Requirements for favorable treatment

To qualify, a corporate contribution of ordinary-income property to a college or university must satisfy the following requirements:

(1) The property contributed must have been constructed by the taxpayer; [2]

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[2] The bill provides that, under Treasury regulations, property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property.

(2) The contribution must be made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the donee;

(4) Substantially all the use of the property by the donee is for research or experimentation (within the meaning of Code sec. 174), including research training purposes; [8]

(5) The property is not transferred by the donee in exchange for money, other property, or services; and

(6) The taxpayer receives the donee's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction is generally for the sum of (1) the taxpayer's basis in the property and (2) one-half of the unrealized appreciation. However, in no event is a deduction to be allowed for an amount which exceeds twice the basis of the property.

Effective Date

The provision applies to charitable contributions made after the date of enactment of the bill, in taxable years ending after that date.

Revenue Effect

It is estimated that the provision will reduce budget receipts by less than $5 million annually.

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[8] For purposes of the fourth requirement listed above, the term "substantially all" means at least 80 percent. Donated inventory-type property will qualify under this use requirement if substantially all the use by the donee is for the conduct of research, if substantially all the use by the donee is for training to conduct research, or if substantially all the use by the donee is for a combination of such research and research training. For example, a charitable contribution of an electron microscope or a computer by the manufacturer will satisfy the use requirement if substantially all the use by the donee college or university consists of training undergraduate or graduate students (either in a laboratory or in a classroom) in how to use the microscope or computer in research, consists of research experiments conducted by such students, e.g., laboratory experiments as part of an undergraduate science course, or consists of a combination of such research and research training.

D. Small Business Provisions

1. Increase in minimum accumulated earnings credit (sec. 231 of the bill and sec. 535 of the Code)

Present Law

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax of 27½ percent to 38½ percent on improperly accumulated corporate earnings where the accumulation occurs in an attempt to avoid the income tax with respect to the corporation's shareholders. In computing the base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. Present law provides a minimum credit of $150,000 of earnings which may be accumulated before any accumulated earnings are subject to this tax.

Since 1975, the minimum credit has been $150,000. During the period from 1958 to 1975, the minimum credit was $100,000, and prior to 1958 the minimum credit was $60,000.

Reasons for Change

Since 1975, when the accumulated earnings credit was increased from $100,000 to its present level of $150,000, there have been substantial increases in costs which require additional capital to make an investment of the same type and scope. Increased borrowing costs cause small businesses to rely more heavily upon internal generation of capital for possible future needs. Quite often, small businesses do not have the specific plans for expansion which are required, under the law, to justify accumulations of corporate earnings in excess of the minimum credit. An increase in the credit not only adjusts for the rise in costs, but also provides a wider margin for the retention of earnings for future contingencies, and, thus, reduces borrowing pressures on small businesses. As a result, the committee believes it generally is appropriate to increase the amount of the credit. However, the committee also believes that it is not appropriate to increase the minimum credit for certain types of service corporations. In the case of these corporations, the existing minimum credit and credit equal to the earnings retained for the reasonable needs of the business are adequate to allow the corporation to accumulate capital for possible future needs.

Explanation of Provision

The committee bill increases the minimum accumulated earnings credit to $250,000. However, this increase does not apply to specified service corporations whose principal business consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million in fiscal year 1982, $33 million in 1983, and $46 million in 1986.

2. Subchapter S corporations (secs. 232 and 233 of the bill and sec. 1371 of the Code)

Present Law

Subchapter S was enacted in 1958 to minimize the effect of Federal income taxes on the form in which a business is conducted by permitting incorporation and operation of certain small businesses without the incident of income taxation at both the corporate and shareholder levels. A corporation engaged in an active trade or business may elect to be treated for income tax purposes under the provisions of subchapter S. Where an eligible corporation elects under the subchapter S provisions, the income or loss (except for certain capital gains) is not taxed to the corporation, but each shareholder reports a share of the corporation's income or loss each year in proportion to his share of the corporation's total stock. Once made, the election continues in effect for the taxable year and subsequent years until it is revoked or terminated.

Under present law, to be eligible for a subchapter S election, the corporation must have 15 or fewer shareholders. In addition, trusts other than grantor trusts, voting trusts, and certain testamentary trusts (for a 60-day period) may not be shareholders in a subchapter S corporation.

Reasons for Change

The committee believes that increasing the permitted number of shareholders to 25 and allowing additional trusts as shareholders will facilitate the use of the subchapter S provisions by more businesses.

Explanation of Provision

Under the committee bill, the maximum number of shareholders permitted for a corporation to qualify for, and maintain, subchapter S status is increased from 15 to 25.

Also, a trust all of which is treated as owned by a person other than the grantor under section 678 will be eligible to hold stock in a subchapter S corporation. The person treated as the owner (and not the trust) will be treated as the shareholder for purposes of determining whether the corporation meets the subchapter S eligibility requirements. The trust will continue to be eligible for 60 days after such person's death.

In addition, under the bill, if the individual beneficiary of a "qualified subchapter S trust" elects to be treated as the owner (under section 678) of stock in any subchapter S corporation held by the trust, then the trust will be an eligible shareholder of such corporation.

The election must be made by the beneficiary (or his legal representative) separately with respect to each subchapter S corporation whose stock is held by the trust. An election may be made retroactive for a period of up to 60 days.

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A qualified subchapter S trust is a trust (1) holding stock of a subchapter S corporation; (2) which has as its sole income beneficiary an individual resident or citizen of the United States; (3) under the terms of which, all of its income is required to be distributed currently and the corpus of which may not be distributed during the term of the trust to any person other than the income beneficiary; and (4) under the terms of which, the trust terminates not later than the death of the beneficiary. If the trust terminates before the beneficiary's death, the trust assets must be distributed to the income beneficiary.

Where the first income beneficiary is the spouse of the grantor, the trust may provide that a lineal descendant of the grantor may be a successor income beneficiary. In this case, the trust termination rules must apply with respect to the successor income beneficiary.

The election to be treated a "qualified subchapter S trust" is in addition to the election by the shareholders of the corporation to have the corporation treated as an electing small business corporation. When the trust is a shareholder at the time of making the subchapter S election, the income beneficiary must consent.

Effective Date

The provision applies to taxable years beginning after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

E. Windfall Profit Tax Provisions

1. Credit against windfall profit tax for royalty owners (sec. 241 of the bill and sec. 6429 of the Code)

Present Law

Under the Crude Oil Windfall Profit Tax Act of 1980, an excise tax is imposed on the production of domestic crude oil. Differing tax rates and base prices apply to oil, generally depending upon its classification in one of three tiers; lower rates apply on up to 1,000 barrels a day of tier one and tier two oil produced by independent producers. Royalty owners, and persons holding similar non-operating mineral interests, are not independent producers eligible for lower rates.

Present law also provides qualified royalty owners with a credit (or refund) of up to $1,000 against the windfall profit tax imposed on the removal of their royalty oil during calendar year 1980. The credit is available only to individuals, estates, and qualified family farm corporations. It may be claimed in 1981, in accordance with Treasury regulations, either on the royalty owner's income tax return or in a separate refund claim.

Reasons for Change

The committee believes imposition of the windfall profit tax on small amounts of royalty oil income may impose a hardship on many low and middle income taxpayers who are not the recipients of the large oil company profits which led, in part, to the windfall profit tax. The committee believes a permanent $2,500 credit is needed to assure that small royalty owners are not adversely affected by the tax. In addition, the committee believes the Treasury Department should implement procedures pursuant to which most royalty owners eligible for the credit do not have to pay the tax and wait to claim a refund after the close of the year.

Explanation of Provision

The committee bill makes the royalty owners credit permanent. It also increases the maximum credit from $1,000 to $2,500, for royalty oil production removed from the premises after 1980.

The committee bill provides that royalty owners need not wait until year-end to receive the benefits of the credit. Rules also are provided to prevent a proliferation of royalty interests eligible for the credit.

The committee bill provides for early utilization of the credit by most royalty owners through two sets of related changes in the administrative rules of present law. First, the definition of estimated income tax, the penalties for failure to pay estimated income tax, and the rules relating to wage withholding allowances are amended to permit a royalty owner's credit to be taken into account to the extent provided in the regulations. Second, the Secretary is directed to provide quali-

fied royalty owners with a procedure for claiming an exemption from windfall profit tax withholding. Generally, a royalty owner who (1) had no windfall profit tax liability (or reasonably expects no tax liability) for the prior year in excess of the amount of the credit allowed under the new provision and (2) reasonably expects that no tax will be owed in excess of the current year's credit will be able to claim exemption from windfall profit tax withholding.[1] However, the Secretary may limit the availability of withholding exemption certificates when necessary for the effective administration of the windfall profit tax. The committee gives the Secretary broad discretion in determining how to permit royalty owners to claim the credit's benefits in a timely fashion. For example, the Secretary may prohibit certification for the withholding exemption by persons able to make adjustments in estimated income tax payments or vice versa. Regulations must be issued before December 15, 1981, and will take effect in 1982.

To assure that information adequate for royalty owners to determine whether their oil is properly exempt from withholding is available, the committee bill directs the Secretary to issue regulations that require first purchasers to supply royalty owners with information regarding the amount of the windfall profit tax imposed.

To prevent a proliferation of royalty interests eligible for the credit, the committee bill retains the allocation and related party rules applicable to the $1,000 credit. In addition, the credit will not apply to production from an interest in proven property transferred after June 9, 1981, in a transfer described in the rules relating to eligibility for percentage depletion (sec. 613A(c)(9)(A)). This transfer rule applies to all tiers of oil, and without regard to the methods of its production. However, the transfer rule does not apply to transfers between persons required to share a single $2,500 credit if production from the property interest transferred was qualified royalty production for the transferor. There also is an exception to the transfer rule for transfers that would not result in loss of percentage depletion because of the exceptions contained in the depletion rules for transfers at death or among related persons (sec. 613A(c)(9)(B)). Similarly, the credit is not available for production from an overriding royalty, net profits interest, production payment, or similar interest created out of an interest in a proven property after June 9, 1981. This rule will prevent the creation of new royalty interests out of existing working interests in proven properties. An exception is provided for interests created under binding contracts entered into before June 10, 1981. The rule does not affect the ability of a landowner to retain a royalty on the lease of a proven property.

The committee bill modifies the definition of a qualified family farm corporation to provide that the family ownership and asset usage tests of present law must be satisfied at all times during the calendar year in question. The committee bill eliminates the requirements that a qualified family farm corporation must have been in existence on, and must have satisfied the asset usage test on, June 25, 1980.

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[1] The reasonable expectation standard for this purpose is similar to the present law rules for exemption from income tax withholding (sec. 3402(n)).

Effective Date

The royalty owner credit will apply to oil produced in calendar years beginning after December 31, 1980. The changes to the withholding estimated tax provisions are effective after December 31, 1981. Regulations implementing the windfall profit tax withholding estimated tax changes must be issued by December 15, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $824 million in fiscal year 1982, $660 million in fiscal year 1983, $576 million in fiscal year 1984, $586 million in fiscal year 1985, and $593 million in fiscal year 1986.

2. Reduction of windfall profit tax on newly discovered oil (sec. 242 of the bill and sec. 4987 of the Code)

Present Law

Under the Crude Oil Windfall Profit Tax Act of 1980, each barrel of newly discovered oil is subject to a tax equal to 30 percent of the windfall profit, i.e., the difference between the oil's actual selling price and the sum of its adjusted base price and the severance tax adjustment. The base price for newly discovered oil essentially is $16.55 a barrel, adjusted for grade, quality, and location. It also is adjusted quarterly for post-June 1979 increases in the GNP implicit price deflator plus 2 percent.

Reasons for Change

The committee believes that reducing the windfall profit tax on newly discovered oil will increase significantly the incentive for exploration for, and development of, new oil prospects. This added incentive is expected to result in a significant increase in new oil production which, in turn, will reduce U.S. dependence on foreign oil.

Explanation of Provision

The committee bill provides for a gradual reduction of the windfall profit tax rate applicable to newly discovered oil. For oil removed from the premises in 1983 and 1984 the rate will be reduced from 30 percent to 25 percent. In 1985, the rate will be 20 percent, and in 1986 and later years the rate will be 15 percent.

The definition of newly discovered oil is the same as that in present law.

Effective Date

The provision applies to taxable periods beginning after December 31, 1982. As a result, the first rate reduction would be for oil removed from the premises after December 31, 1982.

Revenue Effect

It is estimated that the provision will reduce budget receipts by $217 million in fiscal year 1983, $382 million in fiscal year 1984, $809 million in fiscal year 1985, and $1,534 million in fiscal year 1986.

F. Other Provisions

1. Incentive stock options (sec. 251 of the bill and sec. 422A of the Code)

Present Law

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by section 83. The value of the option constitutes ordinary income to the employee when granted only if the option itself has a readily ascertainable fair market value at that time. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time. Instead, when the option is exercised, the difference between the value of the stock at exercise and the option price constitutes ordinary income to the employee. Ordinary income on grant or on exercise of a stock option is treated as personal service income and, hence, generally is taxed at a maximum rate of 50 percent.

An employer who grants a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

Background of Tax Treatment of Stock Options

Restricted stock options

The Revenue Act of 1950 enacted provisions for "restricted stock options," under which neither grant nor exercise of the option gave rise to income to the employee. Instead, income generally was recognized when the employee sold stock received through exercise of the option. No deduction was allowed to the employer matching the amount of income recognized by the employee (the gain on sale of the stock).

If the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time the stock was sold was treated as capital gain. If the option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the market value of stock at the time of the option grant and the option price was treated as ordinary income when the stock was sold, and any additional gain at the time the stock was sold was treated as capital gain.

For a stock option to be classified as "restricted," the option price had to have been at least 85 percent of the market price of the stock at the time the option was granted; the stock or the option had to have been held by the employee for at least two years after the date of the granting of the option, and the stock held for at least six months after it was transferred to the employee; the option could not have been transferable other than at death; the individual could not have held

ten percent or more of the stock of the corporation (unless the option price was at least 110 percent of the fair market value); and the option could not have been for a period of more than ten years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock option provisions and enacted provisions for "qualified stock options." These qualified stock options generally were taxed similarly to restricted stock options.

Qualified options had to be granted with an option price of at least the stock's market price when the option was granted (subject to a 150-percent inclusion in income if a good faith attempt to meet this requirement failed). In addition, qualified stock options were subject to the requirements that the stock had to be held three years or more; the option could not be held more than five years; stockholder approval had to be obtained; the options had to be exercised in the order granted; and no option could be granted to shareholders owning more than five percent of the stock (increased up to ten percent for corporations with less than $2 million equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 enacted a minimum tax, under which a tax was imposed equal to ten percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added by the 1969 Act. Income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976 (except for certain transitional options which ceased to be qualified after May 20, 1981). The 1976 Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax, and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978—Treatment of capital gains

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, taxes on capital gains were reduced, so that the maximum rate of tax on capital gains is 28 percent.

Reasons for Change

The committee believes that reinstitution of a stock option provision will provide an important incentive device for corporations to attract new management and retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business. Encouraging the management of business to have a proprietary interest in its successful operation will provide an important incentive to expand and improve the profit position of the companies

involved. The committee bill is designed to encourage the use of stock options for key employees without reinstituting the alleged abuses which arose with the restricted stock option provisions of prior law.

Explanation of Provision

In general

The bill provides for "incentive stock options," which will be taxed in a manner similar to the tax treatment previously applied to restricted and qualified stock options. That is, there will be no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee will be taxed at capital gains rates when the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an incentive stock option.

The term "incentive stock option" means an option granted to an individual, for any reason connected with his or her employment, by the employer corporation or by a parent or subsidiary corporation of the employer corporation, to purchase stock of any of such corporations.

Requirements (holding period, etc.)

To receive incentive stock option treatment, the bill provides that the employee must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, the tax will be imposed on sale of the stock, but gain will be treated as ordinary income rather than capital gain, and the employer will be allowed a deduction at that time.[1]

In addition, for the entire time from the date of granting the option until three months before the date of exercise, the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirements are waived in the case of the death of the employee.[2]

Terms of option

For an option to qualify as an "incentive stock option," terms of the option itself must meet the following conditions:

1. The option must be granted under a plan specifying the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.

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[1] In the case of a sale which does not meet the holding period requirements, the amount of ordinary income, and the amount of the employer's deduction, will be limited to the difference between the amount realized on the sale and the option price.

[2] For purposes of the holding period requirements, the bill also provides that certain transfers by an insolvent individual of stock received pursuant to exercise of an incentive stock option are not to be treated as dispositions of such stock. The transfers covered by this rule are transfers to a trustee, receiver, or similar fiduciary, or other transfers for the benefit of the individual's creditors, in a bankruptcy case or similar insolvency proceeding.

2. The option must be granted within ten years of the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

3. The option must by its terms be exercisable only within 20 years of the date it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

5. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

6. The employee must not, immediately before the option is granted, own stock representing more than ten percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary.[3] However, the stock ownership limitation will be waived if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

7. The option by its terms is not to be exercisable while there is outstanding any incentive stock option which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding for the period which under its initial terms it could have been exercised. Thus, the cancellation of an earlier option will not enable a subsequent option to be exercised any sooner. Also, for this purpose an option is considered to retain its original date of grant even if the terms of the option or the plan are later amended to qualify the option as an incentive stock option.

Other rules

The bill provides that stock acquired on exercise of the option may be paid for with stock of the corporation granting the option.

The difference between the option price and the fair market value of the stock at the exercise of the option will not be an item of tax preference.

Also, under the bill, any option which was a qualified stock option or restricted stock option under prior law will become an incentive stock option, if it was not exercised before January 1, 1981, and if it otherwise satisfies requirements for incentive stock options. Such an option will not be subject to the minimum tax.

An option will not be disqualified because of the inclusion of any condition not inconsistent with the qualification requirements,[4] nor because the corporation may make a cash payment to the employee at the time of exercise.

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[3] For this purpose, the individual is considered to own stock owned directly or indirectly by brothers and sisters, spouse, ancestors, and lineal descendants, and stock owned directly or indirectly by a corporation, partnership, estate, or trust is considered as being owned proportionately by shareholders, partners, or beneficiaries.

[4] For example, the transfer of shares of stock for local law purposes will not disqualify a plan where the arrangement constitutes the grant of an option for Federal tax purposes. Treas. Reg. §§ 1.83–3(a) and 1.421–7(a) contain rules relating to the definition of "option" and rules setting forth when a "transfer" of property as compensation for services occurs.

Effective Date

The bill generally applies to options exercised or granted after December 31, 1980, or outstanding on such date. However, in the case of an option which was granted on or before December 31, 1980, and which was not a qualified option, the corporation granting the option may elect (within six months after enactment of the bill) to have the option not be treated as an incentive stock option.

In the case of an option granted before 1982, the modification or deletion of any stock appreciation right or right to receive cash payments to permit the option to qualify as an incentive stock option can be made within one year of the enactment of the bill without the modification being treated as the grant of a new option.

In addition, the terms of a stock option plan or an option issued before 1982 can be modified to conform to the incentive stock option rules within one year of the date of enactment of the bill, without the modification being considered as giving rise to a new option requiring a new option price.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually in fiscal years 1981 through 1984. It is further estimated that this provision will increase budget receipts by $11 million in fiscal year 1985 and by $21 million in 1986.

2. Deduction for diminution in value of motor carrier operating authorities (sec. 252 of the bill)

Present Law

Background

Enacted in 1935, Part II of the Interstate Commerce Act (the "1935 Act") provided the basic framework for regulation of the motor carrier industry until enactment of the Motor Carrier Act of 1980. Under the 1935 Act, carriers were obligated to provide nondiscriminatory service at regulated rates for the public convenience and necessity, and further industry regulation was effected by issuing or withholding certificates of operating authority.

During the period 1935 to 1980, the Interstate Commerce Commission ("ICC") granted a limited number of permits and certificates of operating authority to motor carriers and freight forwarders. The basis for the grant of an authority from the ICC was a showing that additional services of the type for which authority was sought was, or would be, required by the public convenience and necessity. Businesses with existing operating rights could intervene in a proceeding for a request of operating authority to show that the proposed service was not, or would not be, required by the public convenience and necessity.

The right of existing operators to intervene (based on ICC procedural rules) and the applicant's burden of showing that the proposed service was required by the public convenience and necessity (based on the 1935 Act) gave existing operators protection against competition. Persons wishing either to enter the motor carrier business or expand an existing business, therefore, often would purchase an existing business with its operating authority.

Substantial amounts were paid for these operating authorities, reflecting, in part, the protection against competition afforded authority owners under ICC administration of the 1935 Act. The value of the operating authorities provided owners with an asset that constituted a substantial part of a carrier's asset structure and a source of loan collateral.

In 1975, the ICC began to grant a higher percentage of requests for operating authorities under the standard of "required by the public convenience and necessity." On July 1, 1980, the Motor Carrier Act of 1980 was enacted (P.L. 96-296). Under the 1980 Act, applicants need not show that the proposed service is required by the public convenience and necessity. Existing operators protesting the grant of an authority bear the burden of showing the proposed service is inconsistent with the public convenience and necessity. Thus, the 1980 statute further lessened restrictions on entry into the interstate motor carrier business. However, an operating authority still must be obtained to conduct interstate motor carrier business. As a result of the increased ease of gaining entry into the interstate motor carrier business, the value of motor carrier operating authorities has been diminished substantially.

The ICC, following an opinion of the Financial Accounting Standards Board, has required that the value assigned to certificates of authority in the regulated books of motor carriers be written off in one year.

Deduction for realized loss of property

Code section 165 allows a deduction for certain losses, including any loss incurred in a trade or business which is sustained during the taxable year and not compensated for by insurance or otherwise. In general, the amount of the deduction equals the adjusted basis of the property involved (sec. 165(b)).

Treasury regulations provide that, to be allowable as a deduction, the loss must be realized, i.e., "evidenced by closed and completed transactions, fixed by identifiable events" (Treas. Reg. § 1.165–1(b)). As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition of the property [1] nor for loss of anticipated income or profits.[2] Thus, for a loss to be allowed under present law, generally either the business must be discontinued or the property must be abandoned or permanently discarded from use in the business (Treas. Reg. § 1.165–2). Generally, if a capital asset declines in value and is sold or exchanged at a loss, the loss is a capital loss, the deduction of which is subject to the limitations of sections 1211 and 1212 (sec. 165(f)).

The courts, in several decisions,[3] have denied a loss deduction when the value of an operating permit or license decreased as a result of legislation expanding the number of licenses or permits that could be issued. These decisions held that the diminution in the value of a license or permit did not constitute an event giving rise to a loss deduction under section 165 if the license or permit continued to have value as a right to carry on a business.

In the *Consolidated Freight Lines* case,[4] the Ninth Circuit denied deductions for lost "monopoly rights" when the State of Washington deregulated the intrastate motor carrier industry by eliminating restrictions on entry. The court reasoned that the taxpayer had not lost any rights conferred by the certificate of operating authority because the taxpayer still was permitted to do business and the operating authority had not given any further rights. Any "monopoly rights," the court stated, resulted from legislation and State administration restricting the availability of operating authorities. Since the taxpayer could not own (or purchase) property rights in legislation or regulations, repeal or modification of legislation or regulations did not give rise to a deductible loss, even if such action had the result of making the taxpayer's business property less valuable.

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[1] See, e.g., *Reporter Publishing Co., Inc.* v. *Comm'r*, 201 F. 2d 743 (10th Cir.), cert. denied, 345 U.S. 993 (1953) (no deduction allowed to newspaper for decline in value of its membership in Associated Press after exclusivity feature held to violate antitrust laws) and, *Monroe W. Beatty*, 46 T.C. 835 (1966) (no deduction allowed for diminution in the value of liquor license resulting from amendment of State law limiting grant of such licenses).

[2] See, e.g., *Alsop* v. *Comm'r*, 290 F. 2d 726 (2d Cir., 1961) and *Marks* v. *Comm'r*, 390 F. 2d 598 (9th Cir.), cert. denied, 393 U.S. 883 (1968) (no loss deduction for difference between actual earnings and what taxpayer's earnings would have been absent revocation of her teaching credentials).

[3] *Consolidated Freight Lines, Inc.* v. *Comm'r*, 37 B.T.A. 576 (1938), aff'd, 101 F. 2d 813 (9th Cir.), cert. denied, 308 U.S. 562 (1939) and *Monroe W. Beatty*, *supra* note 1.

[4] Note 3, *supra*.

Reasons for Change

The deregulation of the interstate motor carrier industry has significantly reduced the value of motor carrier operating rights acquired before deregulation. In many cases, these rights represented a substantial part of a taxpayer's equity in his business and often were collateralized to raise capital. The legislative history of the Motor Carrier Act of 1980 recognized that deregulation might require future consideration of relief for the diminution of the value of these rights.[5]

The committee concluded that the unique circumstances of the deregulation of the interstate motor carrier industry requires some form of relief that is not available under the present tax laws.

Therefore, the committee bill provides that an ordinary deduction is allowed (over a 5-year period) equal to the adjusted bases of operating rights held by the taxpayer on July 1, 1980.

Explanation of Provision

The committee bill provides that an ordinary deduction will be allowed ratably over a 60-month period for taxpayers who held one or more motor carrier operating authorities on July 1, 1980. The amount of the deduction is the total adjusted bases of all motor carrier operating authorities either held by the taxpayer on July 1, 1980, or acquired after that date under a binding contract in effect on July 1, 1980. The 60-month period begins July 1, 1980 (or at the taxpayer's election, with the first month of the taxpayer's first taxable year beginning after July 1, 1980).

Under the committee bill, adjustments are to be made to the bases of operating authorities held on July 1, 1980 (or acquired thereafter under a binding contract in effect on July 1, 1980) to reflect amounts allowable as deductions.

Under regulations to be prescribed by the Secretary, a taxpayer may elect to allocate to the basis of an operating authority a portion of his cost basis in the stock of a corporation that held the operating authority when such stock was acquired, but only if such stock was acquired before July 2, 1980, or was acquired after July 1, 1980, under a binding contract in effect on July 1, 1980. The portion of the cost basis in the stock to be allocated to the operating authority is the amount that would have been properly allocable under section 334(b) (2) if the taxpayer had liquidated the corporation under a plan of liquidation described in section 334(b) (2) (A).

Similar rules shall be prescribed for situations in which the operating rights were transferred to the parent in a transaction in which the parent's basis is determined with reference to the basis of the rights to the subsidiary, but only if the subsidiary could have been liquidated under section 334(b) (2). In all cases, the regulations shall provide for an appropriate adjustment to the basis of other assets.

Effective Date

This provision is effective for taxable years ending after June 30, 1980.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $21 million in fiscal year 1981, $121 million in 1982, $71 million in 1983, and $18 million in 1986.

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[5]See H.R. Rept. No. 96–1069, 96th Cong., 2d Sess. 4, 11 (1980).

TITLE III.—SAVINGS TAX INCENTIVE PROVISIONS

A. Partial Exclusion of Dividend and Interest Income

(Sec. 302 of the bill and secs. 116, 265, 584, 643, 702, and 854 of the Code)

Present Law

Under Section 61, dividend and interest income received by individuals, in general, is subject to Federal income taxation. An exception to this rule applies to most interest received on State and local government obligations. In addition, a partial exclusion of dividend and interest income is available under section 116.

Prior to the enactment of the Crude Oil Windfall Profit Tax Act of 1980, section 116 provided an exclusion from gross income for the first $100 of dividends received by an individual from domestic corporations. In the case of a husband and wife, each spouse was entitled to a separate exclusion of up to $100 for dividends received with respect to stock owned by that spouse. In the Crude Oil Windfall Profit Tax Act of 1980, Congress expanded section 116 to provide that up to $200 ($400 on a joint return) of dividend and interest income from domestic sources may be excluded from gross income. Any combination of eligible dividends and interest may be included within the limits. To encourage further analysis of appropriate incentives for individual savings and of the tax treatment of dividend and interest income, Congress allowed the increase in the exclusion and the expansion of coverage to include interest income only in 1981 and 1982. After 1982, section 116 will revert to the prior law provision (i.e., a $100 exclusion of dividends only).

Reasons for Change

The committee believes that the present partial exclusion of $200 ($400 for joint returns) of dividend and interest income has been inefficient in encouraging individual savings. The committee notes, in particular, that the present exclusion provides no added incentive for individuals to save an amount sufficient to earn interest in excess of the limitation.

Although the committee considered a variety of proposals to provide incentives for savings and investment in addition to the across-the-board tax reductions, no single, long-term solution recommended itself as clearly superior. Therefore, the committee decided to repeal the present partial exclusion for interest income and to provide for a temporary, one-year program of depository institution tax-exempt savings certificates (see section III. B., *below*) and for increases in, and liberalizations of, the retirement savings provisions (see section III. C., *below*).

Explanation of Provision

The committee bill repeals the present $200 ($400 on a joint return) interest and dividend exclusion for taxable years beginning after December 31, 1981. Thus, the $200/$400 exclusion will be available only for taxable years beginning in 1981. For subsequent years, the $100 dividend exclusion of prior law will be available.

Effective Date

This provision of the bill applies to taxable years ending after December 31, 1981.

Revenue Effect

It is estimated that the provision will increase budget receipts by $556 million in fiscal year 1982, and $1,916 million in fiscal year 1983.

B. Exclusion of Interest on Qualified Savings Certificates

(Sec. 301 of the bill and secs. 128, 265, 584, 643, 702, and new sec. 129 of the Code)

Present Law

Present law has no provision specifically for the exclusion of interest earned on savings certificates. Under section 116, and for calendar years 1981 and 1982 [1] only, up to $200 ($400 on a joint return) of dividends and interest from a variety of domestic sources may be excluded from gross income.

Reasons for Change

During recent periods of high interest rates, savings and loan associations, commercial banks, credit unions and similar depository institutions have experienced substantial disintermediation, as depositors and investors in institutional demand deposits, certificates of deposit and other time deposits have transferred their funds to higher-yielding financial instruments purchased from other sources (such as money market funds). Unlike depository institutions, the sources of these instruments have not been subject to statutory limits on the rates of interest they could pay.

In addition, savings and loan associations and many banks and credit unions have made long-term, low-rate loans, especially home loans, in the past. Because of high interest rates, the current cost of obtaining funds to carry these old loans is higher than the income accruing on them. The resulting squeeze on the profitability and cash flow of many of these depository institutions, particularly in light of the disintermediation caused by the competition from financial instruments whose interest rates are not regulated, may threaten their financial viability.

The committee believes that availability of a savings instrument offering either a market rate of interest or a below market rate of tax-exempt interest should help to stem, and perhaps reverse, the flow of deposits out of depository institutions. It also is anticipated that some new savings may be generated by the wider availability of such instruments. In addition, the committee believes that the availability of lower-cost funds from tax-exempt certificates for a 2-year period [2] should give the troubled depository institutions an opportunity to retire much of the low-yield loan portions of their portfolios and replace them with more profitable assets.

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[1] The bill repeals the $200/$400 exclusion for 1982 and allows section 116 to revert to the $100 dividend exclusion of prior law.

[2] One-year certificates of deposit, offered over a 1-year period, would be in existence over a 2-year period.

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Explanation of Provision

The committee bill provides for a lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on depository institution tax-exempt savings certificates.

Qualified certificates

In general, depository institution tax-exempt savings certificates are one-year certificates issued after September 30, 1981, and before October 1, 1982, by a qualified depository institution with a yield equal to 70 percent of the yield on one-year Treasury bills.[1] A qualified depository institution is a bank defined in section 581, a mutual savings bank, cooperative bank, domestic building and loan association, industrial loan association or bank, credit union, or any other savings or thrift institution chartered and supervised under Federal or State law, if the deposits or accounts of the depository institution are insured under Federal or State law or protected and guaranteed by State law.

For interest to qualify for the exclusion, a certificate issued by a qualified institution must meet several requirements. First, such certificates may be issued only during the one-year period beginning on October 1, 1981, and ending on September 30, 1982. Interest paid after September 30, 1982, with respect to certificates properly issued before that date will be entitled to the exemption. Second, the certificates must have a maturity period of one year. Thus, all of the interest excludable by virtue of the new provision will be earned by October 1, 1983. Third, the certificate must have a yield equal to 70 percent of the yield on 52-week Treasury bills. Whether a certificate meets this 70-percent requirement is determined by comparing the yield to maturity on the certificates (including the effect of any compounding of interest) to the yield to maturity on 52-week Treasury bills sold at the last Treasury auction to have occurred in a calendar week preceding the week the certificate is issued. Thus, an auction of 52-week Treasury bills will determine the interest limitation on depository tax-exempt savings certificates issued from the Monday following such auction until the Monday following the next auction of 52-week Treasury bills.

The committee does not intend, by this provision, to preempt the authority of Federal or State banking regulatory agencies to regulate interest rates, minimum deposits, interest penalties, maturities or any other aspect of depository accounts. Thus, the provision does not authorize the issuance of depository institution tax-exempt savings certificates; however, the committee anticipates that the cognizant regulatory authorities will consider such authorization as expeditiously as practicable.

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[1] These certificates may be certificates of deposit or certificates that represent withdrawal or repurchasable shares.

Limitations

The amount that any individual may exclude from income under the new provision is limited to $1,000. This limitation applies to the aggregate of all interest paid on certificates. Thus, a calendar year taxpayer who receives, for example, $800 of otherwise exempt interest in 1982 and $500 in 1983 can exclude only the first $1,000 of interest payments. In the case of individuals filing joint returns, the limit is increased to $2,000. This is true even if all of the $2,000 is earned by only one of the individuals filing the joint return. If two individuals file a separate return in one year and a joint return in the next year, the separate amounts of any exemption claimed in the first year are combined and taken into account in applying the $2,000 limitation in the second year. Similarly, if two individuals file a joint return in one year, they are treated as each having claimed half the amount of any exclusion shown on that return in applying the limitation in any subsequent year for which they file separate returns or joint returns with different individuals.

Interest paid on tax-exempt savings certificates is excludible only when paid to individuals or to estates that receive such certificates by reason of the decedent's death. In the case of a partnership, the individual partners may exclude their distributive shares of interest paid on tax-exempt savings certificates held by the partnership subject to each partner's $1,000 life-time limitation on the exclusion. Under an amendment to section 702, each partnership is required to separately state the amount of such interest distributable to the partners. Amounts paid to trusts (other than a common trust fund) or corporations (including real estate investment trusts, subchapter S corporations, and regulated investment companies) will be fully taxable.

In applying the dollar limitation to estates, the estate is treated as having claimed any exclusion taken by the decedent or by a surviving spouse who files a joint return claiming an exclusion.

If a taxpayer earns interest in excess of the excludible amount, the first interest earned is the interest eligible for exclusion.

If any portion of a certificate is redeemed or disposed of before maturity, the exclusion from income is not available for any interest earned on the certificate any portion of which was disposed of or redeemed. The receipt of interest earned on the certificate prior to maturity is not a premature redemption. If interest paid on a certificate is excluded from income in one year and the certificate is prematurely redeemed or disposed of in a subsequent year, then the amount of excluded interest must be included in income for the year of the redemption or disposition. Previously excluded amounts that are recaptured under this rule are not taken into account for purposes of the $1,000 limitation. Thus, if a holder redeems a certificate and reinvests a portion in a new certificate, interest on the new certificate can be excluded.

The bill provides that using a certificate as collateral or security for a loan will be treated as a redemption of the entire certificate.

The bill also denies deduction for interest paid on indebtedness incurred to purchase or carry investment in depository institution tax-exempt savings certificates. These rules are the same as those that

apply under present law with respect to debt incurred or continued to purchase or carry tax-exempt obligations (sec. 265(2)).

Treasury study

The committee bill requires the Secretary of the Treasury to report to the Congress before June 1, 1982, on the results of a study to be conducted by the Treasury on the effectiveness of the new saving certificates provision in generating additional savings. The committee intends to use this study in determining what permanent savings incentives should be enacted.

Coordination with interest and dividends exclusion

Since some interest earned in 1981 may otherwise be eligible for exclusion under both the new provision and the section 116 interest and dividend exclusion, the bill provides a special transition rule. This rule provides that any amount earned on a depository institution tax-exempt savings certificate may be excluded only under new section 128 and may not be excluded under the general interest and dividend exclusion in section 116 of present law, even if the interest on the certificate is not tax-exempt because of a premature redemption or disposition.

Effective Date

This provision of the bill applies to taxable years ending after September 30, 1981.

Revenue Effect

It is estimated that the provision will reduce budget receipts by $397 million in fiscal year 1982, $1,722 million in fiscal year 1983 and $991 million in fiscal year 1984.

C. Retirement Savings Provisions

1. Individual retirement savings (sec. 311 of the bill and secs. 62, 72, 219, 220, 401, 408, 409, 415, 2039, 2503, 2517, 3401, 4973, 6047, and 6652 of the Code)

Present Law

Individual retirement accounts

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity, or used to purchase retirement bonds (referred to collectively as "IRAs"). The limitation on the deduction for a taxable year is generally the lesser of 15 percent of compensation for the year or $1,500. Under a spousal IRA, the $1,500 contribution limit is increased to $1,750 for a year, if (1) the contribution is equally divided between an individual and the spouse of the individual, and (2) the spouse has no compensation for the year. However, no IRA deduction is allowed for a taxable year to an individual who is an active participant during any part of the taxable year in a qualified pension, profit-sharing or stock bonus plan, a tax-sheltered annuity program maintained by certain tax-exempt organizations or by public educational organizations, or a government plan (whether or not qualified). Except for tax-free rollovers and certain amounts paid for life insurance under an endowment contract, nondeductible contributions are not permitted to be made to an IRA. Income and gain on amounts held under an IRA are not taxed until distributed. Except in the case of certain correcting distributions, all distributions from IRA's are includible in gross income. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent penalty tax. If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual tax rules for distributions apply. Distributions from an IRA must commence no later than the taxable year in which the individual attains age 70½, and special rules require distributions to be made within a prescribed time after the individual's death. Amounts held in an IRA can qualify for exclusions under the estate tax and gift tax rules.

Simplified employee pensions

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), the annual IRA deduction limitation is increased to the lesser of $7,500 or 15 percent of compensation. The $7,500 limit applies only to employer contributions. An employee with a SEP is entitled to make additional deductible contributions to an IRA only to the extent that the annual deduction limitation (*i.e.*, the lesser of 15 percent of compensation or $1,500) exceeds the amount contributed by the employer for the year under the SEP. An individual retirement account or individual

retirement annuity qualifies as a simplified employee pension for a calendar year if certain requirements relating to employee withdrawals and the employer contribution allocation formula are satisfied. The allocation rules are designed to assure that employer contributions are made on a basis that does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

Employee contributions

Many qualified plans and government plans provide for contributions by both the employer and the employee. In many cases, the employee contributions are mandatory (*i.e.*, required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions. Employee contributions to a qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, in the case of voluntary employee contributions, within certain limits, there is presumed to be no discrimination on account of those contributions so long as the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees. Plan income and gain allocable to an employee's contributions to a qualified plan are generally not taxed to the plan or to the employee before the income is distributed or made available to the employee or the employee's beneficiary. However, the employee is generally not entitled to a deduction or exclusion for employee contributions to the plan. Benefits held in a qualified plan can qualify for exclusions under the estate tax and gift tax rules to the extent the benefits are not attributable to employee contributions.

Tax-sheltered annuities

In the case of tax-sheltered annuities (including custodial accounts investing in shares of a regulated investment company) purchased for employees by certain tax-exempt organizations or by public educational organizations, the employees are entitled to an exclusion from gross income for amounts paid by the employer on a salary reduction basis (within limits). Amounts invested in a tax-sheltered annuity purchased by a tax-exempt organization can qualify for exclusions under the estate tax and gift tax rules.

Reasons for Change

The committee is concerned that the resources available to individuals who retire are often not adequate to avoid a substantial decrease from preretirement living standards. The committee believes that retirement savings by individuals can make an important contribution toward maintaining preretirement living standards and that the present level of individual savings is too often inadequate for this purpose. The committee understands that personal savings of individuals have recently declined in relation to personal disposable income (*i.e.*, personal income after personal tax payments). During the years 1973 through 1975, the personal saving rate was no more than 8.6 percent. It declined to 5.2 percent in 1978 and 1979 and rose only slightly in

1980 to 5.6 percent. (These savings estimates include employer payments to private pension funds.)

The committee has found that the present rules providing tax-favored treatment for individual retirement savings have become too restrictive in view of recent rates of inflation and because they do not sufficiently promote individual savings by employees who participate in employer-sponsored plans.

The committee bill is designed to promote greater retirement security by increasing the amount which individuals can set aside for retirement in an IRA and by extending IRA eligibility to individuals who participate in employer-sponsored plans. The bill also extends additional tax-favored treatment to voluntary employee contributions to employer-sponsored plans so that plan participants can take advantage of systematic payroll deductions to accumulate tax-favored retirement savings.

Explanation of Provision

In the case of an individual who is not an active participant in a qualified plan, tax-sheltered annuity program, or government plan (*i.e.*, one who is currently eligible to make deductible IRA contributions), the present annual contribution limit is raised to the lesser of $2,000 ($2,250 for a spousal IRA) or 100 percent of compensation.

In the case of an employee who is an active participant in a plan (*i.e.*, one who is not currently eligible for an IRA deduction), a deduction is allowed to an individual for retirement savings limited to the lesser of $1,500 ($1,625 for a spousal IRA) or 100 percent of compensation. In the case of a plan participant, a deduction is allowed for contributions to an IRA or for qualified voluntary contributions by (or on behalf of) the employee to the plan. An employee can allocate deductible contributions to all plans in which he participates, so long as the total amount deducted does not exceed the lesser of $1,500 or 100 percent of compensation. An employee for whom an employer contributes under a SEP is considered an active plan participant and is allowed a deduction for his own IRA contributions (under the limits applicable to active plan participants) as well as a deduction for employer contributions to the SEP (limited under the SEP rules on the basis of contributions by, and compensation from, each separate employer). (For applicable limits under a SEP, see 2. Retirement plan deduction for self-employed individuals, *Explanation of Provisions, Increased contribution limit.*)

The requirement that contributions to a spousal IRA be equally divided between spouses is deleted, but annual contributions for either spouse cannot exceed $2,000 ($1,500 for an active participant) for a year.

A participant's contributions to a qualified plan, a tax-sheltered annuity program, or a government plan are qualified voluntary contributions if (1) the contributions are not mandatory, (2) deductible employee contributions are accepted under the plan, and (3) the participant does not designate the contribution as nondeductible. An employee is allowed the deduction for qualified voluntary contributions only if the plan has made provision for the acceptance of deductible employee contributions. Rules are provided under which (1) a plan

may permit participants to make or revise their designations for a year retroactively and (2) a plan may permit certain contributions made after the close of a calendar year to be treated as if made on the last day of the year. The bill continues the present law requirement that the opportunity to make voluntary contributions must be reasonably available to a nondiscriminatory group of employees. This availability standard will apply to the aggregate of deductible and nondeductible voluntary contributions and to the deductible voluntary contributions alone. If the eligibility standard is satisfied, the committee intends that the limit on the amount of voluntary contributions permitted under qualified plans of an employer is not to be less than the deductible limit provided by the bill for qualified voluntary employee contributions.

Accumulated deductible employee contributions (*i.e.*, net qualified voluntary contributions adjusted for income, gain, loss, and expense) are subject to the same tax treatment accorded amounts held in an IRA, with certain exceptions. All distributions of accumulated deductible employee contributions are includible in gross income, except for tax-free rollovers to an IRA or to another plan where the rollover amount will be held as accumulated deductible employee contributions. Distributions of accumulated deductible employee contributions may be made without penalty after age 59½ or in the event of disability or death. Other distributions of accumulated deductible employee contributions are subject to the same 10-percent additional income tax that applies to early withdrawals from an IRA.

A distribution of accumulated deductible employee contributions from a qualified plan may be transferred under the rollover rules to an IRA or to another qualified plan if the plan administrator of the other plan (1) treats the amount transferred as accumulated deductible employee contributions, and (2) permits such transfers on a nondiscriminatory basis. Of course, the amount transferred would not be taken into account under the limits on the amount of voluntary employee contributions under qualified plans. Such a rollover may be made without regard to whether the distribution is included in a lump-sum distribution or a distribution on account of termination of the plan, and without regard to whether the distribution constitutes a total distribution of the accumulated deductible employee contributions under the distributing plan. In addition, if a distribution of accumulated deductible employee contributions from a qualified plan is rolled over tax-free to an IRA, a total distribution from the IRA which is attributable only to a rollover from a qualified plan may be rolled over to a plan under which the distribution will be treated as accumulated deductible employee contributions, etc. Similar rules are provided for tax-sheltered annuities.

The IRA rules requiring that distributions commence not later than the taxable year in which the individual attains age 70½ and that distributions be made within a prescribed time after the individual's death do not apply to accumulated deductible employee contributions unless rolled over to an IRA. If accumulated deductible employee contributions are applied toward the purchase of life insurance, the amount so applied is treated as a distribution to which the usual tax rules for distributions apply. In addition, if an employee borrows

from or against such accumulated contributions, the amount of the loan or security interest is treated as distributed.

A plan which accepts deductible employee contributions is not required to hold assets purchased with such contributions (or income and gain therefrom) apart from the plan's other assets. Where these assets are not segregated from other plan assets, the committee expects that an employee's accumulated deductible contributions will be adjusted for income, etc. under the plan at least annually. In applying certain IRA rules to deductible employee contributions, the committee does not intend to imply that it would be appropriate to apply such rules to other plan contributions or benefits.

The bill does not change the usual vesting rules for qualified plans, under which a participant's accrued benefit derived from accumulated deductible employee contributions is nonforfeitable at all times. Under the bill, deductible employee contributions and deductible IRA contributions (other than employer contributions to a SEP) are not taken into account for purposes of the limitations on contributions and benefits for qualified plans and tax-sheltered annuities.

Accumulated deductible employee contributions do not qualify under the bill for 10-year forward income averaging, long-term capital gain treatment, deferred recognition of gain on employer securities, or the income tax death benefit exclusion for certain benefits under qualified plans. For purposes of the estate tax and gift tax exclusions for qualified plans and certain tax-sheltered annuities, as well as for purposes of the income tax treatment of annuities, accumulated deductible employee contributions are treated as a benefit derived from employer contributions.

An employer is not required to withhold income tax on an employee's voluntary contributions to a plan if it is reasonable to believe that the employee will be entitled to a deduction for the contributions.

Treasury regulations are to provide rules under which the plan administrator of a plan accepting deductible employee contributions is to provide reports to the Treasury and to plan participants.

A clarifying amendment is made with regard to the income tax treatment of the proceeds of a retirement bond purchased with a rollover contribution.

Effective Dates

These provisions generally are effective for taxable years beginning after December 31, 1981. The amendments to the estate tax and gift tax rules apply to the estates of decedents dying and to transfers made after such date. The amendment relating to redeemed retirement bonds applies to taxable years beginning after December 31, 1974.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $201 million in fiscal year 1982, $1,118 million in 1983, and $2,124 million in 1986.

2. Retirement plan deduction for self-employed individuals (sec. 312 of the bill and secs. 72, 219, 401, 404, 408, 1379, and 4972 of the Code)

Present Law

In general

A pension or profit-sharing plan is a qualified plan only if it is established by an employer for the benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and the employer, and a partnership is considered the employer of each partner. A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an "H.R. 10 plan" or "Keogh plan", and is subject to special rules which are in addition to the Code's other qualification requirements. These special rules include limits on the contributions and the benefits which can be provided for a self-employed individual. These limits are generally lower than the overall limits on contributions and benefits applicable with respect to all employees under qualified plans.

Limitation on contributions and benefits for self-employed individuals

Under a defined contribution[1] H.R. 10 plan, deductible contributions on behalf of a self-employed individual generally are limited annually to the lesser of $7,500 or 15 percent of net earnings from self-employment. Nondeductible employee contributions to an H.R. 10 plan are generally permitted (within limits) unless all employees covered by the plan are owner-employees (an owner-employee is a sole proprietor or a partner whose partnership interest exceeds 10 percent).

Under a defined benefit[2] H.R. 10 plan, the annual benefit accruals for a self-employed individual are limited by a special schedule designed to permit the accrual of a pension benefit no greater than that which could be provided by the accumulated annual contributions permitted under a defined contribution H.R. 10 plan.

Subchapter S corporations

A qualified pension or profit-sharing plan maintained by an electing small business corporation (a subchapter S corporation) is subject to special limitations corresponding to those for H.R. 10 plans as well as the overall limits on contributions and benefits applicable to all qualified plans. Under a qualified defined contribution plan of a subchapter S corporation, annual employer contributions on behalf of a

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[1] Defined contribution plans are plans under which each participant's benefit is based solely on the balance in the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants (*e.g.*, a profit-sharing plan or a money purchase pension plan).

[2] A defined benefit plan specifies a participant's benefit independently of an account for contributions, etc. (*e.g.*, an annual benefit of 2 percent of average pay for each year of employee service).

shareholder-employee (an employee who owns more than five percent of employer stock) in excess of the lesser of $7,500 or 15 percent of compensation are includible in the income of the shareholder-employee. Under a qualified defined benefit plan of a subchapter S corporation, benefits are limited under the same schedule that applies to a defined benefit H.R. 10 plan.

Simplified employee pensions

If an individual retirement account or individual retirement annuity (IRA) qualifies as a simplified employee pension (SEP), both the employee and the employer may make contributions to the employee's IRA. Generally, employer contributions for an employee under a SEP are includible in the gross income of the employee and the employee is allowed a deduction for the employer contribution for a year limited to the lesser of 15 percent of compensation or $7,500. With respect to employee contributions, the limit is $1,500 (or 15 percent of compensation, if less) reduced (but not below zero) by the amount of deductible employer contributions for the year.

Limit on includible compensation

Under present law, only the first $100,000 of compensation may be taken into account under a defined contribution H.R. 10 plan, a defined contribution plan of a subchapter S corporation, or a SEP for purposes of testing the plan for discrimination and applying limits on contributions.

Employee borrowing from qualified plans

In general, under a qualified plan, loans to participants are permitted if certain requirements are met.[3] However, H.R. 10 plans are not permitted to lend to an owner-employee. Also if an owner-employee participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the amount of the loan or security interest is treated as a plan distribution, and the usual tax rules for distributions apply.

Reasons for Change

The maximum deductible contribution for H.R. 10 plans has not been revised since 1974. The committee believes this limit should be increased as an adjustment for inflation and to make these plans more attractive.

The committee also believes that current provisions permitting partners who are not owner-employees to borrow against their interest in an H.R. 10 plan diminish retirement savings. Accordingly, to promote long-term savings for retirement, the committee believes the current treatment of loans and pledges should be applied to all partners.

Explanation of Provisions

Increased contribution limit

In general, the bill increases the deduction limit for employer contributions to defined contribution H.R. 10 plans, defined contribution

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[3] Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

plans maintained by subchapter S corporations, and simplified employee pensions, to $15,000. The 15-percent limit on contributions is not changed.

For defined benefit H.R. 10 plans or subchapter S corporation plans, the compensation taken into account in determining permitted annual benefit accruals is increased to $100,000. If the compensation taken into account to determine benefit accruals under a plan is increased to an amount greater than that permitted under present law, the bill treats the increase as starting a new period of plan participation.

Increase in includible compensation

Under the bill, the maximum amount of compensation which may be used to determine contributions or benefits in a defined contribution H.R. 10 plan, or subchapter S plan, or a SEP is increased from $100,000 to $150,000. However, if annual compensation in excess of $100,000 is taken into account under the plan, the rate of employer contributions for any plan participant cannot be less than 7½ percent of that participant's compensation (before the application of the rules permitting the integration of the plan with social security).

Employee borrowing

The bill extends to all partners the present law rule under which a loan from an H.R. 10 plan, or the use of an interest in the plan as security for a loan, is treated as a distribution.

Effective Date

These provisions generally are effective for taxable years beginning after December 31, 1981. However, the bill provides a transitional rule for a loan outstanding on December 31, 1981 to a partner who is not an owner-employee. Such a loan will not be treated as a distribution from the plan unless renegotiated, extended, renewed or revised after that date.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $56 million in fiscal year 1982, $157 million in 1983, and $201 million in 1986.

D. Employee Stock Ownership Plans

(Secs. 321–328 of the bill and secs. 44G, 46, 401, 404, 409A, and 415 of the Code)

Present Law

Overview

An employee stock ownership plan (ESOP) is a tax-qualified plan under which employer stock is held for the benefit of employees. The stock, which is held by a tax-exempt trust under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust.

Under the usual rules applicable to tax-qualified plans, an employee's benefits under an ESOP are generally not taxed until they are distributed or made available. Also, the Code provides special 10-year income averaging or tax-free rollover treatment for lump sum distribution, deferral of tax on appreciation in employer securities, and estate tax and gift tax exclusions.

Tax credit ESOPs

An employee stock ownership plan under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. Under present law, an employer is entitled to an additional percentage point of investment tax credit (*i.e.*, 11 percent rather than 10 percent) if it contributes an amount equal to the full additional credit to a tax credit ESOP. The employer's contribution to the ESOP may be made for the taxable year for which the investment tax credit is earned or as late as the taxable year for which the credit is claimed. In addition to the one-percent credit, up to one-half percent of extra investment tax credit is allowed where an employer contributes the extra amount to the tax credit ESOP, if the employer's extra contribution is matched by employee contributions.

The rules allowing an employer the additional investment tax credit for ESOP contributions expire with respect to qualifying investments made after December 31, 1983.

Leveraged ESOPs

An employee stock ownership plan which borrows to acquire employer stock is referred to as a leveraged ESOP. Under a leveraged ESOP, the employer is allowed a deduction, within limits, for contributions to the plan. These contributions may be applied by the plan to service the loan. Under present law, the deduction allowed an employer for contributions to a profit-sharing or stock bonus plan (including a leveraged ESOP) generally is limited to 15 percent of the compensation of all employees under the plan. In addition, present law provides that the annual contributions and other additions (in-

cluding forfeitures) credited to a participant's account under a qualified defined contribution plan (including a leveraged ESOP) generally cannot exceed the lesser of $41,500 for 1981 ($25,000 adjusted for inflation since 1974) or 25 percent of the participant's compensation. In the case of certain ESOPs, the dollar limit is doubled.

Distributions from ESOPs

Under present law, employer securities allocated to an employee's account under a tax credit ESOP generally may not be distributed from the account before the end of the 84th month after the month in which the securities are allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service, death, or becoming disabled. In addition, a participant in a leveraged ESOP or a tax credit ESOP who is entitled to a distribution under the plan is required to be provided the right to demand that the distribution be made in the form of employer securities rather than in cash. Subject to a participant's right to demand a distribution of employer securities, the plan may elect to distribute the participant's interest in cash, in employer securities, or partially in cash and partially in employer securities.

A participant who receives a distribution of employer securities from a tax credit ESOP or a leveraged ESOP must be given a put option on the distributed employer securities if the employer securities are not readily tradable. Under the put option, the distributee must be given up to six months after receipt of the securities to require the employer to repurchase the securities at their fair market value. If the distributee does not exercise the initial put option within the six-month period, the option will temporarily lapse. After the close of the employer's taxable year in which the temporary lapse of a distributee's option occurs and following a determination of the value of the employer securities (determined in accordance with Treasury regulations) as of the end of that taxable year, the employer is required to notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer securities as of the close of the taxable year. Each such distributee must then be given up to three months to require that the employer repurchase the employer securities. If the distributee does not exercise this put option, the option permanently lapses. Because a participant might wish to contribute a distribution from a tax credit ESOP or leveraged ESOP to an IRA in a tax-free rollover, and because the contribution would have to be made before the expiration of the first six-month put option, an IRA trustee or custodian must be able to exercise the same put option as the participant.

Reasons for Change

The committee believes that experience in the operation of the tax laws applicable to employee stock ownership plans indicates that several changes are appropriate. The committee is concerned that the investment-based tax credit for ESOPs has not provided a sufficient incentive for the establishment of ESOPs by labor-intensive corporations. The committee believes that a permanent payroll-based tax credit for employer contributions to a tax credit ESOP will provide

a more effective incentive than the additional investment tax credit currently allowed. In addition, the rules in present law which limit the ability of a leveraged ESOP to acquire employer securities with the proceeds of a loan to the plan have proved too restrictive and have prevented the use of leveraged ESOPs as a technique of corporate finance. Certain of the provisions governing distributions to participants under a tax credit ESOP or leveraged ESOP have proved burdensome and, in some cases, have precluded an employer from establishing an employee stock ownership plan.

Explanation of Provisions

1. Payroll-based tax credit

The additional investment tax credit allowed an employer for contributions to a tax credit ESOP is terminated with respect to qualifying investments made after December 31, 1982. With respect to qualifying investments made after December 31, 1981, and before January 1, 1983, an employer is allowed a partial additional investment tax credit (*i.e.*, an additional credit not in excess of one percent), if it contributes an amount equal to the partial additional credit to a tax credit ESOP. For taxable years ending after that date, in lieu of the additional investment tax credit, an electing employer is allowed an income tax credit for contributions to a tax credit ESOP limited to a prescribed percentage of the compensation of all employees under the plan. For an employer's taxable year beginning or ending in 1983, the tax credit is limited to one-half of one percent of such aggregate compensation paid or accrued after 1982. For an employer's taxable year beginning in 1984, the limit is three-quarters of one percent, and for taxable years beginning after December 31, 1984, the tax credit allowed the employer is limited to one percent of the compensation of all employees under the ESOP.

For compensation paid or accrued in calendar year 1983, the tax credit is limited to one-half of one percent. For compensation paid or accrued in 1984, the limit is three-quarters of one percent, and for calendar year 1985 and thereafter the credit is limited to one percent of the compensation paid or accrued in that year to all employers under the ESOP. Under the bill, no payroll-based credit is allowed for contributions to a plan if more than one-third of the employer's contributions for the year are allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than 10 percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit (for 1981, $83,000).

The amount of the employer's income tax liability that can be offset by the tax credit allowed for contributions to a tax credit ESOP generally is limited to the first $25,000 of tax liability, plus 90 percent of the excess over $25,000. If the employer is a member of a controlled group of corporations, the $25,000 amount against which the tax credit may be fully applied is reduced by apportioning such amount (pursuant to Treasury regulations) among the member corporations. If the tax credit otherwise allowed an employer for ESOP contributions ex-

ceeds the amount of tax liability against which the credit may be applied for a taxable year, the unused tax credit may be carried back to each of the three preceding taxable years and carried forward to each of the ten succeeding taxable years. The amount of any unused credit which expires at the close of the last taxable year to which it may be carried is allowed as a deduction to the employer for such taxable year without regard to the usual limits on deductions for contributions to qualified plans.

An employer is allowed a tax credit for ESOP contributions only if it establishes a plan which meets the Codes requirements for tax credit ESOPs and transfers employer securities to the plan having a total value not in excess of the applicable percentage of the compensation of all employees under the plan. In addition, the employer must agree to transfer the securities not later than 30 days after the due date (including extensions) for filing the return for the taxable year for which the credit is earned (without regard to whether the credit is allowed for such taxable year). For purposes of the tax credit ESOP rules, a contribution of cash to an ESOP is treated as a transfer of employer securities if the plan uses the cash within 30 days to purchase employer securities.

2. Deductible contributions to leveraged ESOPs

Amounts contributed by an employer to a leveraged ESOP and applied by the plan to the payment of principal or interest on a loan incurred to purchase employer securities are allowed separately as deductions to the employer. The deduction allowed the employer for contributions applied to the payment of loan principal (but not interest) is limited to 25 percent of the compensation of all employees under the plan. In addition, the employer's deductible ESOP contributions which are applied by the plan to the payment of interest on a loan to acquire employer securities, as well as any forfeitures of employer securities purchased with loan proceeds, generally are not taken into account under the qualified plan rules which limit contributions and benefits under qualified plans. However, the rule allowing the employer contributions for loan interest and the employee forfeitures to be disregarded for purposes of the annual limitation will apply only if no more than one-third of the employer's contributions for the year are allocated to the group of employees consisting of officers, shareholders directly or indirectly owning more than 10 percent of the employer's stock (other than stock held by qualified plans), or individuals whose compensation exceeds a specified limit (for 1981, $83,000). In addition, a forfeiture of an employer security is disregarded for purposes of the limitations on contributions and benefits only if the security's entire purchase price was paid with the proceeds of a loan to the ESOP. For this purpose, if a unit of employer securities is purchased by an ESOP partly with the proceeds of a loan and partly with other amounts, those securities having an aggregate value not in excess of the applied loan proceeds are treated as having been purchased only with the loan proceeds.

3. Distributions from ESOPs

An additional exception is made to the rule in present law which provides that employer securities allocated to an employee's account under a tax credit ESOP generally may not be distributed before the

end of the 84th month in which the securities are so allocated. Under the bill, the 84-month rule does not apply in the case of the direct or indirect transfer of a participant to the employment of an acquiring employer where all (or substantially all) of the assets used by the selling corporation in a trade or business are sold to the acquiring employer. The 84-month rule is also waived for an employee of a subsidiary of the selling corporation, with respect to securities of the selling corporation, where the selling corporation disposes of its interest in the subsidiary and the employee continues in the employ of the subsidiary. In addition, a tax credit ESOP or a leveraged ESOP may preclude a participant from demanding a distribution in the form of employer securities if the employer's corporate charter (or bylaws) restricts the ownership of substantially all outstanding employer securities to employees or to a trust under a qualified plan. The ESOP must, however, provide that participants entitled to a distribution have a right to receive the distribution in cash.

In the case of a tax credit ESOP or a leveraged ESOP established and maintained by a bank or similar financial institution which is prohibited by law from redeeming or purchasing its own securities, an exception is made to the rule generally requiring that a participant who receives a distribution of employer securities must be given a put option if the securities are not readily tradable. No put option is required if the ESOP provides that participants entitled to a distribution from the plan have a right to receive the distribution in cash. In addition, where a put option on distributed employer securities is required under present law, the employer may provide the option for a period of at least 60 days (rather than six months) following the date of the distribution and for an additional period of at least 60 days (rather than three months) in the following plan year.

A qualified stock bonus plan which is not a tax credit ESOP or a leveraged ESOP is permitted to provide a cash distribution option to participants if (1) a participant has a right to demand that plan benefits be distributed in the form of employer securities, and (2) a participant who receives a distribution of employer securities which are not readily tradable is given a put option on the securities (under the rules applicable to tax credit ESOPs and leveraged ESOPs).

Effective Dates

These provisions generally apply to taxable years beginning after December 31, 1981, except those relating to the 84-month rule, which apply to distributions made after March 29, 1975.

Revenue Effects

It is estimated that this provision will reduce budget receipts by $61 million in fiscal year 1983, $821 million in 1984, $2,011 million in 1985, and $2,750 million in 1986.

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TITLE IV.—ESTATE AND GIFT TAX PROVISIONS

A. Increase in Unified Credit (sec. 401 of the bill and secs. 2010, 2505, and 6018 of the Code)

Present Law

Under present law, the estate and gift taxes are unified so that a single progressive rate schedule is applied to cumulative gifts and bequests. The estate and gift tax rates range from 18 percent for the first $10,000 in taxable transfers to 70 percent on taxable transfers in excess of $5 million. Generally, the estate or gift tax liability is determined by first computing the gross gift or estate tax and then subtracting the unified credit to determine the amount of the gift or estate tax.[1] The amount of the present unified credit is $47,000. With a unified credit of $47,000, there is no estate or gift tax on transfers of up to $175,625.

The unified credit applicable to the estates of non-resident aliens is $3,600.

Reasons for Change

Historically, one of the principal reasons for estate and gift taxes was to break up large concentrations of wealth. Generally, small- and moderate-sized estates have been exempt from the estate and gift taxes. Currently, with a unified credit of $47,000, cumulative transfers of $175,625 may be made without the imposition of any transfer taxes. However, inflation has increased the dollar value of property and, therefore, the transfer tax burdens, without increasing real wealth.

With the existing level of unified credit (which permits cumulative tax-free transfers of $175,625), the estate tax is imposed on estates of a relatively small size, including those containing family farms or closely held businesses. Imposing the tax on these smaller, illiquid estates often results in forced sales of family enterprises.

The committee believes that the unified credit should be increased to offset the effects of inflation and to provide estate and gift tax relief to smaller estates, especially those which consist of family businesses.

Explanation of Provision

The committee bill gradually increases the amount of the unified credit from $47,000 to $192,800 over a five-year period. With a unified credit of $192,800, there would be no estate or gift tax on transfers aggregating $600,000 or less. The amount of the credit is $62,800 for decedents dying in 1982, $79,300 in 1983, $104,800 in 1984, $138,800 in 1985, and $192,800 in 1986 and subsequent years.

The bill also revises the estate tax filing requirements to reflect the increased unified credit amount. When the credit is phased in fully, the

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[1] However, the amount of the estate tax would be reduced further by other credits allowed to an estate.

bill requires that an estate tax return be filed only if the decedent's gross estate exceeds $600,000. During the five-year phase-in period, the filing requirements are to be $225,000, $275,000, $350,000, and $450,000 in 1982, 1983, 1984, and 1985, respectively. As under present law, the threshold filing requirement will be reduced (but not below zero) by the sum of the adjusted taxable gifts made by the decedent after December 31, 1976, and the amount of the specific gift tax exemption under prior law which may have been used by the decedent with respect to gifts made after September 8, 1976, and before 1977.

The bill makes no changes to the unified credit for nonresident aliens.

Effective Date

This provision applies to estates of decedents dying after December 31, 1981, and to gifts made after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million in fiscal year 1982, $1,077 million in 1983, $1,981 million in 1984, and $4,241 million in 1986.

B. Unlimited Marital Deduction (sec. 402 of the bill and secs. 2040, 2056, 2515, 2515A, 2523, and 6019 of the Code)

Present Law

Marital deduction

Present law allows a limited deduction for gifts and bequests between spouses. Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of interspousal lifetime transfers in excess of $200,000. In addition, an estate tax marital deduction equal to the greater of $250,000 or one-half of the decedent's adjusted gross estate generally is allowed for the value of property passing from a decedent to the surviving spouse. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interests generally do not qualify for either the gift or estate tax marital deductions.

Jointly held property

The present estate tax provisions contain several special rules governing the treatment of jointly held property for estate tax purposes. These rules apply to forms of ownership where there is a right of survivorship upon the death of one of the joint tenants. They do not apply to community property or property owned as tenants in common.

In general, under these rules, the gross estate includes the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party (sec. 2040(a)). The decedent's estate has the burden of proving that the other joint owner, or owners, acquired their interests for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, does not include money or property shown to have been acquired from the decedent for less than full and adequate consideration in money or money's worth.

In addition, special rules are provided (1) for certain qualified joint interests held by a decedent and his spouse (secs. 2040 (d) and (e)), and (2) for certain jointly held property used in a farm or other trade or business in which both spouses materially participated (sec. 2040(c)).

The present gift tax provisions contain two special rules governing the treatment of jointly held property. Under section 2515, where a

husband and wife take ownership of real property as joint tenants, there is not a gift between spouses until the tenancy is terminated, unless the spouses elect otherwise. Under section 2515A, where a joint interest is created by a husband and wife after December 31, 1976, any gift is computed assuming each spouse owned one-half of the value of the joint interest.

Reasons for Change

The committee believes that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes. Accordingly, no tax should be imposed on transfers between a husband and wife.

Moreover, the committee believes that the taxation of jointly held property between spouses is complicated unnecessarily. Often such assets are purchased with joint funds making it difficult to trace individual contributions. In light of the unlimited marital deduction adopted by the committee bill, the taxation of jointly held property between spouses is only relevant for determining the basis of property to the survivor (under sec. 1014) and the qualification for certain provisions (such as current use valuation under sec. 2032A, deferred payment of estate taxes under secs. 6166 or 6166A,[1] and for income taxation of redemptions to pay death taxes and administration expenses under sec. 303). Accordingly, the committee believes it appropriate to adopt an easily administered rule under which each spouse would be considered to own one-half of jointly held property regardless of which spouse furnished the consideration for the property.

Explanation of Provision

The committee bill removes the quantitative limits on the marital deduction for both estate and gift tax purposes. The bill does not change the present rule that transfers of terminable interests do not qualify for the marital deduction. However, transfers of community property would qualify.

Because an unlimited marital deduction is permitted for interspousal transfers, the bill exempts all such transfers from gift tax filing requirements. Under section 2035, gifts made within 3 years of death for which a gift tax return is not required are not includible in the gross estate. However, the bill provides that this rule does not apply to interspousal gifts for which a return is not required because of the marital deduction. Thus, all interspousal transfers made within three years of death (other than transfers which are less than the section 2503(b) annual exclusion) will be included in a decedent's gross estate pursuant to section 2035 (without reduction for the amount of the annual exclusion). Accordingly, the exemption for filing on interspousal transfers does not permit decedents to make deathbed transfers to insure that their estate qualifies for certain provisions depending on the size and composition of the gross estate (e.g., secs. 303, 2032A and 6166).

In addition, the bill provides special rules for determining ownership of property held by spouses in joint tenancy with a right of survivorship. Under the bill, each spouse will be deemed to own one-half

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[1] The bill combines existing sections 6166 and 6166A. See F below.

of the value of the property regardless of which spouse furnished the consideration. The bill repeals certain of the special rules applicable to treatment of jointly held property between spouses (secs. 2040(c) to 2040(e), 2515, and 2515A).

Effective Date

In general, the changes apply with respect to gifts made or decedents dying after December 31, 1981.

Because the maximum estate tax marital deduction under present law is limited to the greater of $250,000 or one-half of the decedent's adjusted gross estate, many existing wills and trusts provide a maximum marital deduction formula clause. The committee is concerned that many testators, although using the formula clause, may not have wanted to pass more than the greater of $250,000 or one-half of the adjusted gross estate (recognizing the prior law limitation) to the spouse. For this reason, a transitional rule provides that the increased estate tax marital deduction, as provided by the bill, will not apply to transfers resulting from a will executed or trust created before the date which is 30 days after enactment, which contains a maximum marital deduction clause provided that: (1) the formula clause is not amended before the death of the decedent to refer specifically to an unlimited marital deduction, and (2) there is not enacted a State law, applicable to the estate, which would construe the formula clause as referring to the increased marital deduction as amended by the bill.

Revenue Effect

It is estimated that this provision would reduce budget receipts by less than $5 million in fiscal year 1982, $259 million in 1983, and $242 million in 1986.

C. Increase in Annual Gift Tax Exclusion (sec. 403 of the bill and sec. 2503 of the Code)

Present Law

Under present law, an annual exclusion of $3,000 per donee is allowed with respect to gifts of present interests in property.

A gift made by a husband and wife may, with the consent of both, be treated for gift tax purposes as made one-half by each. The full amount of exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property. Thus, where a couple agrees to split gifts, they may give up to $6,000 per donee per year without gift tax.

Reasons for Change

In establishing the annual gift tax exclusion, Congress originally intended "... to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts ..." [1] The exclusion has remained at its current level ($3,000 per donee per year) since 1942. Since that date, inflation has substantially reduced the real value of the exclusion. For example, because of the effect of inflation, the present level of gift tax exclusion is often insufficient to cover amounts paid by parents to provide higher education for their children.

The committee believes that the annual gift tax exclusion should be increased to $10,000.

Explanation of Provision

The committee bill increases the gift tax annual exclusion to $10,000 per donee. With gift-splitting, spouses will be able to transfer a total of $20,000 per donee per year without gift tax.

Effective Date

In general, the increased gift tax exclusion applies to transfers made after December 31, 1981.

Many existing trusts provide powers of appointment specifically defined in terms of the section 2503(b) annual gift tax exclusion which, under present law, is limited to $3,000. The committee is concerned that many settlors, although limiting the power by reference to section 2503(b), may not have wanted to provide a power over property in excess of $3,000. For this reason, a two-year transitional rule provides that the increased annual gift tax exclusion, as provided by the bill, will not apply to powers granted under a trust created before 30 days after the date of enactment and not amended after that date provided that (1) the power is defined in terms of the section 2503(b) annual gift tax exclusion, and (2) there is not enacted a State law applicable

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[1] S. Rep. No. 72–665, 72d Cong., 1st Sess. (1932)

to such instrument which construes the power of appointment as referring to the increased gift tax exclusion provided by the bill. This transitional rule will be effective only with respect to powers exercisable after December 31, 1981, and before January 1, 1984. This two-year period will provide sufficient time for trustees to obtain clarification of the settlor's intent through judicial construction of the trust governing instrument.

Revenue Effect

It is estimated that this provision will reduce budget receipts by $137 million in fiscal year 1982, $227 million in 1983, and $205 million in 1986.

D. Current Use Valuation of Certain Property (sec. 404 of the bill and sec. 2032A of the Code)

Present Law

In general

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $500,000 (sec. 2032A).

Qualification requirements

An estate may qualify for current use valuation if (1) the decedent was a citizen or resident of the United States at his death; (2) the adjusted value [1] of the farm or closely held business assets in the decedent's estate, including both real and personal property, is at least 50 percent of the adjusted value of the decedent's gross estate; (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property; [2] (4) the real property qualifying for current use valuation passes to a qualified heir; [3] (5) such real property has been owned by the decedent or a member of his family and used or held for use as a farm or closely held business ("a qualified use") for five of the last eight years prior to the decedent's death and on the date of the death; (6) there has been material participation in the operation of the farm or closely held business by the decedent or a member of his family for periods aggregating at least five years out of the eight years immediately preceding the decedent's death; [4] (7) the executor elects the treatment within the time prescribed for filing the decedent's estate tax return; and (8) all parties with any interest in the property to be specially valued enter into an agreement consenting to the election.

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[1] The "adjusted value" of the gross estate or of specific property is its gross value less any mortgages or other indebtedness, payment of which are secured by an interest in the property included in the gross estate (or by the specific property).

[2] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[3] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants. The term does not include members of a spouse's family.

[4] In the case of qualifying real property where the ownership, use, and material participation requirements are satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements, located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

Property owned indirectly through ownership of an interest in a partnership, a corporation, or a trust qualifies for current use valuation to the extent that it would qualify if it were owned directly.

Valuation methods

Under present law, the current use value of qualified real property[5] can be determined under either of two methods: (1) the multiple factor method or (2) the formula method.

Multiple factor method

The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property.

Formula method

If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (sec. 2032A(c)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for tracts of comparable land in the same locality used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal land bank loans.[6]

Recapture

If, within 15 years after the death of the decedent (and before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" imposed on the qualified heir.

Failure by the heir or a member of the heir's family to materially participate in the business operation for periods aggregating three years or more during any eight-year period ending within 15 years after the decedent's death is treated as a cessation of qualified use. Under a special rule, no additional estate tax is imposed where property has been involuntarily converted to the extent it is replaced by qualified property (under sec. 1033) and the heir makes an election.

If an election is made to value property based on its current use, the qualified heir's income tax basis in the property is the current use value. No adjustment is made to this basis if the additional estate tax is imposed.

Reasons for Change

The committee believes that it is desirable to encourage the continued ownership and operation of farms and other small businesses by family units. When real property is actually used for farming

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[5] Growing crops, including standing timber in the case of timber farms, are not treated as part of the qualified real property.

[6] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death.

purposes or in other closely held businesses by members of a family (both before and after the death of the owner of the property), the committee believes that it is inappropriate to value the property for estate tax purposes based on a market value that does not reflect its value in its current use. Valuation on the basis of a use other than current use could result in forced liquidation of many family owned and operated businesses to pay Federal estate taxes and could also result in increased concentration of ownership of the real property necessary for survival of these family businesses.

The current use valuation provision has provided extensive relief to numerous family farms and businesses. However, a number of technical requirements of the current use valuation provision have resulted in incomplete relief being received by the owners of many family farms and other businesses for which the committee wished to provide. For these reasons, the committee has provided for a number of changes to the current use valuation provision to assist further in the preservation of family owned and operated farms and other businesses.

Explanation of Provisions

The committee bill makes a number of changes in the current use valuation provision, affecting each of the three major areas of the provision: pre-death qualification requirements; valuation rules; and post-death recapture rules. These changes generally expand availability of current use valuation to estates not eligible under present law, enable additional farm estates to take advantage of the simplified formula valuation method included in the provision, and reduce the post-death restrictions on qualified heirs inheriting specially valued real property.

1. Changes to pre-death qualification requirements

Qualified use requirement

The bill provides that the qualified use requirement of present law applicable to periods on or before the date of the decedent's death (sec. 2032A(b)(1)) may be satisfied if either the decedent or a member of the decedent's family uses real property otherwise eligible for current use valuation as a farm for farming purposes or in another trade or business. The bill does not change the present law requirement that a qualified use be an active trade or business use as opposed to a passive, or investment, use.

For example, if a decedent has leased otherwise qualified real property to a son pursuant to a net cash lease,[7] and the son conducts a farming operation on the property, the son's business use is attributed under the bill to the decedent for purposes of satisfying the qualified use requirement (sec. 2032A(b)(1)). On the other hand, during any period when the decedent leases the real property to a nonfamily member for use in a qualified use pursuant to a lease under which the rental is not substantially dependent upon production, the qualified use requirement is not satisfied.

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[7] This result would not be affected by the fact that the property was rented for a lesser amount than would be charged in a lease between unrelated parties.

The bill does not change the present requirement that the qualified heir owning the real property after the decedent's death use it in the qualified use throughout the recapture period. However, the bill creates a special one-year grace period immediately following the date of the decedent's death during which failure by the qualified heir to commence use of the property in its qualified use will not result in imposition of an additional estate tax. The 10-year recapture period is extended by a period equal to any part of the one-year grace period which expires before the qualified heir commences using the property in the qualified use. Failure by the heir to use the property in the qualified use after the one-year grace period would result in imposition of an additional estate tax.

Material participation requirement

The bill changes the time periods before the decedent's death when the decedent (or a member of the decedent's family) must materially participate in the operation of the farm or other trade or business where the decedent was disabled or was receiving social security retirement benefits on the date of his or her death. Under the bill, the material participation requirement has to be satisfied during periods aggregating five years or more of the eight-year period ending before the earlier of (1) the date of death, (2) the date on which the decedent became disabled (which condition lasted until the date of the decedent's death), or (3) the date on which the individual began receiving social security retirement benefits (which status continued until the date of the decedent's death).

Under the bill, an individual is considered to be disabled if the individual is mentally or physically unable to materially participate in the operation of the farm or other business. However, while failure by an individual to materially participate may be evidence of disability, no presumption of disability arises from such a failure to materially participate. The committee anticipates that the Treasury Department will develop regulations providing rules for determining when an individual is disabled for purposes of this provision of the bill.

The bill also provides an alternative to the material participation requirements for qualification of real property for current use valuation in the estates of certain surviving spouses who inherit the property from a decedent spouse in whose estate it was valued based on its current use. The bill provides that the spouse will be treated as having materially participated during periods when the spouse (but not a family member) engaged in active management of the farm or other business operation. In the case of spouses who survive a decedent spouse by not more than five years, the requirement of material participation during periods aggregating five years of an eight-year period is considered to be met if such spouse engaged in active management of the farm or other business operation at all times between the deaths of the spouses.

Active management means the making of business decisions other than the daily operating decisions of a farm or other trade or business. The determination of whether active management occurs is factual, and the requirement can be met even though no self-employment tax is payable under section 1401 by the spouse with respect to income derived from the farm or other trade or business operation. Among the farming activities, various combinations of which constitute active

management, are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended. Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should undertake.

2. Changes to valuation methods

Formula valuation method

The bill permits substitution of net share rentals for cash rentals in the formula valuation method for farm real property if the executor cannot identify actual tracts of comparable farm real property in the same locality as the decedent's farm property that are rented for cash. The bill does not change the present requirement that the executor substantiate the comparable land and rental information to be used in valuing the decedent's property.

The amount of a net share rental is equal to the gross value of the produce received by the lessor of the comparable land minus the cash operating expenses (other than real property taxes) of growing the produce which are paid by the lessor. Where produce is disposed of in an arm's-length transaction within a period no longer than the period established by the U.S. Department of Agriculture for its price support program immediately following the date or dates on which the produce is received (or constructively received) by the lessor, the committee intends that the gross amount received in the disposition will be the gross value of the produce.[8]

If there is no arm's-length disposition within the established period, the value of the produce may be determined as of the date or dates on which the produce is received (or constructively received) and shall equal the average price for which the produce sold on the closest national or regional commodities market to the farm property on that date or dates.

As under present law, if there is no comparable land from which a cash or share rental can be determined, the real property is to be valued using the multiple factor valuation method.

Special rule for standing timber

The bill provides that the executor can elect to treat standing timber as an interest in real property and specially value the timber as part of the qualified real property on which the timber is located, rather than valuing it as other growing crops.[9] Standing timber is to be specially valued by reference to similar timber located on comparable land where both the land and timber are rented for timber growing purposes under a cash or share rental lease.[10] If no comparable timber and land are so rented in the locality of the decedent's property, the

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[8] The committee understands that the present period established by the Department of Agriculture price support program is five months.

[9] Specially valued standing timber will be subject to the special lien securing payment of the additional estate tax (sec. 6324B) to the same extent as the land on which the timber stands.

[10] Leases for purposes other than growing timber to which the comparable land is subject are to be ignored in determining the value of qualified timber property in its current use.

timber and land are to be specially valued using the multiple factor method.

Under the current use valuation provision, as amended by the bill, if specially valued standing timber is severed or otherwise disposed of by the qualified heir within 10 years after the decedent's death (or before the death of the qualified heir, if earlier), an additional estate tax would be imposed (sec. 2032A(c)). This additional estate tax is determined by treating the timber as an interest in the real property on which the timber stands or stood.

For purposes of the present rules governing imposition of the additional estate tax in the event of a partial disposition of qualified property (sec. 2032A(c)(2)(D)), the pro rata portion of the value of the property disposed of shall be determined by comparing the number of acres of land on which timber is severed or otherwise disposed of to the total number of acres of specially valued real property owned by the qualified heir. The bill provides a special rule for a severance or other disposition of a portion of the standing timber on an identifiable portion of the specially valued land. In such a case, the amount realized (or the fair market value on the date of severance or disposition in any case other than a sale or exchange at arm's length) on each such severance or disposition is payable as additional tax until the pro rata portion of additional tax attributable to an identifiable portion of the land (including all timber thereon) has been paid.

For purposes of these rules on partial dispositions, an identifiable portion of land is defined as an acre or such other area of land by which the taxpayer normally maintains his business records. The committee anticipates that the Treasury Department will develop regulations defining when a complete severance or other disposition of timber on an identifiable portion of land occurs.

3. Changes to post-death recapture rules

Reduction in recapture period

The bill reduces the present 15-year recapture period to 10 years; the 5-year phase-out period of present law is repealed. Thus, under the bill, the amount subject to recapture is not reduced until expiration of the 10-year period.

Active management in lieu of material participation for eligible qualified heirs

In the case of an eligible qualified heir, the bill provides an alternative to material participation by a qualified heir (or a member of the heir's family)[11] during the recapture period.[12]

The bill provides that an eligible qualified heir is treated as materially participating in the farm or other business operation during periods when the eligible heir (but not a member of the heir's family)

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[11] The required material participation must be that of the decedent or a member of the decedent's family during periods when the decedent owned the property.

[12] Section 2032(c)(7)(B) requires that material participation occur during periods aggregating more than five years of every eight-year period ending after the date of the decedent's death and before 15 years after that date (10 years under the bill).

engages in active management of the farm or other business operation. In the case of an eligible heir who has not attained the age of 21 or who is disabled, the active management may be that of a fiduciary (e.g., a guardian or trustee, but not a general or special agent).

Eligible qualified heirs include the spouse of the decedent, a qualified heir who has not attained the age of 21, a qualified heir who is a full-time student (within the meaning of sec. 151(e)(4) (A) or (B)), and a qualified heir who is disabled (within the meaning of sec. 2032A(b)(4)(B), as added by the bill). Active management means the making of business decisions other than the daily operating decision of the trade or business.[13]

Certain like-kind exchanges nontaxable

The bill provides that an exchange pursuant to section 1031 of qualified real property solely for qualified replacement property to be used for the same qualified use as the original qualified real property does not trigger a recapture of the benefits from current use valuation.[14]

Repeal of election requirement for special involuntary conversion rules

The bill repeals the requirement that a qualified heir make an election to secure the benefits of the special nonrecognition rules for the additional estate tax for involuntary conversions.[15]

Increase in basis of property on which an additional estate tax is paid

The bill provides that the income tax basis of qualified property on which an additional estate tax is paid is to be increased to the fair market value or the current use value of the property as of the date of the decedent's death (or the alternate valuation date under sec. 2032, if the estate elected that provision). This is the basis the qualified heir would have received had current use valuation not been elected for the decedent's estate. This increase in basis is effective as of the date before the disposition or cessation of qualified use; therefore, no retroactive changes in depreciation, or other deductions or credits, would be made to reflect the increased basis. However, in the case of an additional estate tax arising from a disposition of the property, the increased basis is used in determining the gain or loss from the disposition.

Effective Date

These provisions apply to estates of decedents dying after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million in fiscal year 1982, $86 million in 1983, and $81 million in 1986.

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[13] The meaning of active management is more fully discussed in the discussion above of changes to the material participation requirement for qualification of property for current use valuation in the estates of certain surviving spouses.

[14] The lien securing payment of the additional estate tax (sec. 6324B) would have to be transferred to the qualified replacement property before the original qualified property is discharged from that lien.

[15] The lien securing payment of the additional estate tax (sec. 6324B) would have to be transferred to the qualified replacement property before the original qualified property is discharged from the lien.

E. Estate Tax Treatment of Transfers Made Within Three Years of Decendent's Death (sec. 405 of the bill and secs. 1014 and 2035 of the Code)

Present Law

Under present law, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were made in contemplation of death. A gift included in the decedent's gross estate is valued at the time of the decedent's death (or alternative valuation date, if elected). However, any gift tax paid is allowed as a credit against the decedent's estate tax. In general, the net effect of these two provisions is to include in the decedent's gross estate the property's appreciation in value from the date of the gift until the date of death.

An exception to these rules applies with respect to transfers of property (other than transfers with respect to a life insurance policy) where no gift tax return was required to be filed with respect to the gift. Thus, a gift for which no gift tax return was required is generally not included in the decedent's gross estate, while a gift subject to the filing requirements is included at its appreciated value, without reduction for the amount of the gift tax annual exclusion.

Generally, where an interest is brought back into the estate, the donee's basis in such interest is its date of death fair market value, reduced by amounts claimed by the donee as deductions in computing taxable income prior to the decedent's death.

Reasons for Change

The committee generally does not believe it appropriate to tax appreciation that accrues after a gift has been made under the unified estate and gift taxes merely because the donor died within 3 years of the gift. The present rule often results in needless administrative burdens in valuing property twice. However, the committee believes that complete repeal of section 2035 for gifts other than life insurance would allow decedents to arrange their estates on their death bed in order to qualify for certain provisions which depend upon the size and make-up of the gross estate (e.g., secs. 303, 2032A, and 6166). Accordingly, the committee believes that it is appropriate to include gifts made within 3 years of death at their value at the time of the gift.

Explanation of Provision

The committee bill provides that the value of any gift required to be included in a decedent's gross estate because it was made within three years of death shall be its value on the date of gift. The estate will continue to receive a credit for any gift tax paid. Thus, the net effect is to exclude from the gross estate any appreciation in value from the date of gift to the date of death. Conforming changes are made to the basis rules so that the donee's basis in such property is fixed at the time of gift.

The change does not modify the valuation rules with respect to transfers of property included in a decedent's gross estate because (1) the decedent retained the beneficial enjoyment of the property during life, or the power to alter, amend, or revoke a previous lifetime transfer; (2) the property was transferred previously by the decedent but the transfer takes effect at the decedent's death; (3) the decedent possessed a power of appointment over the property; or (4) with respect to the proceeds of life insurance, the decedent possessed an incident of ownership or the proceeds are receivable by the decedent's executor. Thus, such property would still be included in the decedent's gross estate at date of death fair market value. For example, if one year prior to death, a decedent transferred all incidents of ownership in a life insurance policy to a third party, the entire amount of the proceeds would be included in the decedent's gross estate pursuant to sections 2035 and 2042.

Effective Date

This provision of the bill applies to estates of decedents dying after December 31, 1981. Thus a gift made prior to December 31, 1981, and included in the estate of a decedent dying after that date generally will be included at its date of gift value.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million in 1982, $65 million in 1983, and $44 million in 1986.

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F. Extensions of Time for Payment of Estate Tax Attributable to Interests in Closely Held Businesses (sec. 406 of the bill and secs. 6166, 6166A, and 303 of the Code)

Present Law

Under present law, two overlapping provisions permit deferred payment of estate taxes attributable to interests in closely held businesses. If the value of the closely held business (reduced by allowable expenses, losses, and indebtedness) exceeds 65 percent of the value of the gross estate, the applicable estate taxes may be deferred up to 15 years (annual interest payments for five years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special 4-percent interest rate applies to tax on the first $1 million of closely held businesses (sec. 6601(j)). If the value of the closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the applicable taxes may be paid in up to ten annual installments (sec. 6166A). Under both provisions, all payments are accelerated if there is a failure to timely pay any installment, or if there is a disposition of a specified fraction of the value of the decedent's interest in the business. This fraction is one-third in the case of section 6166 and one-half in the case of section 6166A.

Under current income tax law, if more than 50 percent of the gross estate (reduced by allowable expenses, losses, and indebtedness) consists of stock in a single corporation, redemption of all or a portion of that stock to pay estate taxes, funeral and administration expenses will be treated as capital gain instead of dividend income (sec. 303).

Reasons for Change

Under present law, though both section 6166 and 6166A permit deferred tax payments for illiquid estates, there are unnecessary differences between the two sections. The definition of an interest in a closely held business, the percentage of estate assets required to be represented by such interest, the length and conditions of the deferral, the appropriate interest rate and the conditions for acceleration, vary between the sections. In addition, section 303, which permits an estate consisting largely of interests in a closely held business to redeem stock to pay estate taxes, funeral expenses, and administration expenses contains a third threshold minimum value test and different aggregation rules.

The committee believes that these provisions should be simplified and coordinated to provide a single set of rules to govern the estate tax treatment and qualified stock redemption of interests in a closely held business.

In addition, the committee believes that the rules regarding acceleration of deferred payments should be liberalized to permit dispositions of up to 50 percent of an interest in a closely held business.

The committee believes that the acceleration rules with respect to late payments should be expanded to cover all late payments of principal

or interest. However, acceleration should not occur if any such payment is made within six months of the due date.

Explanation of Provision

The committee bill repeals section 6166A and expands the provisions of present law section 6166 to all estates in which the value of a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate. The bill also expands the availability of section 303 which permits qualified stock redemptions to pay estate taxes, funeral, and administration expenses so that redemptions will be permitted if the value of the closely held business exceeds 35 percent of the gross estate or 50 percent of the taxable estate. In addition, the section 303 rules regarding the aggregation of two or more businesses are changed to conform to those in section 6166.

Under the bill, liberalizing changes are made to the acceleration rules in section 6166. First, an estate qualifying for deferral is permitted to dispose of up to 50 percent of the business before triggering acceleration. Second, if any payment of principal or interest is paid within six months of the due date, payments will not be accelerated. Rather, the payment loses eligibility for the special four-percent interest rate and a penalty is imposed, equal to five percent per month, based on the amount of the payment.

Effective Date

These changes apply to the estates of decedents dying after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million in fiscal year 1982, $21 million in 1983, and $14 million in 1986.

G. Disclaimers (sec. 407 of the bill and sec. 2518 of the Code)

Present Law

Under present law, if a person makes a qualified disclaimer, the person is treated as if he never received the property. Instead, the property is considered to have passed directly from the original transferor to the person entitled to receive the property as a result of the disclaimer. A disclaimer is qualified, for purposes of the Federal estate and gift tax law, only if, among other requirements, the disclaimer is effective under local law to divest the disclaimant of ownership and, as a result of the disclaimer, the interest passes without any direction on the part of the person making the disclaimer (sec. 2518).

Reasons for Change

Prior to the enactment of section 2518, the effect of a disclaimer, for Federal estate and gift tax purposes, depended on its validity under the applicable local law. When Congress enacted section 2518, it intended to create a uniform Federal standard so that a disclaimer would be effective for Federal estate and gift tax purposes whether or not valid under local law.

Under section 2518, however, because the disclaimer must be effective to divest the disclaimant of ownership, and pass the interest without direction on the part of the person making the disclaimer, the disclaimer must still satisfy local law. Because applicable law varies from State to State, there is still no uniformity.

The committee believes that a disclaimant should be able to perfect an otherwise valid disclaimer by directing that the interest pass to the person who would have received the property had the refusal been effective under local law.

Explanation of Provision

Under the committee bill, for purposes of the estate and gift tax, a refusal to accept any property interest that is not effective to pass title under local law will be considered to pass the property without any direction on the part of the disclaimant if the refusal otherwise satisfies the Federal requirements and the disclaimant timely transfers the property interest to the person who would have received the property had the refusal been an effective disclaimer under local law. Although the State disclaimer rules will be used to determine the transferee, the refusal need not be a valid disclaimer under local law.

Effective Date

The provision applies to transfers made after December 31, 1981.

Revenue Effect

It is estimated that this provision will reduce budget receipts by less than $5 million annually for fiscal years 1982 through 1986.

TITLE V—COMMODITY TAX STRADDLES

A. Postponement of Recognition of Certain Straddle Losses

(Sec. 501 of the bill, new sec. 1092 and secs. 1091 and 1233 of the Code)

Present Law

Under present law, gain or loss on property is recognized by the taxpayer at the time of the sale or other disposition of the property, unless there is specific statutory provision for nonrecognition.[1] However, losses are allowable only if incurred in a trade or business, incurred in a transaction entered into for profit, or resulting from casualty or theft.

Wash sales

The Internal Revenue Code includes a wash-sale rule providing for non-recognition of certain losses which do not constitute true economic losses where the taxpayer has not terminated his investment in the loss property. This provision disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option or contract to acquire such stock or securities) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date.[2] This provision prevents a taxpayer from selling stock which has declined in value in order to establish a loss for tax purposes and immediately reacquiring similar stock, because the sale and reacquisition together do not significantly alter the taxpayer's position with respect to that stock. No similar Code provision applies with respect to the disposition of property other than shares of stock or securities.[3]

Capital gains and losses

Generally, under present law, gain or loss from the sale or exchange of a capital asset [4] receives special treatment. In the case of individuals, only 40 percent of the excess of the net long-term capital gain over net short-term capital loss for any taxable year is included in the taxpayer's adjusted gross income.[5] In addition, capital losses of individuals are deductible in full against capital gains and against up to $3,000 of

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[1] Sec. 1001.

[2] Sec. 1091.

[3] For this purpose, commodity futures are not treated as stock or securities. Rev. Rul. 71-568, 1971-2 C.B. 312.

[4] Sec. 1221. Capital assets generally include all property held by the taxpayer other than inventory, depreciable property or real property used in a trade or business, certain taxpayer-created property, certain receivables and certain short-term government obligations.

For this purpose, commodity futures contracts may not qualify as inventory. However, they are not allowed capital gains treatment if used as an integral part of the taxpayer's business, such as farming or food processing. *Corn Products Refining Co.* v. *Comm'r.*, 350 U.S. 46 (1955).

[5] Sec. 1202.

ordinary income each year.[6] Only 50 percent of the net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income.[7] Capital losses in excess of this limitation may be carried over to future years indefinitely, but may not be carried back to prior years.[8]

In the case of a corporation, the net capital gain is taxed at an alternative rate of 28 percent.[9] Capital losses are allowed only against capital gains.[10] Any excess loss may be carried back three years and forward five years.[11]

Generally, in order for gains or losses on the sale or exchange of capital assets to be considered long-term capital gains or losses, the assets must be held for one year or more.[12] In the case of futures transactions in any commodity subject to the rules of a board of trade or commodity exchange, the required holding period is six months.[13]

Short sales

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer,[14] but the gain ordinarily is treated as short-term gain.[15] A contract to sell is treated as the short sale for purposes of these rules.[16]

The Code contains several rules which were enacted to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale shall be considered short-term gain, and the holding period of the substantially identical property will generally be considered to begin on the date of the closing of the short sale.[17] These rules prevent the conversion of short-term capital gain into long-term capital gain where the taxpayer is free of any significant risk. Also, if a taxpayer has held property for more than one year and sells substantially

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[6] Sec. 1211(b).

[7] Sec. 1211(b)(1)(C).

[8] Sec. 1212(b).

[9] Sec. 1201.

[10] Sec. 1211(a).

[11] Sec. 1212(a).

[12] Generally, options held for investment are governed by the same provisions of the Internal Revenue Code as are other capital assets. However, section 1233(c) exempts certain options to sell property from the short sales rules if the option was acquired on the same day as the property and the option, if exercised, is exercised through the sale of the property. Section 1234 provides that gain or loss from the sale or exchange of an option has the same character as gain or loss from the sale or exchange of the property underlying the option, if the property were in the hands of the taxpayer. Gain or loss from closing transactions in options is treated as short-term capital gain or loss.

[13] Sec. 1222.

[14] Sec. 1233(a).

[15] Sec. 1233(b)(1). However, if on the date of a short sale, the taxpayer has held substantially identical property for over a year, a loss on the closing of the short sale will be treated as a long-term capital loss. Sec. 1233(d).

[16] Thus, in any commodity futures contract transaction, the person holding the obligation to sell may recognize only short-term capital gain or loss from that position.

[17] Sec. 1233(b).

identical property short, any loss on the closing of the short sale shall be considered long-term capital loss.[18] This rule prevents the conversion of long-term capital loss into short-term capital loss. For purposes of these rules, property includes stock, securities, and commodity futures,[19] but commodity futures are not considered substantially identical if they call for delivery in different calendar months.[20] In addition, these rules do not apply in the case of hedging transactions in commodity futures.[21]

Straddles

Generally, the Internal Revenue Code does not contain any special rules dealing with straddles in commodities or commodity futures contracts.[22] In the case of the typical straddle in commodities (i.e. the holding of a contract to buy a commodity in one month and the holding of a contract to sell the same commodity in a different month), neither the wash sale rule applicable to stocks or securities (sec. 1091), nor the special short sales rules preventing conversion of short-term gain to long-term gain or long-term losses to short-term losses (secs. 1233 (b) and (d)) apply.

However, the Internal Revenue Service has ruled [23] that the loss from certain silver futures contracts constituting part of a straddle was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions." [24] The ruling also stated that the loss claimed on the disposition of one leg of the straddle was not *bona fide* because the disposition represented no real economic change and was not a closed and completed transaction. This ruling has been the subject of much controversy, and the IRS is litigating the deductibility of certain losses claimed in straddle transactions.[25]

Reasons for Change

The possibility that certain transactions called spreads or straddles can defer income and convert ordinary income and short-term capital

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[18] Sec. 1233(d).

[19] Sec. 1233(e) (2) (A).

[20] Sec. 1233(e) (2) (B).

[21] Sec. 1233(g).

[22] Section 1222 provides a six-month holding period for regulated commodity futures contracts. Section 465 contains rules limiting losses from an activity to amounts which certain taxpayers have "at-risk" in that activity. These rules are generally applicable to all activities, other than real estate, in taxable years beginning after 1978. It is unclear whether these rules apply to straddles.

[23] Rev. Rul. 77-185, 1977-1 C.B. 48.

[24] In the transaction described in the Revenue Ruling, the taxpayers on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

[25] The Internal Revenue Service litigation in the area of straddles and the other shelter transactions discussed in this report, such as the cash and carry shelters explained in section B, below, is proceeding on the basis of several theories. If successful, this litigation would result in the disallowance of some or all of the claimed tax benefits.

gain into long-term capital gain has been recognized by the investment industry for decades. In the last ten to fifteen years, the use of such tax shelters in commodity futures has extended beyond investment professionals to significant numbers of taxpayers, individual and corporate, throughout the economy. The tax advantages of spread transactions, especially those structured in commodity futures contracts, have been touted in commodity manuals, tax services and financial journals. Brokerage firms have promoted tax spreads or straddles to their clients. Domestic and offshore syndicates have advertised tax straddle shelters for which purchasers pay a fee in an amount equal to a percentage of their desired tax loss.

Simple commodity tax straddles generally are used to defer tax on short-term capital gain from one tax year to the next tax year and, in many cases, to convert short-term capital gain realized in the first year into preferentially taxed long-term capital gain in a later year. However, in some cases straddles are used to defer tax on ordinary income and convert that income into short- or long-term capital gain. (See discussion of straddles in Treasury bill futures contracts at E, below.) A simple commodity straddle is constructed by taking equal long and short positions in futures contracts in the same commodity with different delivery dates. The two positions, called "legs," are expected to move in opposite directions but with approximately equal absolute changes. Thus, for example, if one leg of a straddle in futures contracts increases $500 in value, the other leg can be expected to decrease in value by about the same amount. By maintaining balanced positions, the risks of the transaction are minimized.

The committee believes that commodity futures markets play an important role in the economy. These markets provide a valuable means for farmers to reduce their risks in the production of crops and for bulk consumers to hedge their risks of price shifts. There has been explosive growth in the futures market over the past decade, and, there is good evidence that such growth will continue. Because of the importance of the commodities markets, particularly in the agricultural and commercial sectors, it is critical that the efficiency of these markets be preserved. The liquidity of these markets must be maintained. Thus, for example, the committee has included an exception to the rules for hedging transactions.

Four considerations dictate that legislative action be taken at this time. First, the use of tax straddles has received substantial public attention. The result is that a broad perception has arisen that it is possible, indeed, perhaps legitimate, to pay no tax at ordinary income rates. The committee recognizes the adverse effects of such a perception and believes that an immediate response to conversion and deferral through commodity transactions is necessary.

Second, the committee believes that the revenue loss, approximately $1 billion annually, may grow substantially because of the low transaction cost and significant leverage available in many commodity futures transactions. Thus, the revenue loss from a failure to act may be substantial. It is estimated that the committee bill will increase budget receipts by $1,351 million in fiscal year 1982.

Third, the widespread tax sheltering activity can cause substantial disruption in the commodity markets. The tax benefits allegedly avail-

able through commodity transactions will cause many taxpayers to engage in transactions that are otherwise uneconomic, with a resulting distortion of supply and demand curves. The percentage of tax-motivated transactions in certain markets may already be very substantial. The marked increase in the number of demands for delivery on Treasury bill futures contracts, noted in recent Decembers, has been linked to tax-motivated transactions and causes some distortion of the market.

Fourth, taxpayers currently confront unnecessary uncertainty in the area of futures and forward contracts. Greater simplicity in the rules governing such transactions and greater certainty about the results of common transactions is essential.

The committee believes that the changes which it is making affirm general principles of present law. Fundamentally, the new rules require that commodity futures transactions be taxed on their economic substance.

Explanation of Provisions

1. Loss deferral rule

The committee bill provides rules to prevent deferral of income and to prevent conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions. Generally, the deduction of losses on straddle positions involving property not on the mark-to-market system (described below) is limited to the amount by which such losses exceed unrealizeed gains on any offsetting straddle positions. In addition, the bill authorizes the Secretary of the Treasury to prescribe regulations applying rules similar to those in subsections (a) and (d) of section 1091 (relating to wash-sales) and those in subsections (b) and (d) of section 1233 (relating to short sales) to straddle gains and losses.

Under the bill, a taxpayer's straddle losses are deferred to the extent the taxpayer has unrealized gains in offsetting straddle positions. If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of loss which may be deducted is the excess of the loss over the unrealized gain (if any) in positions which offset the loss positions and which were acquired before the taxpayer disposed of the loss position. Losses on positions in straddles which the taxpayer identifies as such are not subject to this loss deferral rule, but gain and loss on such identified position must be netted. Losses on such identified straddles are treated as sustained no earlier than the day on which all positions in the identified straddle are closed.

Deferred losses are carried forward to the succeeding year and are subject to the application of the deferral rules in that succeeding year. Deferred losses are recognized in the first taxable year in which there is no unrealized appreciation in offsetting positions acquired before the disposition of the loss position. If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating the loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions. The committee intends that allocation of unrealized gain

positions to unrealized losses be done in a consistent manner that does not distort income. Regulations issued under this bill should provide that one dollar of unrealized appreciation at the end of any year defer at most only one dollar of realized loss.

A straddle composed entirely of futures contracts is not subject to this loss deferral rule. Such straddles will be taxed under the mark-to-market system. (See section C., below.) However, if a straddle is composed only partially of one futures contracts, it will be subject to this loss deferral treatment, unless the taxpayer elects to apply the mark-to-market rules to all positions in the straddle.

Under the bill, certain straddles are exempted from the loss deferral rule and taxed under special rules. The losses on the positions which make up an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all the positions comprising such a straddle. To be treated as an identified straddle, the bill requires that the straddle be clearly marked as an identified straddle on the taxpayer's records before the close of the day it is acquired. For a straddle to qualify as an identified straddle, all of its original positions must be acquired on the same day and either must have all of its positions closed on the same day during the taxable year or must have no positions closed by the end of the taxable year. In addition, an indentified straddle cannot constitute part of a larger straddle (for example, a butterfly).

In determining whether a taxpayer has deductible losses, the unrealized gain taken into account for a straddle position held by the taxpayer at the close of the taxable year shall be equal to the amount of gain which would be realized if the position were sold on the last business day of the taxable year at its fair market value in the case of futures contracts, fair market value is determined by the final settlement prices set by the futures exchanges for each contract on the final trading day of the year.

To verify the amount of loss deductible by the taxpayer, the taxpayer's unrealized gains must be disclosed. The bill requires taxpayers to disclose all their positions which have unrealized gain at the close of the taxable year and the amount of unrealized gain in each of the positions. Positions with unrealized gain must be disclosed whether or not the positions are part of a straddle. Taxpayers will not be required to file disclosure reports on unrealized gains if they have sustained no recognized loss on any position (including regulated futures contracts) during the taxable year. No disclosure report is required for positions which are part of an identified straddle. The exceptions available for identified straddles effectively will make such disclosure elective for most taxpayers. Additionally, a taxpayer is not required to report unrealized gain in inventory positions. The Secretary is authorized to issue regulations prescribing the time, manner and form required for disclosure of such unrealized gains on taxpayers' annual tax returns.

2. Wash sales; short sales

The committee bill requires that the Secretary issue regulations applying rules similar to certain provisions of the wash-sale rule (sec. 1091 (a) and (d)) and of the short-sale rule (sec. 1233 (b) and (d)) to

straddle positions. It is intended that the wash-sale rule be applied in appropriate cases to disallow losses in certain straddle transactions prior to the loss deferral rule of new section 1092. In the typical tax-shelter straddle transaction, for example, the taxpayer, after disposing of the loss leg immediately replaces it in order to remain in a balanced position and protect his unrealized gain. In this case, the modified wash-sale rule will prevent deduction of the loss. Thus, the loss deferral rule of section 1092 does not apply to this loss because section 1092 defers losses only if they are otherwise allowable. Any loss subsequently sustained on either leg of the reconstituted straddle may be deferred by application of new section 1092. Of course, an adjustment must be made to the replacement leg analogous to the basis adjustment made under section 1091(d). Thus, in most cases, the disallowance of losses under the section 1091 rule functions merely to defer the loss.

Under section 1233(b), gain on closing a short position generally results in short-term gain. In addition, the holding period of property held by the taxpayer which is substantially identical to the property sold short and not used to close the short sale, does not commence until the short position is closed (unless the long-term holding period requirement was already satisfied for such property when the short position was created). However, the holding periods of properties not satisfying the substantially identical standard of section 1233 are unaffected by its holding period rule, even if they are offsetting positions subject to the loss deferral rule of new section 1092. Section 1233(b) does not affect, for example, the typical tax-shelter commodity straddle because futures contracts calling for delivery in different calendar months are defined as not substantially identical (sec. 1233(e)(2)(B)). As a result, a short-term gain can be converted into a long-term gain by creating a straddle if the "long leg" increases in value and by holding the straddle for enough time to satisfy the long-term holding period requirement. To prevent this result, the bill authorizes the Secretary to prescribe regulations adopting rules comparable to section 1233(b), but applying such rules to suspend commencement of the holding period for any positions which are part of a straddle subject to new section 1092. For purposes of these rules, a futures contract to sell a commodity is equivalent to the short sale of a long futures contract for the same commodity or the short sale of the commodity itself. The regulations are also to adopt a rule comparable to section 1233(d), to prevent converting a long-term loss into a short-term loss.

Generally, the rules developed under the regulatory authority with respect to sections 1091 and 1233 will have broader application than the present law rules. In the new regulations, the concept of offsetting positions will be substituted for the present law concept of substantially identical property. The application of the new regulatory rules under sections 1091 and 1233 is to supercede any present law applications of those sections in situations where both the new regulations and present law appear to apply.

3. Definition of straddle

The bill defines straddles as offsetting positions with respect to personal property. A taxpayer is treated as holding a straddle if there is

a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property. Although the concept of offsetting positions is not narrowly defined in the statute, certain cases fall outside its scope. For example, a mere diversification of positions usually would not substantially diminish risk for purposes of this bill where the positions are not balanced, and thus, would not be offsetting. Positions in personal property may be treated as offsetting whether or not the property is the same kind. Thus, a straddle can consist of two futures contracts for delivery of silver. A straddle also may consist of two positions which are not the same type of interest in property. A straddle may be made up of a cast position in silver, i.e., holding the physical commodity itself, and of a futures contract to sell the same amount of silver.

Under the bill, taxpayers are presumed to hold offsetting positions in certain specified circumstances. The first presumption provides that positions in the same personal property, whether in the physical commodity itself or in a contract for the commodity, are considered offsetting positions, provided the values of the positions vary inversely with each other. Generally, values vary inversely if the value of one position decreases when the value of the other position increases. A straddle in silver futures contracts or a straddle in cash silver and a futures contract to sell silver falls within this presumption.

The second presumption covers positions in the same personal property, even though the property may be in a substantially altered form, provided the values of the offsetting positions vary inversely with respect to each other.

The third presumption covers positions in debt instruments of similar maturities if the positions ordinarily vary inversely in value in relation to each other. The Secretary may prescribe other types of positions in debt instruments which will be presumed to be offsetting, provided the inverse variation test is passed.

The fourth presumption treats positions sold or marketed as offsetting positions as straddles. The presumption does not depend on the positions being labelled by any particular name, such as straddle, spread, or butterfly.

The fifth presumption provides that positions are presumed offsetting if the aggregate margin requirement for such positions ordinarily is lower than the sum of the margin requirements for each of the positions when held separately. Thus, if the value or amount of the deposit, pledge, payment, security, or other requirement for holding two or more positions together ordinarily is less than the cost of holding each alone, this presumption applies. Generally, the lower margin for the aggregate holdings is evidence that there is less economic risk associated with holding the combined positions than with holding each of the positions separately.

The bill also authorizes the Secretary to issue regulations prescribing other factors, including subjective or objective tests, to establish a presumption that positions are offsetting. The values of positions presumed offsetting under this regulatory authority must vary inversely. This authority enables the Secretary to develop presumptions which treat complex or innovative types of straddles as offsetting positions.

Any presumptions established under the bill's specific rules or under the regulatory authority provided by the bill can be rebutted.

4. Definitions and special rules

The bill defines personal property as any personal property, other than stock, of a type which is actively traded. A position is an interest in personal property, including a futures contract, a forward contract, or an option. In addition to corporate stock, the bill does not apply to real property nor to property which is not actively traded.

The term "position" includes options to buy or sell stock which is actively traded, provided either that the exercise period exceeds that required for long-term capital gain treatment or that the options are not traded on a domestic exchange. Thus, the bill's major rules apply to offsetting positions in stock options which can be held for more than 12 months. The definition of position excludes, and thus the major rules are inapplicable to, stock options traded on United States exchanges, if the options cannot produce long-term capital gain or loss.

An attribution rule treats positions which are held by a person related to the taxpayer as positions held by the taxpayer. Persons related to the taxpayer are the taxpayer's spouse and a corporation which files a consolidated return with the taxpayer under section 1501. In addition, certain positions held by flow-through entities, such as trusts, partnerships, or subchapter S corporations, are treated as held by the taxpayer. If part or all of the gain or loss from a position held by a flow-through entity would be properly taken into account in determining the taxpayer's own Federal tax liability, the position is treated as held by the taxpayer, unless regulations provide otherwise.

New section 1092(a) providing for deferral of certain losses and the regulations to be issued under this bill to apply wash-sale (sec. 1091) and short-sale (sec. 1233) principles to straddle transactions do not apply to hedging transactions. The hedging transactions excepted from these rules also are excepted from the bill's mark-to-market and capitalization rules. (See sections B. and C., below.) Hedging is defined in the mark-to-market provisions (sec. 1256(e)) and refers to certain risk-limiting transactions conducted in the normal course of the taxpayer's trade or business which produce ordinary income or loss. A transaction qualifies for the exception only if it is clearly identified by the taxpayer as being a hedging transaction before the close of the day on which the transaction is executed. Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items.

Taxpayers may elect to apply the new rules governing the taxation of straddles to positions which they held on June 23, 1981, for periods after that date, provided they make the election for all positions held on that date.

5. Penalty for failure to disclose gains

Taxpayers who without reasonable cause fail to report their unrealized gains are subject to a penalty, if they have a tax deficiency attributable to a denial of a loss deduction because they hold an off-

setting position with unrealized gain. The penalty for the failure to report unrealized gain is determined in the same way as the penalty for negligence or intentional disregard of rules and regulations (but without intent to defraud) in section 6653(a). The penalty assessed is the amount equal to 5 percent of the underpayment. Thus, for example, if a taxpayer who does not report all unrealized gain positions has an underpayment because the taxpayer is determined to have held an offsetting unrealized gain position, the taxpayer must pay the penalty, even if the taxpayer obtained a counsel's opinion that the unrealized gain did not offset the loss. To avoid the penalty, a taxpayer claiming a deduction for the loss may rely on the opinion, but the taxpayer also must disclose all unrealized gain positions and must indicate that none of the disclosed gain positions is considered an offsetting position.

Effective Date

The changes made by this provision generally apply to property acquired and positions established by the taxpayer after June 23, 1981.

B. Capitalization of Certain Interest and Carrying Charges

(Sec. 502 of the bill and sec. 263 of the Code)

Present Law

Under present law, carrying charges, such as storage, insurance, and interest on indebtedness incurred or continued to purchase or carry a commodity held for investment are deductible as an expense paid or incurred for the management, conservation, or maintenance of property held for the production of income (secs. 163 and 212), notwithstanding that the sale of the property may result in long-term capital gain.

However, a limitation is imposed under section 163(d) on interest on investment indebtedness. Generally, the deduction for such interest is limited to $10,000 per year plus the individual taxpayer's net investment income. Any remaining amount can be carried over to future years.

Reasons for Change

The committee believes that the use of certain straddles, which are executed with deductible financing and carrying charges, to defer ordinary income and to convert it into long-term capital gain, has become a serious tax-avoidance problem posing substantial revenue losses. The committee intends to discourage these transactions, sometimes called "cash and carry" shelters, in its legislation.

"Cash and carry" tax shelters usually involve the purchase of a physical commodity, such as silver, and the acquisition of a futures contract to deliver (sell) an equivalent amount of the same commodity more than twelve months in the future. The taxpayer finances the purchase with borrowed funds, and deducts the interest expense, storage, and insurance costs in the first year. These deductions offset ordinary investment income, e.g., interest and dividends.

Because the price differential between the current price of the physical commodity and the price of the futures contract for a distant month is largly a function of interest and other carrying charges, the futures contract will have a value approximately equal to the total payment for the physical commodity plus interest and carrying costs. The taxpayer will hold the silver and the offsetting futures contract into the next year.

When the 12-month holding period has passed, the taxpayer will deliver the silver on the futures contract and realize a gain on the silver. If the price of silver has increased, the taxpayer can sell the silver, producing long-term capital gain, while closing out the short futures position, creating a short-term capital loss. In either event, the net gain on the two positions will be about equal to the interest and carrying charges but will be treated as long-term capital gain. Thus, in 1981, investment income taxable at rates as high as 70 percent, would be deferred for a year and converted into capital gains taxable at

maximum rates no higher than 28 percent. (The bill also reduces the maximum rate on investment income from 70 to 50 percent in 1982, which results in the reduction of the maximum long-term capital gains rate from 28 to 20 percent.)

Because the committee recognizes that certain legitimate business transactions, such as hedging, which result only in ordinary income or loss, lack significant tax avoidance potential, it exempts such activities from the bill's rules on "cash and carry" transactions.

Explanation of Provision

The committee bill requires taxpayers to capitalize certain otherwise deductible expenditures for personal property if the property is held as part or all of an offsetting position belonging to a straddle. Such expenditures must be charged to the capital account of the property for which the expenditures are made. Thus, these expenditures will reduce the gain or increase the loss recognized upon the disposition of the property.

Expenditures subject to this capitalization requirement are interest on indebtedness incurred or continued to purchase or carry the property, as well as amounts paid or incurred for insuring, storing or transporting the property. The amount of expenditures, called carrying charges, to be capitalized is reduced by any interest income from the property (including original issue discount), which is includible in gross income for the taxable year, and any amount of ordinary income acquisition discount (new sec. 1232(a)(4)(A)) includible in gross income for the taxable year.

The capitalization requirements do not apply to any identified hedging transactions (sec. 1256(e)) or to any position which is not part of a straddle. Thus, for example, a farmer still can deduct currently the costs of financing crops. Similarly, securities dealers' expenses for financing their inventory and trading accounts which generate ordinary income or loss remain deductible currently.

Effective Date

This provision applies to property acquired and positions established by the taxpayer after June 23, 1981, in taxable years ending after that date.

C. Regulated Futures Contracts Marked to Market

(Sec. 503 of the bill and new sec. 1256 of the Code)

Present Law

Generally, the Internal Revenue Code does not contain any special rules dealing with straddles in commodities or futures contracts in commodities. In the case of the typical straddle in commodity futures contracts (i.e. the holding of a contract to buy a commodity in one month and the holding of a contract to sell the same commodity in a different month), neither the wash sale rule applicable to stocks or securities (sec. 1091), nor the special short sales rules preventing conversion of short-term gain to long-term gain, or long-term losses to short-term losses (secs. 1233 (b) and (d)) apply.

However, the Internal Revenue Service has ruled [1] that the loss from certain silver futures contracts was not deductible because the taxpayer "had no reasonable expectation of deriving an economic profit from the transactions." [2] This ruling has been the subject of controversy, and the IRS is litigating the deductibility of certain losses claimed in straddle transactions.[3]

Tax rules of general application which affect the taxation of transactions in commodity futures contracts are discussed in section A., ***Present Law,*** above.

Reasons for Change

Because of the rapid, significant growth in the use of tax straddles, especially those structured in commodity futures contracts, by high- and middle-income individuals as well as corporate taxpayers, the commodities. In the case of the typical straddle in commodity futures tax-avoidance transactions.

A taxpayer using a simple futures straddle as a tax shelter will establish a position in contracts with contract prices of about, say, $10,000 each. The two contracts, one to buy, the other to sell, are identical in every respect, except for their delivery months. Because the taxpayer's position is a straddle, his margin deposit will be very low—as little as one percent of the value of the position ($200). The taxpayer will wait for the market to move, so that one leg of the straddle

[1] Rev. Rul. 77–185, 1977–1 C.B. 48.

[2] In the transaction described in the Revenue Ruling, the taxpayers on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

[3] *Smith* v. *Comm'r*, Docket No. 12709–77 and *Jacobsen* v. *Comm'r*, Docket No. 185–78.

shows a loss, e.g., $500, and the other leg shows an almost identical gain. The taxpayer will liquidate the loss by entering into the opposite futures contract for the same month. (A contract to sell December wheat, for example, is liquidated by executing a contract to buy December wheat.) In order to maintain a balanced, minimal-risk position, the taxpayer will replace the liquidated leg with a contract which is identical, except for its delivery month. (The replacement contract will have a contract price of about $9,500, if the original long leg was liquidated at a loss, or a contract price about $10,500, if the original short leg was liquidated at a loss.)

The taxpayer will claim the decrease in value in the liquidated leg as a $500 short-term capital loss and deduct it from his income, thereby eliminating a $500 short-term gain for the tax year. At the same time, the taxpayer will continue to hold the other leg, which will have an unrealized gain approximately equal to his "realized loss," that is, about $500. However, the taxpayer will not have made any payment on the liquidated leg because no payment is due on a futures contract until its delivery date. In addition, because the taxpayer maintained a balanced position, he ordinarily will not be required to deposit any additional margin into his margin account.

The taxpayer will hold the two legs into the following year. In the second year, the taxpayer will close out the two positions. Assuming the holdover contract has increased another $500 in value, the taxpayer will recognize a total gain of about $1,000 on the original leg and about a $500 loss on the replacement leg. If the gain is on the long (buy) position and that position was held for over six months, the taxpayer will report a $1,000 long-term capital gain on the long position and a $500 short-term capital loss on the short position. If he has no other capital transactions for the year, he will report the $500 difference between these legs as long-term capital gain. (His margin, less commissions, will be returned.) Thus, he will have succeeded in deferring his short-term capital gain for one year and converting it to a long-term capital gain. If the gain is in the short (sell) position, the gain will be short-term capital gain. In this case, the taxpayer gets a one-year deferral, but no conversion.

The committee believes that the enactment of tax rules, based on the actual operations of futures trading, will end this use of futures for tax-avoidance purposes, establish an accurate method of determining a taxpayer's futures income (or loss), and ease tax administration and paperwork for both Government officials and taxpayers.

The United States commodity futures exchanges employ a unique system of accounting for every contract's gain or loss in cash on a daily basis. Even though a futures trader does not close out a position but continues to hold it, the trader receives any gain on the position in cash as a matter of right each trading day.

If a trader's position has increased in value during the day, the net increase in the position is computed and transferred to the trader's account before the beginning of trading the next day. The trader has the right to withdraw the full amount of such gains immediately every trading day. However, if a trader's position decreases in value, the trader will have to meet a margin call, that is, deposit additional funds before the next business day. Money paid on position losses is paid

into the exchange clearing association which transfers such amounts to accounts which gained during the trading day. This daily accounting which includes the determination of contract settlement prices and margin adjustments to reflect gains and losses is called "marking-to-market."

Marking-to-market requires daily cash adjustments through the exchange clearing association to reconcile exchange members' net gains and losses on their positions. At the close of trading each day, every member must mark all customer accounts to the settlement prices (current market value) for the day. Gains and losses are immediately deposited into or withdrawn from the customer accounts. Customers in turn are entitled to withdraw their gains, or are required to deposit any margin required because of losses in their accounts at the close of every day under this marking-to-market system.

The committee bill adopts a mark-to-market system for the taxation of commodity futures contracts. This rule applies the doctrine of constructive receipt to gains in a futures trading account at year-end. The application of this rule in present law means, for example, that taxpayers must include in their income any interest which has accrued during the year, even though they may nto have withdrawn the interest from their savings accounts. Because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, the committee believes it appropriate to measure the taxpayer's futures' income on the same basis for tax purposes.

Explanation of Provision

In general

Under the committee bill, gain and loss from regulated commodity futures contracts must be reported on an annual basis under a mark-to-market rule which corresponds to the daily cash settlement, mark-to-market system employed by commodity futures exchanges in the United States for determining margin requirements. Futures contracts subject to the new mark-to-market rules are excepted from the loss deferral rule (new sec. 1092), the regulations authorized to adopt wash-sale and short-sale principles which apply to straddle positions, and the capitalization rule (sec. 263(g)).

All futures contracts must be marked-to-market at year end. Each regulated futures contract held by a taxpayer is treated as if it were sold for fair market value on the last business day of the year. Ordinarily, the settlement prices determined by an exchange for its futures contracts on the year's last business day are to be considered the contract's fair market value. Any gain or loss on the contract is taken into account for the taxable year, together with the gain or loss on other contracts which were held during the year but closed out before the last business day. Thus, taxpayers' net gain or loss is approximately equal to the aggregate net amount which is credited to their margin accounts, or which they had to pay into their accounts, during the year.

If a taxpayer holds futures contracts at the beginning of a taxable year, any gain or loss subsequently realized on these contracts must be adjusted to reflect any gain or loss taken into account with respect to these contracts in a prior year.

Any capital gain or loss on a regulated futures contract which is marked-to-market is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent of the gain or loss is long-term capital gain or loss. For 1982 and later years, this allocation of capital gain between short-term and long-term results in a top rate of tax of 32 percent. Any ordinary income or loss items on the mark-to-market system continue to be taxed at the regular tax rates applicable to such income.

The mark-to-market rules, including the allocation between long-term and short-term capital gain or loss, apply to a termination of a taxpayer's obligation with respect to a regulated futures contract whether the termination is executed by offsetting, by taking or making delivery, or in some other manner. Gain or loss upon termination is determined on the basis of the contract's fair market value at the time of termination, ordinarily the actual price received or paid.

Unless specifically excepted, all regulated futures contracts are subject to the mark-to-market rules.

A regulated futures contract means a contract (1) which requires delivery of personal property or an interest in personal property, as defined in new section 1092(d)(1); (2) which is marked-to-market under a daily cash flow system of the type used by United States futures exchanges to determine the amount which must be deposited, in case of losses, or the amount which may be withdrawn, in the case of gains, as a result of price changes with respect to the contract during the day; and (3) which is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or of any board of trade or exchange which the Secretary determines operates under rules adequate to carry out the purposes of the mark-to-market provisions.

The bill provides special rules for the taxation of straddles composed of at least one position in regulated futures contracts and one or more positions in interests in property which are not regulated futures contracts. If the taxpayer clearly identifies each position in such a straddle as belonging to the straddle by the close of day of the position's acquisition, the straddle is called a mixed straddle. The taxpayer may elect either to treat all the positions in mixed straddles, regulated futures contracts as well as other property, on a mark-to-market basis for tax purposes; or, to exclude all positions in the mixed straddle, including regulated futures contracts, from the mark-to-market rules, in which case, they will be subject to the loss deferral, wash sale, and short sale rules. The taxpayer's election is permanent and may be changed only with the consent of the Secretary.

If a taxpayer fails to identify the positions constituting a mixed straddle, or, if a taxpayer fails to make an election of a consistent tax treatment for all the positions in such a straddle, the amount of any gain or loss on futures contracts in the straddle is determined under the mark-to-market rules. Gain or loss on other positions in the straddle is determined under the regular tax rules. All poisitions in the straddle, both futures contracts and other property, are subject to the loss deferral rule in section 1092, the modifications of the wash sale and short sale rules applicable to straddles, and the capitalization rule in section 263(g). The application of section 1092 to such uniden-

tified mixed straddles will result in the deferral of all losses with respect to which there is offsetting unrealized gain, so that losses realized on the mark-to-market system are deferred to the extent there are unrealized gains in other property. Similarly, losses on property outside the mark-to-market system are deductible to the extent of gains on futures contracts in the mark-to-market system (provided there are no unrealized gains in other offsetting positions.)

Hedging exemption

The mark-to-market rules do not apply to hedging transactions. For purposes of the mark-to-market rules, a hedging transaction means an identified transaction which the taxpayer executes in the normal course of his or her trade or business primarily to reduce certain risks and which results in only ordinary income or loss. Hedging transactions are varied and complex. They may be executed in a wide range of property and forms, including options, futures, forwards, and other contract rights and short sales.

A hedging transaction may be executed to reduce the risk of price change or of currency fluctuations with respect to property which is held or to be held by the taxpayer and which, if disposed of, whether by sale, exchange, lapse, cancellation, or otherwise, at a gain, produces ordinary income. Also, a hedging transaction may be executed to reduce risk of price or interest rate changes, or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, provided all income or gain on such borrowings or obligations is treated as ordinary income. Transactions which result in capital gains or capital losses do not qualify for the hedging exemption. Speculation in commodity futures contracts, for example, does not qualify for this exemption whether a trader takes outright long or short positions, or whether a trader speculates in spreads, because futures speculation always produces only capital gains or capital losses.

For a transaction which would generate ordinary income or loss under normal tax principles to qualify as a hedging transaction, the transaction must be clearly identified in the taxpayer's records as being a hedging transaction before the close of the day on which the transaction was entered into. Regulations should allow taxpayers to minimize bookkeeping identification requirements in as many cases as practicable. In situations where hedging transactions are numerous and complex, but opportunities for manipulation of transactions to obtain deferral or conversion of income are minimal, it generally is unnecessary to require taxpayers to identify and match in their records hedging activities with hedged properties. In certain hedging transactions, for example, those conducted by banks, it may be extremely difficult to match a hedging contract with a specific hedged property. In such cases, it may be sufficient for this identification requirement to mark an entire account, such as the bank's securities trading account, as a hedged account. If the bank's securities trading account, which produces only ordinary income or loss, is managed and recorded independently and separately from the bank's investment account (and any other capital asset account), there is little danger of manipulation for conversion. Moreover, because Federal regulatory agencies impose

certain standard accounting practices on banks, their deferral opportunities too are limited. Thus, detailed identification or matching of such hedging activities ordinarily would serve no useful purpose.

However, in cases where taxpayers do not maintain and manage their ordinary income transactions separately from their capital transactions and where other factors indicate a danger of manipulation, more detailed identification records may be required. If property has ever been identified by the taxpayer as being part of a hedging transaction, gain from the sale or exchange of the property may never be treated as capital gain but must be reported as ordinary income. In no event is the provision of this hedging exemption to be interpreted as precluding the Commissioner of Internal Revenue from exercising his present law authority to require that taxpayers employ accounting methods which clearly reflect their income.

Syndicate rule

In order to prevent possible manipulation of the hedging exemption by tax shelters structured as limited partnerships, the exemption for hedging transactions does not apply to transactions entered into by syndicates. Thus, unless excluded as mixed straddles, a syndicate's transactions in futures contracts are taxed under the mark-to-market rules, the loss deferral rule in section 1092, the modifications of the wash sale and short sale rules, and the capitalization rule in section 263(g).

A syndicate means any partnership or other entity (other than a regular, subchapter C corporation), if at any time interests in the entity have been offered for sale in an offering required to be registered with any Federal or State agency authorized to regulate security sales offerings; or, if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs within the meaning of section 464(e)(2). The Secretary may increase the percentage of losses allocable to limited partners or limited entrepreneurs by entities which are dealers in securities on a case-by-case basis. The Secretary may exercise this discretion to waive the 35-percent test with respect to dealers in securities when the facts and circumstances in a specific case indicate that a waiver is necessary for legitimate and demonstrated business reasons and that the waiver is not sought, nor could it be exploited, for tax-avoidance purposes. The waiver authority provides flexibility to deal with situations involving hardship or changed circumstances, such as the death or retirement of general partners. In some cases, it may be appropriate to grant the waiver from the effective date of the provision. An individual who actively participates in the management of an entity is not considered a limited partner or a limited entrepreneur with respect to the entity for the period of the individual's active management.

Election

Taxpayers may elect the new rules governing the taxation of straddles, including the mark-to-market rules, for positions which they held on June 23, 1981, for periods after that date. The election must cover all positions held by the taxpayer on that date.

Effective Date

The changes made by this provision generally apply to property acquired and positions established by the taxpayer after June 23, 1981, in taxable years ending after such date.

The identification requirement for hedging transactions in section 1256(e)(2)(C) shall apply to property acquired by the taxpayer after December 31, 1981, in taxable years ending after that date.

D. Carryback of Losses From Regulated Futures Contracts to Offset Prior Gains From Such Contracts

(Sec. 504 of the bill and sec. 1212 of the Code)

Present Law

Under present law, taxpayers may carry ordinary losses which are net operating losses back to each of the three taxable years preceding the losses and forward to each of the seven subsequent taxable years (sec. 172(b)).[1] Corporations generally may carry capital losses back to the three preceding taxable years and forward to the five subsequent taxable years (sec. 1212(a)). Individual taxpayers may carry capital losses forward, but not back to prior years (sec. 1212(b)).

Individual taxpayers with significant increases in income may qualify to average their income over a five-year period which includes the four preceding taxable years (secs. 1301–1305). However, significant decreases in income do not entitle taxpayers to benefit from the provisions for income averaging.

Reasons for Change

Investors in commodity futures contracts bear substantial risks and sometimes incur very significant losses because of the volatility of many futures markets. The committee recognizes the significance of these risks, and the unique nature of futures contracts which are marked-to-market daily for both trading and tax purposes, even though an investor may continue to hold the same position in futures contracts. The committee believes that the possible economic distortions in income tax liability which might result from these factors should be alleviated; therefore, the committee provides a three-year carryback for losses on futures contracts taxed under the mark-to-market rules.

Explanation of Provision

The committee bill permits an election under which net commodity futures capital losses may be carried back 3 years and applied against net commodities futures capital gains during such period. The carryback applies only if, after netting regulated futures contracts and other positions subject to the marked-to-market rule of section 1256 with capital gains and losses from other sources, there is a net capital loss for the taxable year which, but for the election, would be a capital loss in the succeeding year under section 1212(b). The lesser of such net capital loss or the net loss resulting from the application of the marked-to-market rule of section 1256(a) constitutes the "net commodity futures loss" which may be carried back.

The amount carried back may be applied only against net gains resulting from application of the marked-to-market rule of section

[1] This bill amends 172(b) to allow a 10-year carryforward of net operating losses.

1256(a) in the carryback year. Such gains must be reduced by any net capital loss to which section 1256(a) did not apply in the carryback year, so that only to the extent the taxpayer had a net capital gain in the carryback year would any portion of the loss be allowed.

Amounts carried back under the election are to be treated as if 40 percent of the losses are short-term capital losses and 60 percent are long-term capital losses. Such losses must be absorbed in the earliest year to which they may be carried back and any remaining amount is then carried forward to the next year in the same proportions of 40 and 60 percent. Losses are not allowable to the extent they would create or increase a net operating loss for the carryback year. Amounts against which losses may be applied in the carryback year, i.e., "net commodities futures gain," are determined without regard to "net commodity futures loss" for the loss year or any year thereafter. Because the marked-to-market system begins in 1981 and no taxpayer has net marked-to-market capital gains for a prior year, 1981 is the earliest year to which net commodity futures capital losses can be carried back.

Losses absorbed in carryback years under the election are treated as capital gains for the loss year in the 40-percent short-term and 60-percent long-term proportions for the purpose of determining the amount of any net capital loss to be carried forward to a succeeding year under section 1212(b)(1). If capital losses are carried forward under section 1212(b), to the extent they were determined under the marked-to-market rule of section 1256(a), they continue to be treated as losses from regulated futures contracts in the year to which they are carried.

The carryback election does not apply to an estate or trust.

The capital loss carryback election for regulated futures contracts may be illustrated by the following example:

Assume that the taxpayer in 1985 has net losses of $100,000 from regulated futures contracts under the marked-to-market rule of section 1256(a). In addition, the taxpayer has a $3,000 short-term capital loss and a $50,000 long-term capital gain. Under section 1211, the taxpayer's capital losses are applied against the $50,000 of long-term capital gain and $3,000 of other income, leaving a $50,000 loss. If the carryback election under section 1212(c) is not made, the $50,000 loss may be carried to 1986 under section 1212(b). Initially, the $100,000 net loss from regulated futures contracts is treated as $40,000 of short-term loss and $60,000 of long-term loss under the marked-to-market rule. Since the taxpayer has $50,000 of long-term gain from other sources, only $10,000 of long-term loss remains, which, along with the $40,000 short-term loss, is carried to 1986 and treated as losses from regulated futures contracts in that year.

If the taxpayer makes the section 1212(c) election, his net losses from regulated futures contracts are carried back to 1982 but only to the extent of the net capital loss which would otherwise become a capital loss in 1986 under section 1212(b), i.e., $50,000. The amount carried back is treated as 40-percent short-term loss and 60-percent long-term loss in the carryback year. Thus, the $50,000 carried back will be treated as $20,000 of short-term loss and $30,000 of long-term loss from regulated futures contracts in 1982. The amount carried

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back may be applied only against gains from regulated futures contracts in the carryback year and only to the extent the taxpayer had a net capital gain in such year.

Assume that the taxpayer in 1982 had a net gain of $50,000 from regulated futures contracts and a long-term capital loss from other sources of $30,000. His gains subject to section 1256 were $20,000 short-term and $30,000 long-term which was absorbed by the $30,000 of unrelated long-term loss, leaving a net short-term gain of $20,000 to be offset by $20,000 of the $50,000 loss carried back from 1985. The unused portion of the loss, $30,000, may be carried to 1983 and treated as 40 percent short-term and 60 percent long-term in that year. The short-term and long-term amounts would be $12,000 and $18,000 in 1983.

If the taxpayer has no net gains or losses from regulated futures contracts in 1983 or 1984, the $30,000 of unused loss would be carried forward to 1986 under section 1212(b) and would be treated as losses from regulated futures contracts in that year. For this purpose, section 1212(b)(1) is applied by treating the amount of loss absorbed as a carryback loss, $20,000, as though it were additional capital gain in the 40-percent short-term, 60-percent long-term ratios in 1985. Thus, of the $20,000 of short-term loss and $30,000 of long-term loss carried back, $12,000 ($20,000 minus $8,000) and $18,000 ($30,000 minus $12,000) of short-term loss and long-term loss respectively remain to be carried forward as losses from regulated futures contracts in 1986.

Effective Date

This provision applies to property acquired and positions established by the taxpayer after June 23, 1981, in taxable years ending after that date. Losses may be carried back to taxable years no earlier than taxable years ending in 1981.

E. Certain Governmental Obligations Issued at Discount Treated as Capital Assets

(Sec. 505 of the bill and secs. 1221 and 1232 of the Code)

Present Law

Under present law, most assets held for investment are treated as capital assets. Net long-term gain from the sale or exchange of these assets results in favorable tax treatment and any deductions for net losses from sales or exchanges of capital losses are limited. (See discussion of capital gains under the present law discussion of straddles.) Gain or loss from the disposition of assets which are neither capital assets nor business assets is treated as ordinary and is not eligible for lower tax rates nor subject to the capital loss limitations.

Certain governmental obligations (Treasury bills) issued on a discount basis payable without interest at a fixed maturity not exceeding one year from the date of issue are not treated as capital assets (sec. 1221(5)). This provision was originally added to the Internal Revenue Code in 1941, to relieve taxpayers of the requirement of separating the interest element from the short-term capital gain or loss element when an obligation is sold before maturity.[1] Thus, all gains or losses from transactions in such obligations are treated as ordinary income or ordinary loss at the time the obligation is paid at maturity, sold, or otherwise disposed of (sec. 454(b)).

The IRS has held that a futures contract to purchase Treasury bills is a capital asset if held for investment.[2] Thus, for tax-avoidance purposes, some taxpayers holding offsetting positions in Treasury bill futures take delivery of the Treasury bills on the loss leg of the straddle and sell the bills themselves in order to convert the short-term capital loss on the futures contract into a fully-deductible ordinary loss on the bills.

Reasons for Change

Because of the ordinary income character of Treasury bills, these obligations have been used together with capital assets in the design of tax shelters to convert ordinary income to capital gains. In combination with other bonds, all of which are capital assets, and with futures contracts for Treasury bills, straddles have been structured which their promoters say result in significant tax-savings. Tax shelter straddles in Treasury bill futures are causing significant losses in tax revenues.

Tax straddles in Treasury bill futures are believed to offer features unavailable in other futures straddles. These shelters can be used to convert ordinary income, including, for example, salary, wages, interest, and dividends, into long-term capital gain. This opportunity occurs because, under statutory rule, gain or loss on the sale of Treasury

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[1] S. Rep. 673 (77th Cong.), Part I, p. 30.

[2] Rev. Rul. 78-414, 1978-2 C.B. 213.

bills is considered ordinary income or loss, while, under IRS interpretation, gain or loss on the sale of T-bill futures contracts is considered capital gain or loss. Straddles in Treasury bill futures generally are structured in the same way as other futures straddles: contracts to buy Treasury bills are offset by an equivalent number of contracts to sell Treasury bills. The execution of these "T-bill" shelters involves one difference: in the case of a loss on a long leg, when the delivery month for the loss leg of the straddle arrives, the taxpayer takes delivery of the bills and then disposes of the bills themselves creating an ordinary loss; in the case of a loss on a short leg, the taxpayer purchases the bills at the market price and delivers the bills themselves at the contract's lower price creating an ordinary loss. Ordinary losses are fully deductible against any type of ordinary income.

The remainder of the straddle transaction is executed in the usual fashion. The taxpayer immediately replaces the liquidated leg. In the following year, the entire straddle is closed out and, if the gain occurs on the long position (contract to buy), the gain is reported as long-term capital gain. Some taxpayers may decide to re-straddle in the second year and roll-over their gains and other income indefinitely into the future.

The committee is concerned about the adverse impact of Treasury bill straddles on Government tax revenues. Moreover, the number of contract holders demanding performance on Treasury bill futures contracts has at the end of some years threatened to exceed the supply of deliverable bills. This delivery problem could disrupt Treasury bill markets and damage Government financing generally. Therefore, the committee believes that Government revenue and finance considerations require that these shelter activities be discouraged and that Treasury bills be characterized as capital assets. This change will protect both Government revenues and debt management.

Because securities dealers' inventories are ordinary income or loss accounts under present law, without regard to sec. 1221(5), this change does not affect their operations. The computation of discount income will entail only a minor increase in taxpayers' paperwork. The committee rule is adopted as the simplest and most correct method of measuring such income.

Explanation of Provisions

The committee bill provides that obligations of the United States, of its possessions, of a State or political subdivision of a State, or of the District of Columbia, issued on a discount basis and payable without interest in less than one year, are treated as capital assets in determining gain or loss. Thus, these obligations are treated by the holder in the same manner as similar debt obligations. Any discount at issue is considered interest and is taxed under generally applicable tax rules.[3] Obligations with respect to which interest is not includable in income under section 103 are excluded from the new rules.

In order to facilitate the determination of discount applicable to any holder, the bill adds a new paragraph (4) to section 1232(a), treating as ordinary income the gain from the disposition of an obligation to the extent of the ratable share of "acquisition discount" applicable

[3] See e.g., *U.S.* v. *Midland Ross Corporation*, 381 U.S. 54 (1965).

to the taxpayer. The ratable share is the portion equal to the ratio of the number of days the obligation is held by the taxpayer to the number of days between the date of acquisition by the taxpayer and the date of maturity. Acquisition discount is the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation. For purposes of this provision, stated redemption price at maturity includes any interest payable at maturity. This formulation will enable each holder to determine the portion of any proceeds from disposition of an obligation to be treated as ordinary discount income without reference to original issue discount or the treatment applicable to any other holder. Any gain exceeding the taxpayer's ratable share of acquisition discount is short-term capital gain and any loss on disposition of an obligation is short-term capital loss.

Effective Date

This provision applies to property acquired and positions established by the taxpayer after June 23, 1981.

F. Prompt Identification of Securities by Dealers in Securities

(Sec. 506 of the bill and sec. 1236 of the Code)

Present Law

Under present law, gains and losses from property held primarily for sale to customers in the ordinary course of business are taxed as ordinary gains or losses. Gains and losses from property held for investment are taxed as capital gains and losses.

Gains and losses of a person from the sale of property of a type held by the person primarily for sale are generally ordinary. However, the Code contains a rule (sec. 1236) to allow a securities dealer to identify and segregate certain of its assets as held for investment. Gains and losses from the sale of these assets may be treated as capital gains or losses.

In order to receive capital gains treatment, a security held by a dealer must be "clearly identified" on the dealer's records as held for investment within 30 days following the date of acquisition and may not thereafter be held primarily for sale to customers. If a security is at any time clearly identified as held for investment, ordinary loss treatment is denied.

The term "security" means any share of corporate stock, any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to any of the above.

Reasons for Change

Because a dealer can wait 30 days to identify securities held for investment, the dealer may wait the 30 days to determine which securities increase in value. The dealer might choose to identify these appreciated securities as held for investment in the expectation that this appreciation will hold or continue and be eligible for preferential treatment as long-term capital gain upon disposition of the security. Also, the dealer might want to treat any securities which have declined in value as held primarily for sale to customers in order to treat losses from these securities as fully deductible ordinary losses.

Some taxpayers consider securities dealers' unique tax-planning opportunities so significant that they establish themselves as broker-dealers solely to exploit these opportunities. Large broker-dealer partnerships pass these tax benefits through to hundreds of partners. Many of these broker-dealer partnerships sell shares in their operations for fees which are based on a percentage, usually ten percent, of the tax loss sought by the investor.

The committee believes that requiring dealers to identify securities held for investment on their date of acquisition will end most abuse of the broker-dealer role. Because computers are used commonly now and because prudent investors, including dealers, know the purpose of their transactions when executed, delay in identification is unnecessary and unwise.

Explanation of Provision

The committee bill requires a dealer in securities to identify a security as held for investment not later than the close of business on the date of the security's acquisition. No security which is part of an offsetting position may be treated as clearly identified in the dealer's records as a security held for investment unless all securities belonging to the offsetting position are properly identified in a timely manner.

Effective Date

This provision applies to property acquired and positions established by the taxpayer after December 31, 1981, in taxable years ending after that date. Property acquired or positions established by the taxpayer after June 23, 1981, but before January 1, 1982, must be identified as held for investment by the close of business on the first day after the day the security was acquired.

G. Treatment of Gain or Loss From Certain Terminations

(Sec. 507 of the bill and new sec. 1234A of the Code)

Present Law

The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.[1] This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange of a capital asset. If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains. However, a transaction in which a taxpayer has suffered an economic loss may be terminated in a manner which produces a fully deductible ordinary loss, even though the loss in substance is the equivalent of a loss from the disposition of a capital asset.

Reasons for Change

The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. These transactions already cause significant losses to the Treasury.

Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222 which requires that there be a sale or exchange of a capital asset.

As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which are not sales or exchanges of the property, are reported as fully deductible ordinary losses instead of as capital losses, whose deductibility is restricted. However, if such property increases in value, it is sold or exchanged so that capital gains, long-term when the holding period requirements are met, are reported.

Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities.

The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the

[1] See *Teh* v. *Comm'r*, 260 F. 2d 489 (9th Cir., 1952) and *Comm'r* v. *Pittston Co.*, 252 F. 2d 344 (2d Cir., 1958), cert. denied, 357 U.S. 919 (1958).

contract. For example, a taxpayer may simultaneously enter into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.

Explanation of Provision

In order to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment, the bill adds a new section 1234A to the Code providing that gains or losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is, or which would be if acquired, a capital asset in the hands of the taxpayer shall be treated as gains or losses from the sale of a capital asset. Property subject to this rule is any personal property (other than stock) of a type which is actively traded (sec. 1092(d)(1)).

Effective Date

This provision applies to property acquired and positions established by the taxpayer after June 23, 1981.

H. Revenue Effect

Title V is expected to increase budget receipts $142 million in fiscal 1981 and by $1,351 million in fiscal year 1982. The extent to which the committee bill will affect revenues in future fiscal years will depend upon judicial decisions about the present law treatment of straddles.

V. COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of H.J. Res. 266, as reported.

The table below summarizes the estimates of decreases in budget receipts from the tax reduction provisions of the bill for fiscal years 1981-1986 and the increased receipts under the commodity tax straddles provisions. The estimates are present in greater detail in Part III, Revenue Effects, of this report.

SUMMARY REVENUE EFFECTS OF TAX BILL PROVISIONS

[In billions of dollars]

Item	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Individual income tax provisions (title I)	[1]	−26.8	−70.6	−114.1	−134.2	−157.1
Business tax incentive provisions (title II)	−1.6	−11.2	−19.6	−29.3	−41.0	−57.2
Savings tax incentive provisions (title III)		−0.1	−1.1	−3.5	−4.1	−4.1
Estate and gift tax provisions (title IV)		−0.1	−1.7	−2.6	−3.7	−4.8
Commodity straddles tax provisions (title V)	0.1	1.4	[2]	[2]	[2]	[2]
Total, net tax reductions	**−1.5**	**−37.0**	**−93.1**	**−149.5**	**−182.9**	**−224.2**

[1] Less than $50 million.
[2] Revenue effect for these years will depend upon judicial decisions.
Note: Details may not add to totals due to rounding.

Under the administration's economic assumptions, the Treasury Department estimates of the net tax reductions made by this bill are as follows:

TREASURY DEPARTMENT ESTIMATES OF NET REVENUE CHANGE

[In billions of dollars]

	Fiscal year—					
	1981	1982	1983	1984	1985	1986
Net revenue change	**−2.0**	**−36.3**	**−94.0**	**−148.7**	**−180.3**	**−222.0**

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to report the bill. H.J. Res. 266, as amended, was ordered favorably reported by a rollcall vote of 19 ayes and 1 no.

VI. REGULATORY IMPACT OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of this bill.

A. Numbers of individuals and businesses who would be regulated

The bill does not involve new or expanded regulation of individuals or businesses.

B. Economic impact of regulation on individuals, consumers and businesses

The bill does not involve economic regulation. Through the general tax rate reduction and targeted tax reductions for individuals and the several business tax reductions intended to stimulate capital formation and enhance productivity, the bill increases the amount of income after taxes that individuals and businesses will have available and will tend to increase their abilities to implement their own economic plans.

C. Impact on personal privacy

This bill does not relate to the personal privacy of taxpayers.

D. Determination of the amount of paperwork

The bill generally will not affect the current amount of paperwork for most individual taxpayers, and business taxpayers generally will be able to reduce their paperwork.

Individuals who earn income abroad will have fewer calculations to make in determining the amount of their incomes subject to tax. Two-earner married couples will need to compute an additional deduction that will reduce their taxable income.

The depreciation and investment credit revisions will simplify substantially the depreciation computations of virtually all businesses. Businesses will make additional computations of readily available internal data to claim the tax credit for increased research and experimental expenditures. The estate tax and gift tax revisions will eliminate the need for preparing returns on behalf of the bulk of estates.

The explanations of the provisions in the bill (in Part IV of this report) describe in more detail how the tax revisions will affect individuals and businesses.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has

examined the committee's budget estimates (as shown in **Part III** of this report) and agrees with the methodology used.

The views of the CBO with respect to the revenue estimates of the provisions in H.J. Res. 266 are expressed in the letter that follows.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., July 6, 1981.

Hon. ROBERT J. DOLE,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In accordance with Section 403 of the Budget Act, the Congressional Budget Office has examined the Senate Finance Committee amendment to H.J. Res. 266 in the nature of a substitution, the Economic Recovery Act of 1981. This bill contains the following general tax provisions:

(1) Individual tax provisions including rate reductions and changes in the taxation of foreign earned income;

(2) Business tax incentive provisions including cost recovery, investment tax credit, small business, and other provision changes, research and experimentation incentives, and windfall profit tax provision changes;

(3) Savings tax provisions, including changes in interest exclusion and retirement savings provisions, and extension of tax credits for Employee Stock Ownership Plans;

(4) Estate and gift tax provision changes; and

(5) Commodity tax straddle provisions.

The Congressional Budget Office agrees with the methods used to generate the estimates of revenue effects listed in the Committee's Report. These revenue estimates, however, are based on economic assumptions which are different from those of the 1st Budget Resolution for FY 1982. The economic assumption differences imply different estimates of the revenue effects of this bill. It is not feasible, however, to estimate these revenue loss differences at this time.

Sincerely,

ALICE M. RIVLIN,
Director.

New Budget Authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill creates new budget authority under the individual tax rate reduction provisions that result in an increase in the amount of the refundable earned income tax credit for individuals (treated as an outlay under the budget procedure).

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee makes the following statement.

The bill creates new tax expenditures in (1) the deduction for two-earner married couples, (2) the partial expensing of business assets,

(3) the tax incentives for research and experimental expenditures and contributions of equipment used in research and experimentation, (4) the payroll-based tax credit for contributions to an employee stock ownership plan, (5) the deduction for motor carrier operating rights, and (6) the exclusion for interest earned on certain savings certificates.

Increased tax expenditures include (1) the removal of the limit on the amount of used equipment eligible for the investment tax credit, (2) the incentive stock options, (3) the increased exclusions for contributions to individual retirement accounts, H.R. 10 plans, simplified employee pension plans and subchapter S corporations, (4) the revisions in the exclusion for income earned abroad, (5) the increased investment tax credit for rehabilitation expenditures, and (6) revisions in tax provisions affecting small business.

Reduced tax expenditures include (1) the repeal of the limited exclusion for interest income for 1982 and the return to the prior law limited exclusion for dividend income, (2) the revisions in the tax treatment of commodity tax straddles and (3) repealing the maximum tax on earned income because of the reduction in the highest marginal tax rate to 50 percent.

The depreciation reform and the associated revisions in the eligibility rules for the investment tax credit involve elements of both increased tax expenditures and restructuring of basic business income tax provisions to provide a desired economic objective. The characterization of these provisions as tax expenditures will be reanalyzed before the next tax expenditures pamphlet is published for the Committee on Finance in 1982.

The estimated effects on budget receipts of each new or increased tax expenditure is presented in Part III of this report, Revenue Effects.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of Rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by H.J. Res. 266, as reported by the committee).

A. Additional Views of Senators Packwood, Heinz, Durenberger, Bentsen, Moynihan, and Baucus

We voted to report the tax cut bill, H.J. Res. 266. The bill, of course, raises many issues. These views relate to only one—the future for a vigorous, broad based voluntary sector in the United States.

In Finance Committee mark-up of H.J. Res. 266, we proposed to allow all taxpayers to deduct contributions to charitable organizations whether or not they itemize their deductions. Our amendment was structured to meet budget restrictions endorsed by the Finance Committee.

This proposal would help preserve the vitality of our nation's charitable and volunteer community. We are confident that volunteer groups, dollar for dollar, can equal or exceed the job done by government in delivering services. We believe that his proposal can help achieve this. Unfortunately, the proposal was defeated by a 10–10 tie vote.

We believe that the President and a majority in Congress favor extending the deduction for charitable contributions to non-itemizers. However, some believe that the budget cannot accommodate it, and that there is no particular need to approve it now. We respectfully disagree with these objections.

Description of Proposal

In Committee, we proposed to allow people who do not itemize their deductions to deduct contributions to charitable, religious, scientific, cultural and educational organizations.

One purpose of proposal is to help reverse the decline in support for charitable groups. In 1970, we gave 1.99% of our personal income to charity. By 1980, this fell to 1.84%—a loss in contribution of more than $3 billion per year by 1980.

One important explanation for the loss of giving is that fewer people itemized deductions. This means fewer people have a tax incentive to give.

In 1970, 57.4% of taxpayers itemized deductions. By 1981, due to successive increases in the zero bracket amount (formerly called the standard deduction), the percent of taxpayers itemizing deductions is estimated to be 38.3%. Thus 61.7% of taxpayers, 43,000,000 households, no longer have a tax incentive to contribute.

There is growing evidence that the tax incentive for charitable contributions works. Survey research contained in a Gallup opinion poll in 1979 shows that itemizers contribute between two and three times as much to charity as non-itemizers.

The distinguished economist Martin Feldstein of Harvard University has also confirmed this conclusion. He testified before the Finance Committee's Subcommittee on Taxation that the revenue loss from

this bill would be exceeded by new contributions to charitable groups. He said each $1 of revenue loss from this bill could produce from $1.30 to $2.00 in contributions.

We believe the incentive works. We also believe that this provision would be one of the most cost effective federal initiatives we could undertake. We can think of no way to get more money to solve human needs at less cost to the federal government.

Studies showing the effect of tax incentives on giving do not even attempt to measure the enormous importance of volunteer help. For example, the American Red Cross, in testimony before the Taxation Subcommittee of the Senate Finance Committee in January, 1980, indicated that it has 77 volunteers for each of its paid workers. Charitable organizers have often found that if a person gives financial support to an organization, soon after he or she often wishes to be personally involved by volunteering time. Reduced contributions can weaken this important volunteer resource.

As the incentive to give applies to fewer and fewer people, community organizations also lose their democratic base. They become more dependent on corporations and wealthy contributors.

The average income in 1981 for itemizers is estimated to be $31,533. In contrast, the average income for persons taking the standard deduction is estimated to be only $12,600. This legislation will encourage these 43,000,000 households to participate in giving.

Vast support for S. 170

Support for S. 170 among policy makers is overwhelming. Thirty-five Senators of both parties have cosponsored S. 170 in the first six months of this new Congress, and 43 did in the last Congress. Two hundred and ninety-one members of the House of Representatives—a clear majority—have cosponsored the current companion bill sponsored by Representatives Gephardt and Conable, H.R. 501.

Last September, the Senate Finance Committee approved a form of this bill as a Committee amendment to its tax cut bill. The vote was 16–4.

The 1980 National Republican Platform endorses this proposal:

> "The American ethic of neighbor helping neighbor has been an essential factor in the building of our nation. Republicans are committed to the preservation of this great tradition."
>
> "To help non-government community programs aid in serving the needs of poor, disabled, or other disadvantaged, we support permitting taxpayers to deduct charitable contributions from their federal income tax whether they itemize or not.
>
> * * * * * * *
>
> "Government must never elbow aside private institutions—schools, churches, volunteer groups, labor and professional associations—in meeting the social needs in neighborhoods and communities.
>
> * * * * * * *
>
> "Most important, to ensure the continued primacy of private support for the arts, we reiterate our support of broader tax incentives for contributions to charitable and cultural organizations."

On September 18, 1980, then-candidate Reagan sent a telegram to the National Conference of Catholic Charities citing the above language, and stating that he was strongly committed to it. Support for this proposal has been bipartisan from its inception.

Need for Approval Now

A study prepared by the Urban Institute and released in May, 1981, finds that non-profit organizations will lose $27.3 billion in direct funding in fiscal years 1981–1984 under the Administration's budget reductions. Direct funding lost to non-profit organizations in each of these years is $100 million in fiscal year 1981; $4.8 billion in fiscal year 1982; $9.8 billion in fiscal year 1983; and $12.7 billion in fiscal year 1984.

In addition, the tax reductions in the Senate Finance Committee version of H.J. Res. 266 will further hamper our citizen's voluntary effort to meet community needs. The reduction in marginal rates will decrease tax incentives at each income level to contribute to charity. For example, the reduction in maximum rate from 70% to 50%, although fully meritorious to stimulate investment, will lead to less giving by persons in those higher brackets. Also, the reductions in estate and gift taxes will decrease the role of charitable giving in estate planning.

If the independent sector is to become more active in areas affected by budget cuts, we must give it the tools it needs to assume the broader responsibilities which it can handle so capably.

Accommodating Budget Limits

This proposal can be enacted now.

In September, 1980, the Senate Finance Committee approved a four year phase-in for this legislation. In the first year, non-itemizers would be permitted to deduct ¼ of their contributions. In the second year they would be permitted to deduct ½; in the third, ¾; and in the fourth year and thereafter, all contributions would be deductible. In light of budget restrictions, we think this concept is acceptable.

Delay in approving the bill will hamper non-profit volunteer efforts. But action now will send the word that America's tradition of reliance on volunteer organizations for alternative delivery systems will continue.

Our goal is to strengthen people's ability to solve problems for themselves in their own communities. Unintentionally, budget and tax cuts present a twin threat to this effort. We think it's vitally important that we signal to our fellow Americans that we wish their efforts to continue and we intend for them to succeed. Approval of this legislation now will send this message.

BOB PACKWOOD.
DAVE DURENBERGER.
JOHN HEINZ.
DANIEL MOYNIHAN.
LLOYD BENTSEN.
MAX BAUCUS.

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B. Additional Views of Senator Heinz, Senator Symms, Senator Packwood, and Senator Durenberger

While H.J. Res 266 is an important component in the national strategy to restore prosperity and will prove beneficial in many ways, we remain concerned that efforts to ensure a more even distribution of effective business tax incentives across all industries and firms failed in Committee on a tie vote, 10–10. The failure to do so increases the risk that investment patterns will become distorted, leading to a misallocation of capital and job opportunities.

The problem is an inadequate appreciation for the likely side effects from rapidly increasing the rate of capital cost recovery through accelerating depreciation deductions and increasing the investment tax credit for certain short-lived property as proposed under the bill. Already many major industries cannot absorb the existing level of deductions and credits for a simple reason. They operate in the red or earn only a modest taxable income. Their problem will be shared by others in the future when the amount of depreciation and investment tax credits taken by businesses grows sharply. Yet, unless all American industries are in a position to benefit from tax incentives to purchase productivity-enhancing plant and equipment, we cannot expect them to do so faster than they would otherwise. Thus, under H.J. Res 266, certain industries and firms will move ahead at a faster rate than others depending, in part, on their ability to utilize additional deductions and credits.

While current tax law contains provisions to prevent this, the scope of the changes in the investment tax incentives proposed under the Committee bill means that adjustments in the old way of handling this problem are warranted. Under existing rules, corporate taxpayers may apply unused investment tax credits and current operating losses against their tax returns of the previous three years or the next seven. This practice provides reassurance to companies considering productive investments that they will benefit from the credit and depreciation deductions even if they are not profitable during the next 12 month period. By doing so, they encourage industries with substantial annual changes in profitability to make larger investments in plant and equipment by lowering the risk that the credits and deductions will be "crowded out" due to misestimates of profitability levels.

Nevertheless, even the existing rules have not been sufficient to prevent the buildup of $14 billion in unused investment tax credits that are being carried forward and are in jeopardy of being lost. For this reason, it is vital that the carryback and carryforward provisions be modified to accommodate the large increase in investment tax credits and depreciation deductions that will occur in the future. By 1986, for example, under the Committee bill, it is anticipated that depreciation deductions will be over $90 billion larger than would otherwise be the case, compared to a total of $93 billion in total corporate depreciation deductions in 1976.

In Committee, therefore, we proposed the "banking rule". Under the banking rule, firms would have additional flexibility in determining the amount of depreciation they took in any taxable year. While the maximum amount in any year would depend on the classification of assets as 15, 10, 5, or 3 year property, the difference between the amount taken and the maximum would be banked. All or part of it would be used at sometime in the future. The effect of this would be to extend the carryforward term however long as would prove necessary, on a case-by-case basis, to eliminate "crowding out". This proposal failed on a tie vote, 10–10.

A more ambitious alternative that solves the "crowding out" problem would be to permit taxpayers to carry back investment tax credits over an extended period of time rather than just three years. This approach recognizes that the selection of an annual accounting period for measuring and taxing corporate income is arbitrary. (In fact, the amount of income earned by corporations annually varies by a wider percentage than that of individuals so corporate income averaging is justified.) Many currently unprofitable firms that now must carry forward unused investment tax credits paid substantial taxes in previous years. Had their historical pattern of losses and gains been reversed, by showing a profit now rather than previously, they could fully use new credits and deductions. By clearing away their backlog of credits through provision of extended carryback rules, such companies would be in a position to benefit fully from the modernization incentives contemplated under the Committee bill. Any new credits and deductions could be taken immediately.

Another alternative to flexibility under the banking rule or extended carryback terms is greater reliance on tax-motivated corporate leasing. In such transactions, one company which can take advantage of additional tax credits and depreciation deductions buys assets needed by a firm that cannot, due to a "crowding out" problem.

In return for the tax benefits created by ownership, the company purchasing the equipment agrees to lower its rental price. The Committee bill envisions a significant increase in such transactions by relaxing the rules deemed most to limit current growth of the corporate leasing industry. While there is nothing wrong with the leasing concept, we should recognize that up to 50% of the tax benefits may not be passed through by the leasing company and that certain expenditures, such as refurbishing an old factory, do not necessarily lend themselves well to the concept. However, leasing does allow some companies the opportunity to avoid a buildup of investment tax credits that must be carried forward, and perhaps, be lost one day.

These and other possible alternatives for assuring that investment tax incentives are neutral need continual evaluation, and we must expect to make adjustments in the future. In doing so, we improve the chances that the desirable and long overdue improvements in the rate of capital cost recovery have their intended effect, an across-the-board revival of all business enterprises and job opportunities, not just for those in favorable tax situations.

JOHN HEINZ.
STEVE SYMMS.
BOB PACKWOOD.
DAVE DURENBERGER.

C. Additional Views of Senator Heinz

If the American economy is to regain its lost vigor, the level of productive investment must rise accordingly. This is the reason why accelerating depreciation deductions as proposed under the Committee bill enjoys wide support. By providing more favorable tax treatment for investments in plant and equipment, we anticipate that our nation's businesses will respond by purchasing the new tools that our workforce needs to become more productive.

One class of investments that we especially need for national security reasons is coal conversion property to lower national petroleum consumption. Americans use petroleum products chiefly in three ways. We drive automobiles and trucks. We heat our homes and offices. And we generate energy for our utilities and industrial facilities. While important progress toward energy independence is being made as automotive fuel efficiency rises and insulation of new and old buildings accelerates, important steps should be taken to encourage greater use of coal as a replacement fuel for oil and gas when used by power plants and industrial concerns.

Perhaps the single most important step we can take is to place coal conversion property in the 3 year ACRS category. Depending on who makes the conversion, such property will receive a write-off of 5 to 15 years under the Committee bill. This is an unacceptably slow rate for assets central to any sound strategy for lowering national use of petroleum.

Similarily, other capital formation incentives that should be considered include extending the 10% energy tax credit to coal conversion property and permitting utilities to utilize the tax exempt industrial development bond mechanism to finance such conversions.

Together, these steps will save at least 500,000 barrels per day in petroleum. With a cost of less than $300 million, there may be no cheaper and efficient way to substantially lower our dependence on imported energy sources.

JOHN HEINZ.

D. Additional Views of Senators Symms and Packwood

While this tax proposal is an essential part of an historic effort to change the direction of our Nation's economic policy, we do have certain reservations concerning various aspects of the tax package. In particular, our concern is with the estate tax reforms impacting on the timber industry.

The principal public policy objective should be the attainment and preservation of equitable Federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved. In addition, forest taxation policies should encourage forest conservation and stable land ownership patterns.

Presently, excessive Federal estate taxes now deter reforestation and force premature harvesting of our Nation's private forestlands. The provisions included in the Senate Finance Committee tax proposal, while attempting to address this problem, are in fact not much better than current law.

The current estate tax lowers productivity for two basic reasons. First, the estates of landowners are often forced to cut timber before its proper time in order to pay the estate tax. Cutting younger trees before they have reached optimal harvestable size is bad management. Depending on the region, tree species and forest management practices, timber crops take between 30 and 100 years to reach harvesting size. It is during the latter part of this lengthy growing period that timber increases in value most rapidly.

Rapid liquidation of timber just to meet tax liabilities is bad forestry in that it may not coincide with either optimal biologic or economic management considerations.

The second reason the estate tax lowers productivity is that it discourages reforestation. The present law reduces the rate of return on growing timber below the level required for continued investment. An owner usually will replant solely in order to benefit his heirs. Yet, before the trees grow to a size that will yield a fair return, the owner will die and the trees will be cut in order to pay estate taxes. Neither the owner nor his heirs will ever see a fair return on their investment.

The result of this matter is simply economics. We have reached a point where the obvious adverse economics are redirecting investments away from forestry. Owners are discouraged from replanting after harvest, and intensive management is being curtailed.

Stable land ownership is also discouraged because an executor may be forced into a sale of all or part of the forestland to a large company or to a developer. Such action is detrimental to the established social premise of maintaining a balance of ownerships between the industrial and non-industrial sectors.

Congress was evidently concerned about such occurrences, and included special provisions for family farm and timberlands, and

certain closely held businesses in the estate tax portion of the 1976 Tax Reform Act.

These provisions are twofold. First, a special rule permits certain managed woodlands to be valued for estate taxes on the basis of current use rather than at fair market (speculative) value. Second, payment over a ten-year period of that portion of the tax attributable to the forestland is now automatic in certain cases. In some situations, the first payment may be deferred for five years and the remainder made from the sixth through the 15th years.

In practice, a number of prerequisites and restrictions will severely limit use of these options. First, those assets used in the qualifying use must, at fair market value, comprise at least 50 percent of the total estate. Thus, the heirs of a forest owner who also had substantial other assets, such as life insurance, could very well be precluded from utilizing the use-value provision. In addition, even when timberland is the major asset of an estate, the IRS has interpreted the statute in such a way as to eliminate again the benefit of special use valuation. When land containing timber is valued, the value of the timber may not be counted as real property in the 25 percent test, although it is counted in valuing the whole estate. Timber, however, is often worth many times more than the land itself. Obviously, when the land by itself is worth less than 25 percent of the whole estate, the timberland estate will not qualify for the special use valuation. As a result, under current law, the only timberland that will ever qualify for special use valuation will be land that has been clearcut or that contains a poorly stocked stand of timber.

Second, in order for a property to qualify for use-valuation, the decedent or a member of his family must have materially participated in the management of the property, and such material participation by a family member must continue after probate. Current law virtually excludes land managed by a forestry consultant or under lease to industry.

Third, in order to qualify for the 10-to-15 year tax payment extension, the forest property must have been a "closely held business" under the strict definition of the Internal Revenue Code for this purpose.

The Senate Finance Committee attempted to address some of these concerns by modifying the current use valuation test for timberland so that timber would be considered part of the qualified real property in the estate for purposes of Section 2032A of the Internal Revenue Code. However, if current use valuation is elected for timberland, the difference between the estate tax saved in the decedent's estate under current use valuation and the estate tax based upon the fair market value of the estate would be recaptured upon severance or disposition before severance of the timber.

In addition, the Senate Finance Committee provision does not address the problem in determining the value of the timberland for special use valuation. Current law under subparagraph (e)(7) permits farm property to be valued solely on the basis of the average annual gross cash rental for comparable property. This valuation method is virtually meaningless in the case of timberland. Often there is no comparable property for which cash rental figures can be ob-

tained. In addition, comparable property is usually not rented for "cash." Finally, the formula in (e)(7) does not work well because timberland does not produce a recurring annual crop. Consequently, timberland property will still have to be valued for special use purposes under the highly subjective five factor method now used in (e)(8).

Current law and the Senate Finance Committee proposal are particularly troublesome given the fact that our country faces a significant shortage of timber in the decades to come. The Forest Service projects that domestic demand for paper and wood products will double in the next 50 years.

If our tax policies create a reduction in timber production, severe shortages may result. Historically, shortages exerted pressure on the price of wood products and the derivatives of those products. The effects would be felt throughout the entire economy.

Over 5,000 consumer products are derived from our forests—commodities which are essential to education, communication, sanitation and health, and many of which contribute in unique ways to the maintenance of the American standard of living.

A side benefit is that growing forests contribute significantly to the overall ecosystem. Unlike other basic resources, forests are renewable. Timber, a storehouse of solar energy, is most compatible with man's use in his present environment because of its strength, its versatility, its ease of production, and its biodegradability.

The greatest potential for increased production comes from the 283 million acres owned by 5 million private landowners. In general, these lands are not intensively managed for timber production, and produce wood at only about 63 percent of their potential.

In contrast, public lands are under constant pressure for uses other than commercial forestland. Harvest levels are nearly static and funds perennially have not been provided for adequate forest management. The industry lands comprise only 14 percent of the total and are producing at close to their full potential. It is, therefore, less feasible to achieve significant improvements in timber production from industrial or public lands than from nonindustrial private lands. However, if private timberland owners are further discouraged from continuing to manage and harvest timber, we will most likely be forced to attempt to meet our timber needs by harvesting more timber from our public lands.

The current estate tax law and the Senate Finance Committee proposal interferes with our attainment of an adequate supply of wood and fiber for the future.

STEVE SYMMS.
BOB PACKWOOD.

E. Additional Views of Senator Bentsen and Senator Boren

Windfall Profit Tax: 1,000 Barrel Exemption

We are pleased that the Committee has decided to address some of the inequities of the so-called windfall profits tax in this tax bill. The $2,500 permanent tax credit for royalty owners and the phase-down of the tax rate on new oil provide needed relief to a grossly inequitable act. However, these changes do not go far enough to provide the type of relief we believe is warranted. The failure of the committee to accept the amendment on the 1,000 barrel exemption does not take into account the extra incentives that it will provide the independent producer.

In recent years, independent producers have drilled approximately 90 percent of all domestic wildcat wells, found 75 percent of the new fields, and discovered 54 percent of all new oil and gas. It has been demonstrated that independent producers reinvest 105 percent of their gross revenues in their production budgets. Because of their efforts to reinvest in new production, we see today a new level of domestic drilling. However, the figures plainly show that we will still need to double or triple our current drilling efforts if we are to substantially decrease our dependence on foreign crude. America's thirst for foreign crude drained our economy of about $80 billion last year. The amendment would have cut that deficit by over $2 billion in 1985.

Now, more than ever, independents need the extra incentives that my amendment will provide them. The cost of drilling an average well has increased over 350 percent since 1970. It is currently costing approximately $10 million to drill a 20,000 foot well in Oklahoma. At the same time, the cost of crude oil is leveling off or in some cases decreasing. In addition, the windfall tax has created a tidal wave of complex new crude oil regulations that have swamped thousands of smaller operators. Without the battalions of accountants and lawyers employed by the major oil companies, the windfall tax has diverted substantial drilling revenues into administrative overhead expenses, further reducing their competitive ability.

We believe the public interest is best served through government policies that promote diversity in the market place and that encourage vigorous competition among producers. In the domestic petroleum industry these goals can best be achieved through policies that foster a thriving segment of independent producers. For these reasons, when the full Senate considers the tax bill, we intend to offer an amendment which will provide for a 1,000 barrel a day exemption for independents and royalty owners from the windfall profits tax act.

All-Savers Certificate

The Committee's approval of the All-Savers Certificate proposal should provide some relief to our vital and hard-pressed housing in-

dustry. It should also act as a welcome and long-overdue incentive to savings in our economy.

It would be a mistake, however, to conclude that the All-Savers Certificate provides a comprehensive or even adequate response to the dilemma facing both the housing industry and our Savings and Loan Associations. Approval of the All-Savers Certificate is a first step in the right direction, but to be effective it must be followed by other initiatives to stimulate savings and investment in America.

The need for prompt and effective action to provide relief for the housing industry and the thrift institutions that serve it could not be more apparent:

—Housing starts, the most widely accepted indicator of health in the industry, are down 43 percent since 1979.

—Unemployment in the construction industry exceeds 16 percent, more than double the national average. Over 1 million jobs in construction and housing have been lost since 1979.

—The supply of mortgage money has dried up as the traditional lenders, savings and loans and mutual savings associations, have suffered staggering losses that ran to $28 billion in 1980 alone.

—The cost of mortgage money has soared to 16 percent, pricing all but a handful of Americans out of the housing market.

—At many thrift institutions the cost of capital now exceeds earnings, and reserves are rapidly being eroded. As a result, over 260 savings and loan institutions are on the troubled list, twice the 1980 level.

—In April of this year the thrifts suffered a $6.6 billion deposit loss.

Less obvious but equally important is the need to generate new savings in our economy. The United States has one of the lowest rates of savings in the industrialized world, and that is a key factor in our general economic difficulties as well as in the area of housing. Cost-effective incentives for savings are an essential element in any formula for economic recovery.

The Committee and the Congress now has a unique opportunity to combine a temporary stimulus for the housing industry with a significant savings incentive. We are attempting to reduce the cost of loanable funds to mortgage lenders, thereby reducing mortgage rates. Lower mortgage rates should induce additional demand for housing, new economic activity in that industry, and new jobs. Those jobs will, in turn, create new income and savings.

We are concerned, however, that the All-Savers Certificate may fail to provide cost-effective incentives for either savings or housing. Our prolonged experience with six-month money market certificates suggests that only about 40 percent of the All-Savers deposits will find their way into the housing sector. If that past pattern holds true, All-Savers Certificates will not generate new savings but will merely shuffle funds from one form of savings to another and will do little to help the housing industry.

We believe that a savings incentive, to be fully effective, should be carefully and specifically targeted at housing. Targeting will insure maximum new economic activity in return for the tax revenue lost through the program. It will maximize new savings and help eliminate federal deficits in future years as the housing industry picks up, generates new tax revenues, new jobs, and a reduced requirement for un-

employment compensation. We also believe that we should target the All-Savers proposal to housing for a period of at least three years. The Administration has spoken out forcefully and convincingly in favor of a three-year tax reduction in order to create stability and minimize uncertainty. The same rationale, in our opinion, should apply for savings incentives targeted at housing.

The Committee took a step in the right direction when it broke new ground and approved the All-Savers concept. We supported that effort because we believe it moves our policy in the direction of incentives. However, in an area as important as incentives for savings, we believe, we must strive for maximum effectiveness and minimal cost. We therefore plan to offer modifications to the All-Savers Certificate proposal when it is considered by the Senate. Our proposals will seek to insure that the savings incentives are targeted specifically at housing and our thrift institutions. We believe that the basic concept of incentives is sound; it will work. But it will work best if we focus it specifically on the sectors of our economy most in need of such support.

By no means will our proposal be limited to thrift institutions. Any financial institution which does mortgage lending can participate. If the institution does not presently hold mortgage, it can make them or purchase them in the Secondary market. This will insure that the maximum benefits of this proposal are targeted to those institutions which have or are willing to lend to that segment of the economy most in need.

LLOYD BENTSEN.
DAVID L. BOREN.

F. Additional Views of Senator Bentsen and Senator Symms

Small Business

While we are pleased that the Finance Committee included a number of provisions which aid Small Business, the bill does not adequately reflect the importance of small business to our economy. Small businessmen and women employ 60% of all workers and account for 75% of all new jobs being created in our economy. Fully one half of all business output and innovation flows from small businesses.

Only five of the nine tax provisions we proposed, with the support of the small business community, were adopted by the Committee. Given the size, importance, and broad scope of this tax cut—$280 billion over the next four years—we consider that the legitimate needs of American small businesses are not adequately reflected in this legislation.

Sky-high interest costs, complicated tax laws, burdensome federal rules, regulations, and paperwork, and a slack economy have stretched the financial and managerial resources of many small businesses to the breaking point.

The provisions of this legislation targeted at small business are only a modest beginning in helping this important segment of our economy cope with its problems. The provision dealing with estate tax reform, investment expensing, an increase in the permissible amount of accumulated earnings, an increase in the number of permissable Subchapter S stockholders and retirement savings provisions will all encourage small business stability, investment, and modernization. That, in turn will mean greater productivity, more jobs, and an enhanced ability to compete and prosper.

But the job is only half done . . .

LLOYD BENTSEN.
STEVE SYMMS.

I. MINORITY VIEWS

Minority Views of Senator Bradley

Although there are some laudable provisions in the Senate Finance Committee bill, such as the reduction of the marriage tax penalty and the research and development tax credit, I cannot endorse this legislation. First, I fear that a three-year tax cut, coupled with the Administration's rigid adherence to extreme monetary policies and steep increases in defense spending, will stifle economic growth, not promote it.

Second, I am concerned that a three-year tax cut, in the context of these other Administration economic policies, is a recipe for higher inflation, higher interest rates, and much larger budget deficits. A more prudent and responsible fiscal policy would reduce inflation and interest rates.

Third, I believe that the distribution of the personal tax cuts is inequitable and that more relief should have been targeted toward middle and low-income taxpayers who are most heavily burdened by rising prices and payroll tax increases.

Finally, although I believe we need much more liberalized depreciation schedules, I am not persuaded that the bill's depreciation provisions will adequately stimulate our lagging productivity or improve the competitiveness of our industries in international markets. Rather than enhance the efficiency of capital allocation, 10–5–3 as written would worsen it by widening the gaps in effective tax rates for different assets and industries that exist under present tax law. The resulting inefficiency would dampen innovation and depress productivity. I prefer a depreciation change more similar to simple expensing or the 2–4–7–10 changes that the Senate Finance Committee passed last year.

Before the Finance Committee began its consideration of this bill, I introduced an alternative to the Administration's tax proposals. This legislation was designed to provide relief from inflation induced tax increases and rising payroll taxes and to accelerate economic recovery by reforming the depreciation allowance and increasing incentives for work, saving and productive investment.

During the Finance Committee's markup, I objected to the three-year nature of the personal tax cut. My objection was based on the uncertainty over what the budget, interest rates and inflation will look like in 1983 and the potential that a large tax cut has for fueling inflationary expectations and generating a serious deficit in 1983 or 1984. I offered an amendment to address this problem by making the third year of the tax cut conditional on the success of the Administration's economic recovery program. I felt it was necessary to have a safety valve for this experimental plan since no one really knows if it will work. This amendment was defeated.

I also objected in markup to the across-the-board nature of the tax cuts. I argued that they would not provide enough tax relief for middle

and low-income individuals and I offered an amendment to correct that. This amendment was also rejected.

Because I am committed to stimulating risk-taking and capital formation, I wholeheartedly supported cutting the top rate on investment income from 70 percent to 50 percent. For upper income individuals, that will be a significant tax reduction and it will increase investment and stimulate innovation. At the same time, I am concerned that the combination of the 70 to 50 change and the across the board tax cuts provides unnecessarily generous relief to upper-income taxpayers and risks eroding the broad consensus for economic recovery that is so critical to achieving and sustaining high rates of growth. I believe, therefore, that the Finance Committee bill could needlessly polarize the society around economic issues and jeopardize our prospects for restoring the economy to robust health.

Taken together, I believe these risks are too great to take with the only economy we have and I, therefore, cannot support the Finance Committee bill.

BILL BRADLEY.