EXECUTIVE SESSION

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TUESDAY, SEPTEMBER 12, 1978

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United States Senate,
Committee on Finance,
Washington, D.C.

The Committee met, pursuant to recess, at 10:20 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (Chairman of the Committee) presiding.

Present: Senators Long, Talmadge, Byrd, Gravel, Matsunaga, Moynihan, Curtis, Hansen, Dole, Roth, Packwood and Danforth.

The Chairman. Let me call this meeting to order.

Let me start out by asking the staff if they would bring in the blackboard that they were showing me and explain to the members present what the suggestion is that staff has been working on. It is really not my fault. Staff has been trying to figure out how we could raise a substantial amount of revenue with a minimum tax and one that hopefully would have more uniform justice than we have now, and also avoid the criticism of the so-called micro-mini tax.

As I understand it, why do you not take charge, Mr. Shapiro, and have somebody explain how you think that the minimum tax might raise a substantial amount of money and, at the same time, offset some of the shortcomings and the criticism that has been levied at

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the present minimum tax.

Mr. Shapiro. The example that is on the board also has been passed out to you so you can look at the board or the sheet in front of you, under the heading "Minimum Tax Sample."

The Chairman. Just explain what the minimum tax proposal is that the Committee has been working on.

Mr. Shapiro. Senator Long, as you know, has been advocating a larger exclusion of capital gains than present law. Instead of 50 percent, Senator Long has suggested a 70 percent credit.

At the same time, Senator Long is advocating to maintain a minimum tax at the same revenue levels. That is two things: one, to continue to pick up approximately the same amount of revenue that the present minimum tax picks up and also to convert it from an add-on tax to a true alternative tax.

As you know, the present minimum tax starts with computing your regular tax and you total up your preference income and after your deduction, you apply a flat rate of 15 percent to it, and you add that on to your regular tax.

Senator Long has suggested to convert that to an alternative tax, whereas after you compute your regular tax, you compute an alternative tax based on expanded income. I will describe it in just a second.

After you finish your total of the alternative tax, then you pay whichever is greater, either your regular tax or your alternative tax. But Senator Long wants to have the same for revenue pick-up in this alternative tax as you have under present law. That is a part of the quid pro quo for large exclusion is 70 percent exclusion, not to reduce the effect of the minimum tax.

Senator Curtis. How much of an exclusion?

Mr. Shapiro. Capital gains exclusion of 70 percent. A quid pro quo for a larger exclusion of 70 percent on capital gains would be to have an alternative minimum tax that picks up approximately the same amount of revenue as the present law minimum tax.

That is to say, the individuals could reduce their tax because of making investments, having capital gains reductions at the time they are going to pay at least a 25 percent alternative tax on the economic income.

The way the proposal will work, I will describe it in a conceptual form before going into an example. You will start with taxable income, after all deductions, taxable income under present law, after your business deductions, your personal exemption and all of your itemized deductions, so after all deductions you have taxable income computed the same way as under present law.

You add to taxable income preferences, essentially as in present law. That is the list of preferences such as capital gains, accelerated depreciation, percentage depletion, excess itemized deductions over 60 percent of adjusted gross income.

Senator Byrd. Does this include contributions and interest on mortgages?

Mr. Shapiro. It does not include it per se.

Senator Byrd. It does include it?

Mr. Shapiro. It includes it to the extent that these exceed 60 percent of adjusted gross income. If the contributions -- it does not include medical expense or casualty. That is not taken into account at all.

If you itemize deductions, including interest, including charitable contributions, and all the itemized deductions other than medical deductions, and they exceed 60 percent of adjusted gross income, then under present law, the minimum tax would include that excess as a preference.

Then you add these preference items to taxable income. You take a $20,000 exemption. Then you have what would be referred to as an alternative taxable income. You apply a 10 percent rate on the first $40,000 of income, expanded alternative taxable income; a 20 percent rate on the next $40,000 of income and then a 25 percent rate on all income above that.

So the effect of it is, your first $20,000 would be exempt, then the next $40,000 at 10 percent, the following $40,000 at 20 percent. So the first $100,000 of this would be taxed at a rate of $12,000, or 12 percent.

So if someone has this expanded income of $100,000, then the minimum tax would be at a 12 percent rate. If they get up to $200,000, that rate would go up to 18.5 percent. It would never go to more than 25 percent, but where an individual had more preference items, it would approach 25 percent.

The purpose of this alternative tax is to insure that taxpayers in higher brackets with preference income would pay a minimum tax if it were greater than the regular tax, approaching 25 percent on the economic income, which we would define to include taxable income plus preference income.

The Chairman. It would be better -- I am afraid you cannot see that whole chart over there -- if you would put it on the dias.

Mr. Shapiro. Each Senator has a copy in front of you as well.

The Chairman. If you put it up there, I guess the audience can see it.

Senator Curtis. Are these actual cases of an individual?

Mr. Shapiro. This is an actual case that came out of the model that has been rounded off to make sure there is no disclosure.

The Chairman. Here is the point, gentlemen. You are not going to be able to judge whether this proposal is a fair proposal or not until you take a lot, not just one, but a whole series of tax returns and see how it works, so that I do not think anybody wants to pass judgment until he pulls his own tax return. I am not talking about everybody here, but the average fellow.

If he paid a minimum tax, he would like to pull his own tax return and see how it would work when he does a trial run on himself. That is how your constituents are going to react to it, I suppose.

This is one tax return to show how it would work out with regard to one of the cases that Treasury pulled as a case that, from their point of view, is not fair. Here is a fellow who made, on what they think is a fair base for comparison, expanded income. That is what they think their income was -- $7,192,000.

Then, by the time he gets through to the end, you see what percentage of his income he paid in taxes -- 10.2 percent. If that had been a working man with a wife and two children on $10,000 income, he would have paid more than that. So there is a higher percentage.

That is the kind of thing that obviously, from the point of view of the Treasury and the point of view of most people, is not right. They can explain to you how it works out, but you can notice in summary that the House bill would reduce that man's tax from 10.2 down to 7.1 percent. This concept here would move it back up from 10.2 percent up to 14.7 percent, rounding it off to 15 percent.

Suppose you explain the item in between?

Mr. Shapiro. Senator, as indicated, this is a case that was in the models of the tax returns. It was blown up to represent current levels and also rounded off so as not to have any disclosure problems, and the staff has prepared a series of other cases to give you better examples, so you just do not look at one. We have additional ones this morning, but so as not to show you just a few, we are going to have a series of examples presented and distributed to you so it is a broad sample of the type of case that Treasury presented as the so-called horror list under the House bill.

Senator Byrd. Will you not have some examples of more average people than somebody making $7 million? There are not more than half a dozen of those in the whole country.

Mr. Shapiro. The second example we have is someone who has $237,000. These are the individuals who have the high income, where these taxes are going to apply. An individual making $50,000 or $60,000 is not one who would be covered under the alternative tax. Those are not the ones, I think, that the Congress ever intended to focus in on, not having a large amount of preferences.

Senator Curtis. The present law does.

Mr. Shapiro. You are not picking up a large minimum tax from individuals at middle-income levels. You are picking up a minimum tax.

Senator Curtis. I have had a case brought to me, a case where revenuewise it was a small sum, but it was quite a burden, quite an injustice.

Mr. Shapiro. The cases we have heard where that happens have been in personal residences. We have heard of individuals who have sold their residence, middle-income taxpayers; because personal residences were treated as preference items, the capital gain on the preference item, they paid, for them, a significant minimum tax.

The Chairman. This proposal that we are looking at here, it would reduce the minimum tax on a great number of people more than it would increase it. Could you recall those comparative figures, Mr. Wetzler?

Mr. Wetzler. Under the combination of the minimum tax and the 70 percent exclusion, it would be 4.3 million returns with the tax reduction and 32,000 returns with the tax increase.

The Chairman. 4 million. If you couple this with the reduction in capital gains, you say you have 4 million tax returns with the reduction?

Mr. Wetzler. That is right.

The Chairman. How many would an increase be?

Mr. Wetzler. 32,000.

The Chairman. Only 32,000 would have an increase.

Mr. Shapiro. What is happening, the middle-income taxpayer is covered under present law, are being taken off because the exemption is being raised, so the fact that this proposal raises approximately the same amount of revenue as present law, you are getting that revenue from the high-income taxpayers, not from the middle- or lower-, but high-income people.

The Chairman. Let us understand. If you do what we are talking about -- I am not trying to mislead anybody. Those 32,000, some of them are really going to bellow, where you are going to think you have ten times that amount of people. No doubt about that.

Go ahead and explain this.

Mr. Shapiro. Under present law, in the first example to your right, you have expanded income, which is $7,192,000. That includes taxable income, adjusted gross income plus capital gains.

Item number 2 is adjusted gross income which excludes one-half of capital gains, so in item 3 there where you see $2.8 million, that is excluding one-half. The total capital gains was $5,600,000. One-half was excluded.

So if you look at items two and three together, that equals one, so expanded income is your total economic income.

2 is your total income less 50 percent of your capital gains.

Item number 4 is itemized deductions. This particular individual had a large amount of itemized deductions -- $4.2 million of itemized deductions.

Senator Curtis. Is that all itemized deductions?

Mr. Shapiro. All itemized deductions, Senator.

Senator Curtis. None are excluded?

Mr. Shapiro. That is correct. Itemized deductions representing one-half of the charitable contributions; another $1.2 million is taxes; $800,000 of miscellaneous items. There was no medical expense and no casualty expense.

Senator Curtis. There was interest?

Mr. Shapiro. There was an interest expense of $916.

Senator Packwood. $1.2 million was taxes?

Mr. Shapiro. $1.2 million was taxes. Almost $2.2 million was charity, and a little over $800,000 --

Senator Hansen. What was that?

Mr. Shapiro. Charity. Over $800,000 was miscellaneous, generally, or business-type expenses below the line, what are called the miscellaneous business expenses, and so forth.

So that that total itemized deductions is $4,195,000. That leaves a taxable income of $160,000.

What that is is line number 2 less line number 4, so that line number 5 is $160,000. The regular tax on that is line number 6, $78,000.

Present law has the add-on minimum tax. What you would do is add your preferences, which is excluding capital gains, line 3. Then you would take the excess of 60 percent of adjusted gross income of the itemized deductions, line 4. To the extent that line number 4 is more than 60 percent of adjusted gross income, then that is a preference too, so the excess itemized deductions, with capital gains, less the exemption times the 15 percent rate, gives you an add-on minimum tax of $656000. That is listed on line 7 on the board.

Senator Packwood. How did you get there again?

Mr. Shapiro. The minimum tax would be, you take your excluded capital gains plus the excess of 60 percent of your itemized deductions over the adjusted gross income. You take

60 percent of AGI, 60 percent of line 2. To the extent that 60 percent figure is less than line 4, the excess of line 4 over that is added as a preference item.

Senator Packwood. 1.7?

Mr. Shapiro. Roughly. Then you add that to the 2.8, which is excluded capital gains, then you multiply that by 15 percent and that is how you get $656,000.

What you do for your total tax is line 6 and line 7, present law has an add on -- $78,000 plus $656,000, giving you a total tax of $734,000, which is 10.2 percent of economic income of $7 million.

Senator Packwood. Now, the taxes were what?

Mr. Shapiro. State and local taxes paid last year. That would be allowed as a deduction on this year's return.

Senator Packwood. $1.3 million?

Mr. Shapiro. $1.2 million.

Senator Byrd. Is that regarded as a tax shelter, paying state and local taxes?

Mr. Shapiro. Not necessarily a tax shelter. What Congress decided in 1976 was when you look at the returns that the Ways and Means Committee finally looked at, the nontaxables that you had not hit previously, there were a large number because of itemized deductions, charitable contributions, state and local taxes, interest and miscellaneous items.

The fact that the itemized deductions were allowed, the individuals not to pay tax. Congress wanted to make sure that all individuals paid some minimum tax so that you would not have the statistics that shows zero tax for some individuals.

The way that the Congress did it, the Ways and Means Committee came up with the proposal, if I recall correctly, that said you give them 65 percent of adjusted gross income and assume that that would be a normal level of itemized deductions. The excess of that, they would pay 50 percent on an excess.

The Senate Finance Committee was concerned that medical and casualty was really not something that is controllable. There are extraordinary medical expenses, casualty losses. You excluded medical and casualty and you lowered the percentage to 60 percent. That was agreed to in conference.

That means that an individual could have all of these deductions, but to make sure that they pay some minimum tax, the Congress wanted to put a portion of that in minimum tax so they would pay a 50 percent tax on a portion of the itemized deductions above this level, and that was the decision that the Ways and Means Committee, Finance Committee, and both Houses made to make sure that the nontaxables were reduced by people who got on that list only because of itemized deductions.

Senator Talmadge. If all this income came from tax-exempt bonds, would this tax apply?

Mr. Shapiro. No, the minimum tax does not apply to taxes on interest.

The Chairman. As far as I am concerned, we will not get involved, I hope, in any of these taxes, interest and state and localk bonds.

Senator Talmadge. I share that view completely.

The Chairman. It seems to me Bill Simons' argument that these people accept a lesser rate of return than they would get on U.S. government bonds which are safer, so they are receiving a lesser rate of return and taking a more speculative bond to do it.

Senator Talmadge. When you consider inflation, they have been losing money year after year.

The Chairman. That being the case, taking those things into account, in fact they have already been taxed. They have been taxed, because they are getting less money than they would have gotten if they had taken what otherwise would be a better investment, and the Treasury is not pushing for that.

So it seems to me that we would do better to take the view that this is an area where this is paying the tax and letting the government have the money at a lesser rate than it would make the money available.

Senator Roth. If I could ask a question at this point, one of the things that always concerns me that people point out these horrible examples as a means of getting what they call tax reform -- usually the income transfer proposal.

How many of the millionaires and other groups are paying no taxes depend on these state and local bonds as a tax shelter?

I know what you are saying. It is true that they get a lesser rate and it is speculative. I am just curious. How many of these horrible examples that are thrown, to what extent do they rely on the state and local?

The Chairman. I do not think any of them, because the income is not being reported. They are not reporting the income, therefore they are not reporting deductions against it.

Mr. Shapiro. Senator Long is correct. None of the statistics you see in nontaxable include any individual's tax-exempt interest because that is not reportable and that data is not available to the Treasury Department for their tables.

To the extent that any individual would make taxable interest to pay no tax, that is not included in the statistics.

Senator Roth. I see.

Senator Gravel. What does that mean?

Mr. Shapiro. It means that the figures -- individuals with high incomes -- the figures would be greater if you included high income individuals who had tax-exempt interest. That information is not available to the Treasury. Therefore, the Treasury's tables as to high-income individuals who paid no or very little tax does not include any individual who has taxable interest.

The Chairman. Let us look at it this way. In this year, the inflation will be about 7 percent. That is more than any one of these bonds are paying.

So if you look at the erosion of your principal, there is no net income from it. If you take inflation into account -- even if you wanted to take inflation into account, they could have earned about 25 percent more if those bonds were taxable.

That being the case, they have accepted a lesser rate of return by the bond's being tax exempt. To that extent, they have made a payment to government already, because the government is paying them less for the use of their money.

So looking at those two factors, it seems to me that we are not taxing it, we are not proposing to tax it, even with the minimum tax, and I do not know of anybody who is particularly upset about it. There may be a few, but not many.

Treasury has not indicated it is upset about that item. That being the case, I do not think you ought to get into it. Just leave it the way it is.

I think we have enough problems without raising that.

Senator Gravel. Why can they not get the data so that we can know?

Mr. Shapiro. It was not available. At one time, in 1969, the House had a provision in its bill that required an individual to put on his tax return the amount of taxes on interest. In addition, the House had a provision that put taxable interest on the minimum tax.

If you recall, there was such concern about taxable income being minimum taxed -- if I recall, even before the Committee started its mark-up, there was an announcement by the Committee that there would not be a minimum tax.

Senator Gravel. I am not pressing you to put on a minimum tax. I am surprised there is an element of an economic transaction in our society that we purposefully put the blinders on and do not want to know anything about it.

Mr. Shapiro. The way to do that, the Committee chose in the past -- neither the Ways and Means Committee or the Finance Committee or the Congress has had an interest in doing it -- but put an item somewhere possibly on the tax return that indicates how much taxable interest an individual has.

Senator Gravel. Would that be unreasonable?

The Chairman. I am trying to recall the first fight we had around here that I was involved in. The first time that we had it before the Committee -- that has been quite awhile back -- can you recall the first time that we had our fight?

Mr. Shapiro. The one I recall was in '69. If you had one before that, I do not recall it. In '69, I remember the Ways and Means Committee marked up a bill in private mark-up session, so it was not that the full impact of the minimum tax was made aware nationally, and they heard from local governments, state governments and Mayors and the request that you had to testify and so forth was so intense that you made that decision early with a tremendous amount of pressure not to take the tax-exempt interest at that time.

Senator Gravel. If I could clear up this one point, I do not want to step into something that sounds logical. I am absolutely thunderstruck that we do not have the information about an income item that is so easily collected when we know basically this income item is enjoyed by the very wealthy in this society.

I am not saying they are ripping it off or avoiding something. I think your logic is very proper -- they are paying taxes already within the economic stream with that money. But I think it would be worthwhile and reasonable to expect that we should have this data when we ask the question how many people are doing this or what is the impact of that. That could simply be by putting an item on the return so we could be made aware of it.

The Chairman. Senator, all I can tell you, as one who has been through that fight, if you want to lead the charge for that, after you have been in for awhile you will back off. That is my impression. I have been around that for awhile.

Senator Gravel. Maybe I will lead a little charge. Maybe a little one.

Senator Hansen. Mr. Chairman, I would like to say this. I appreciate the interest that the Senators have in knowing what the situation is. As I understand Mr. Shapiro, the information is not all that easily gotten. It could be you could approach it from the other way if you wanted to inquire of cities and state governments as to the number of bonds that they were selling and what the interest rate was paid to them. You might get something

There is not anything presently in the tax return that requires that information. Is that right?

Mr. Shapiro. We have the data. You are suggesting how many bonds are out and to what extent the total amount of taxable interest is. That is generally available.

The information we do not have is the tax return information on the individuals who own those bonds.

Senator Hansen. What I was going to say, I could not agree more than I do with the Chairman that we have our hands pretty full, it seems to me, to deal equitably with this situation, and I sure think that we would pass up an opportunity to bring about some needed changes now to delay the whole thing until we get this additional information.

Senator Gravel. I do not want to do that. I just want to put a little square on the form.

The Chairman. Mr. Sunley?

Mr. Sunley. There are estimates of the amount of tax-exempt interest received by individuals as a part of the Federal Reserve Board flow of funds accounts. What we do not have is information from the tax return itself.

In the case of corporate tax returns, corporations are required to reconcile their taxable income for tax purposes with their financial accounting, net income. One of the reconciliation items is the amount of tax-exempt interest, so on the corporate tax return, we do pick up the amount of taxes.

We do not have the authority at this time, nor are we seeking it, to require individuals to report the amount of tax-exempt interest. The Internal Revenue Service is very reluctant to require any information on tax returns that is not needed for tax administration.

So if we were going to require taxpayers to report the amount of tax-exempt interest, we would need legislative authority to require adding that information on the tax return.

Senator Gravel. Would that be desirable knowledge on your part?

Mr. Sunley. We have an idea of the total amount of interest received by individuals. There is one other study -- it is not very old; I think it was done in 1962 when the Federal Reserve Board, based on a sample of high-income families, surveyed the actual asset holdings of those families, and you found just exactly what you expected. To the extent that individuals hold tax-exempt bonds, they tend to be the very high-income individuals.

And it has been the basis of that study that when we have been ask to impute the tax savings from not including tax-exempt interest, we have made some rough estimates. They are very crude. For our purposes, they would probably be adequate at this time.

Unless the Committee wanted to get into this subject in a big way at some future date, we probably should not open up this hornet's nest. We clearly are not seeking any change in the tax exemption other than the taxable bond option proposal that we continue to have an interest in.

The Chairman. It seems to me we have plenty of other areas that we can get into if we want to tax somebody. For example, it seems to me maybe we should not let a person have a complete deduction when he puts that money into his own private foundation. I have always had my doubts about these people escaping taxes. It looks like I am going to pay more taxes, so I am going to put more money in my foundation.

If that happened to be a foundation doing precious little good for anybody, to me that is an area where I think right there we are heading in the wrong direction by voting as a Committee, if the Committee has already voted against my protest to say that private foudnation would have their tax-cut for what little tidbit that they are paying.

We are not talking about that in this bill. All we are talking about are things that are recognized as preferences-- is that right, Mr. Shapiro?

Mr. Shapiro. That is correct. The only preferences that are being considered are the existing preferences.

The Chairman. What the existing law is.

Senator Byrd. May I say on that point, you are including in the preferences state and local taxes that are paid. Is that a shelter? Is that somebody gaining by paying state and local taxes?

The Chairman. What you are talking about there, when a person gets through itemizing and taking all the itemization they can find, this was Larry Woodworth's suggestion. When he looked at that minimum tax, he said if you want to stop this thing where they still come in and you still have 150 to 250 people getting by without paying any tax at all, you will have to put some limit on the extent to which they can avoid taxes by itemizing, because you just have enough possible ways open that you will still be looking at quite a few people paying no taxes.

That is true in absolute numbers. Not many, but that Roper poll came in, reporting that the public thinks that half the millionaires in America are not paying any tax because of all the conversation about the 200 who were getting by without paying anything.

So Larry Woodworth's suggestion was, if you say with regard to your minimum tax, if you do not pay anything in any other respect, then have that one last item for the purpose of the minimum tax they cannot itemize and deduct more than 60 percent of it.

That is what you are talking about. That would say, when they start itemizing they cannot out of all of it.

Mr. Shapiro. For the regular tax, they can deduct 100 percent of itemized deductions. They can itemize all of the deductions that they have. For the purposes of the minimum tax, they would have to include a portion of those itemized deductions except for medical expense and casualty. Those are not included in any case.

All itemized deductions other than medical or casualty would be included as a preference item if those itemized deductions exceed 60 percent of adjusted gross income.

The Chairman. That is the law.

Mr. Shapiro. That is present law.

The Chairman. As a matter of fact, my impression was that when Treasury this year -- I want to ask Mr. Lubick -- when Treasury started to do their scorekeeping about how many millionaires got by without paying us taxes, it looked like there was going to be a lot more than that 22 you wound up with. After you went back, a lot of people are not aware of that Larry Woodworth amendment which said for the minimum tax you cannot deduct more than 60 percent of itemized deductions.

Mr. Lubick. That is correct, Mr. Chairman.

The Chairman. Quite a few people who are going to get by without paying anything, they had to file and they did pay something, small though it may be.

Mr. Lubick. That is correct.

The Chairman. If, among any of those people, they can come in and show some cases that would draw the tears, I would be glad to vote them some relief. I have not seen it yet.

Here is the case on the blackboard that causes taxpayers to grit their teeth and get angry at some of us, to say why do you people let those folks get away with that?

All I am saying, in this case, rather than pay less, the fellow would pay a lîttle more.

Do you want to go ahead?

Mr. Shapiro. We have gone over present law just now. Next is the House bill.

Down through line 5, there is no change. That means the House bill did not change the regular computation, computing present law. The House bill, as you know, took capital gains out of the minimum tax as preference items and repealed the alternative tax, the 25 percent rate on the first $50,000. And then the House added an additional alternative minimum tax only on capital gains.

If you start with line 6, the reason it is an addition over the present law, it is $81,000 over $78,000, is that the House bill repealed the alternative tax. You could always get the first $50,000 of capital gains, and that was repealed. That is why the regular taxes were $81,000 where under present law it is $78,000 in the House bill.

The minimum tax, line 7, is $231,000. Essentially, that is on the excess itemized deductions where you can see on line 4 it is $4,195,000 and the excess of 60 percent of that over adjusted gross income at a 60 percent rate would provide the amount of $231,000.

The alternative minimum tax on line 8 is where the House bill takes the excluded one half of capital gains. That is line 3, that $834,000. Subtract a $10,000 exemption and then add, I think, a 10 percent rate. That 10 percent rate gives you $282,000. The way the House bill works, you compare line 6 with line 8. Line 6, $31,000; line 8, $282,000. You pay whichever is greater. That is the $282,000 on line 8. Then you add on the minimum tax to that.

So line 9, which is $513,000 is the total of line 7 and line 8, so you have a total tax on line 9 of $513,000 which is an effective tax rate of 7.1 percent of the economic income of $7,192,000.

The proposal that Senator Long is suggesting is a pure alternative tax, which is the third column on the board, would repeal the add-on tax but have a 70 percent capital gain exclusion. Then you would have a $20,000 exclusion from the alternative tax, and then rates of a 10 percent rate on the first $40,000; a 20 percent rate on the next $40,000; and a maximum rate of 25 percent on all income above $100,000.

Your expanded income is the same. $7,192,000, total economic income. Line 2, adjusted gross income, is less because we have a $70,000 exclusion. That means only 30 percent of the capital gains is taken into account, so the adjusted gross income is $3,224,000.

Line 3, excluding capital gains, 70 percent of the total capital gains are excluded. That is the $3,968,000.

The itemized deductions are the same. The $4,195,000.

So the taxable income on line 5 is minus $974,000. That is line 2, adjusted gross income less itemized deductions, line 4. So your taxable income would be minus $974,000. The regular tax would be zero under this proposal.

Senator Hansen. Let me interrupt you. Did you say that taxable income, line 5, that the minus $974,000 is line 2 minus line 4?

Mr. Shapiro. That is correct. Also, you have personal exemptions that have to be taken into account. That is the reason.

Line 6, no regular tax. This proposal has no add-on tax at all. That is why there is a 0 on line 7.

One line 8 is the alternative tax. The way you compute the alternative tax, you take taxable income which is minus $974,000. You add to that excluded capital gains on line 3, and then you add the same itemized deduction preference, the excess of 60 percent of adjusted gross income. You take that total, you subtract $200,000 as an exemption, and the rate schedule -- I included 10 percent of the first $40,000; 20 percent of the next $40,000 and 25 percent of all the expanded income above $100,000 and that gives you an alternative minimum tax of $1.058,000.

You would compare that to line 6, and, as you can see, line 6 has 0 tax. Total tax would be the alternative minimum tax of

$1,058,000. That is an effective tax rate of 14.7 percent of the expanded income of $7,192,000.

There you can see the effective tax rates of the three that are present law, the House bill, and this present alternative tax.

Senator Roth. I missed part of the discussion. When does the alternative tax apply?

Mr. Shapiro. It would apply to taxable income, plus preference income and theoretically, it could apply to any case where the taxpayer has large amounts of preference income, which you add taxable income plus present law preference items.

Senator Roth. How much preference income do you have to have? Does it apply to a little guy?

Mr. Shapiro. Generally speaking, the $20,000 exemption would exclude the small taxpayer also, and you start off with a 10 percent rate on the first $40,000. It would depend on whether or not a small taxpayer would be paying more than 10 percent.

Senator Roth. What if he sold his home?

Mr. Shapiro. Two things were contemplated. First, that the residence could be excluded from the alternative minimum tax but, in addition, you have a 70 percent exclusion on capital gains as well. If you exclude personal residences that we are assuming in this case, if you do assume personal residences from the personal tax, that sale of the residence would not account for the minimum tax.

Senator Roth. In effect, it would apply to a little guy if he had the preferences.

Mr. Shapiro. Then you have the question as to how little. Every time I suggest a number, someone laughs, so I question whenever we talk about a little person.

The Chairman. There is one thing about the proposal that I want to ask you about. Is that a standard income figure? Has that figure been reduced by the amount of state and local taxes that a person has paid?

Mr. Shapiro. Expanded income is total income with no deductions, total income received by the taxpayer.

The Chairman. It would seem to me -- I do not think that the minimum tax ought to apply on the tax that a person has paid to state and local government. I gained the impression that what is up there, it would apply to that.

Mr. Shapiro. Senator, to the extent that the itemized deductions include state and local tax, this particular individual that is up there -- on line 4, $4,195,000. That $4,195,000, $1,191,000 includes taxes.

The Chairman. State and local taxes?

Mr. Shapiro. That is correct.

The Chairman. It seems to me that would reduce the yield somewhat. I do not think it would reduce it a great deal.

There are not many people who are able to find itemized deductions for more than 60 percent of their expanded income. It would seem to me that, to the extent that we wind up levying a tax on top of a tax, that that is subject to considerable criticism and I just think it might be better, in that area, to the extent that the liability has been reduced by the taxes he has paid to state and local governments, that the tax base ought to be reduced. That would reduce your tax. You would not make as much money there, but I would like to see what it would look if we did that.

On that particular return, it would reduce it substantially, would it not?

Mr. Shapiro. Yes. You would take almost $1.2 million out of the alternative minimum tax.

The Chairman. How much would he be paying if you did that? How much would he be paying?

Mr. Shapiro. You would reduce it by approximately $200,000. The $1 million would be about $800,000.

The Chairman. $800,000. He would be paying more, but he would not be paying that much more. I would think in most of the places where it would apply that by taking the state and local tax out of it, it would not make any difference at all because the 60 percent would not come into play.

Mr. Shapiro. That is correct in this particular case, but in many of the cases it may not have an effect. You have several options that you could do in this regard.

The Chairman. That reaches the point that Senator Byrd is concerned about, saying that you are treating as a preference if a guy pays taxes to state and local government. I do not know if anybody does him a favor by having him pay taxes to state and local government, to the extent that if you take that out, to me, I would think that would be a better proposal. That would somewhat reduce the revenue income. I do not think it would reduce it much. On that illustration it does, but on the overall, I do not think it would make much difference.

Mr. Shapiro. I think that is correct.

The Chairman. Could I ask that the staff do a study to see to what extent that would reduce the revenues, because I do not think it would reduce it very much. I think, on the overall, on that illustration it would reduce it substantially, but on the overall, I do not think it would make much difference.

Senator Dole. You are talking about taking out state and local taxes?

Mr. Shapiro. Senator Long is talking about all taxes, state and local, property taxes, sales taxes, the total tax column that is paid as itemized deductions would be eliminated from the alternative tax.

The Chairman. In terms of expanded income, I do not see why we should think that we are doing somebody a favor. There are some states that do not let you deduct the Federal taxes that you are paying. That was done in Louisiana. It was so unpopular that they repealed that in the next session of the legislature.

It would seem to me that the Federal government has long recognized that the taxes paid to state and local government, that is not income to the person. I would be inclined to think, even on the expanded income tax basis, we should not think of that as income to the individual.

Does that upset you in Treasury, Mr. Lubick?

Mr. Lubick. Basically you are doing is trying to review the decision as to whether there should be an item of tax preference, the excess of itemized deductions. I think there is a real question that will be raised about that.

Basically what you are getting down to is a question of charitable contributions and interest.

The Chairman. You are talking about a lot of itemized deductions where a person has no choice about it. He does not have any choice about paying those state and local taxes. That seems to me -- it is just a judgment call, but it seems to me that that is one -- that provision is there by Larry Woodworth's idea that the minimum tax could not be reduced by itemized deductions to more than 60 percent, so you would leave some income subject to taxation.

I do not believe that if we leave the state and local taxes out of this, knowing what we know now about it, that you are going to have anybody escape without paying taxes. I do not think that is income.

That being the case, it would have some appeal to me to say that that part would be left out. On that illustration, that brings that down.

I would assume, if we decide to do this, that we would have to defend it against a lot of attack, and I think the very point that Senator Byrd made, taking the view that the man is getting the preference because he is getting the tax to a state government is a valid point.

Senator Hansen. Mr. Chairman, I am sorry I had to be called out a couple of times, but do I understand the way the figures under the column headed "Proposal" works is that the alternate minimum tax is figured on state and local taxes that were paid the year before?

The Chairman. If you get there in this respect, that under existing law -- and this would retain that part of it on tax preferences, for purposes of the minimum tax, you can only reduce it by itemized deductions to the extent of 60 percent, so the other 40 percent would remain subject.

It seems to me, if we are going to improve on our minimum tax and try to make it a better and fairer tax, that we are already leaving out of that, Senator, medical and casualty. The reason we are leaving that out is that we assume that that is something that the taxpayer has no control over. If you are sick, you have to go to the hospital and try to live.

If you are going to leave those out, it seems to me that you should also leave out the state and local taxes. If you leave those out on the illustration up there on the board, that would reduce that tax down to where he would be paying maybe 12 percent rather than 14.7 percent and on that illustration, it might look like a substantial reduction, but if he is paying more taxes because he is paying a tax to the state and local government, I think that is difficult to defend.

Senator Hansen. I would agree.

Senator Curtis. I think that is right.

The Chairman. So that I would think that it would be an appropriate modification of this suggestion to say that, to the extent the proposal should be modified to where the expanded income concept should not include the state and local taxes that this person is paying. That would reduce the $7,192,000 down to what, about $6 million?

Mr. Shapiro. Yes.

The Chairman. That is $7,192,000 that would come down to $6 million.

Mr. Shapiro. Approximately $6 million.

Senator Hansen. Then, would this be the effect that you would reduce the expanded income amount by the state and local taxes paid?

Mr. Shapiro. The effect of what we would do is reduce itemized deductions that would be a preference item. The $4,195,000 would be reduced by the $1 million, almost $1.2 million, of deductions, so you take almost $4.2 million in itemized deductions less $1.2 million. That would end up to be $3 million.

And, to the extent that your adjusted gross income on line 2, you multiply 60 percent times line 2, and to the extent that line 4, that $3 million now exceeds 60 percent of line 2, that amount would be treated as your preference.

The Chairman. That would mean he would be paying $800,000 on $6 million. How much would that be? What percent would that be?

Mr. Shapiro. A little over the 10.5 percent, maybe close to 11 percent.

Senator Hansen. Is there anything else in there besides taxes whereby you treat an expenditure as income?

Mr. Shapiro. All the itemized deductions. That would include interest, charitable contributions, and all miscellaneous items.

The way it works, all itemized deductions other than casualty and medical, which is excluded under present law, and all taxes: state and local taxes, real property taxes, sales taxes, the total taxes as is being suggested by the Committee now. That means all other itemized deductions would be potentially treated as a preference item.

The Chairman. It seems to me -- I think you are a little bit off in your calculations. You are paying $800,000 tax on $6 million. You are paying about 13 percent, so that tax would come down from 14.7 to about 13 percent.

Mr.Lubick. I think you have two questions here. One is what you treat as an item of tax preference in calculating the minimum tax. The second question is the use of expanded income as a measurement guide.

In that respect, measuring expanded income, that you are judging what deductions come off in measuring a person's income. I do not see any particular reason to treat the state and local taxes differently than any other expenditure, like food or rent, that he would have to pay. That would have nothing to do with the measurement of how much income a man has.

But when you get to the question of whether you, indeed, want to impose an extra tax including these items as an item of tax preference, I think that is a very different question. I think we ought to keep those two distinct.

The Chairman. Mr. Lubick, if it would make you feel happier and make Treasury generally feel happier, maybe we can just dispense with the use of the term "expanded income," and use some other term. But I am looking for what would be a fair starting point to relate a person's income to his taxes.

And we agreed that adjusted gross income is not very good, because after you get to adjusted gross income, you have state and local taxes, casualty. Is there medical there, at that point?

You have the charitable contributions. So to try to arrive at a fair comparison, what you do after you get your adjusted gross income is to take those further deductions and state and local taxes and casualty losses, reduce the total by those deductions that come directly, and then add back in the preferences. It would seem to me, at that point, you would have a meaningful basis for comparison. And I, for the life of me, do not see that a man ought to pay more taxes to the Federal government just because he had the privilege of paying more tax to the state government.

I do not think the state is doing a guy any favors to tax him. It seems to me, if that reduces his income, he does not have any choice about it. Most states do not put you in the penitentiary the way the Federal government does, but they will sure sue you to get their money if they can, and usually they do.

That being the case, it would seem logical to me that whatever comes up you want to agree on as a starting point from which you tax somebody, if we are going to tax them on itemized deductions, there ought to be some, at least, that he had some discretion about, not the ones that he had no discretion about.

Mr. Lubick. I do not think we are necessarily disagreeing with you on what necessarily you put the tax on. It is a question of measuring, for statistical purposes, a man's income, and I think you have a different consideration to take into account to see what you are talking about.

I also think that there are some differences among the different kinds.

The Chairman. The thing that came up here -- I do not know if he had any input in this suggestion. When we come in here with a suggestion, it is just an idea we are talking about, this sort of concept, that when you come in and look at what we would like to do I do not personally like to think that I am voting to put a tax on a tax, to tax somebody on top of a tax he is paying to state government.

Mr. Lubick. I do not think anybody is suggesting that you should.

The Chairman. The effect of this proposal, as it was brought in here, has that result and I think that we should not do it. It seems to me we can have a good minimum tax without doing that, and I think it would be a fair minimum tax if we did not do that.

Senator Hansen. I would like to make this observation, if I understood Mr. Lubick correctly. I think that he was saying that you could roughly equate the payment of state and local taxes with cost of living, food, and those other expenses. Did I understand you correctly, to imply that?

Mr. Lubick. What I am saying, for statistical purposes, if you are measuring what income a man has, you take into account generally his receipts. You exclude certain receipts which are the cost of obtaining -- you exclude the cost of obtaining those receipts.

You get to a number of items that are regarded as personal expenditurs. You do not exclude those in determining what his overall income has been.

As far as what the Chairman is suggesting, I agree with him. You do not necessarily put a tax on some of these expenditures. I think that is a different question. I think what we are trying to keep track of is, statistically, how we measure expanded income for statistical purposes. I think that is one question.

But the question of what preferences we are going to put a tax on, I think, is a separate question.

But I think the point the Senator makes is well-taken.

Senator Hansen. Fine. I do not have any argument. I think, if we are going to equate living expenses with taxes paid, there is a clear distinction that should be drawn. One is you have no choice over the taxes that are paid.

I think we have to keep in mind also that taxes contribute to government. They go to the support of government, whereas how much a person may want to spend on his own living is entirely up to his own judgment.

But I would agree with you, Mr. Chairman. It is no problem for me to say that the taxes paid ought not to be included in that overall figure.

Senator Curtis. If I could ask a question, what is your definition of adjusted gross income? Gross income less business expenses?

Mr. Shapiro. Yes. These are what were referred to as deductions above the line, before adjusted gross income, and those below, itemized deductions.

Senator Curtis. Taxes can fall in either place.

Mr. Shapiro. They can; to the extent they represent itemized deductions, they do. They are below the line and the others are above the line.

Senator Curtis. The state income tax?

Mr. Shapiro. Below the line.

Senator Curtis. In farming?

Mr. Shapiro. Above the line.

Senator Curtis. Where would you be -- I am not proposing this, but I am frightened about all of these things to see how they work out. If you are going to have a minimum tax, suppose for simplification, starting with adjusted gross income and you had a $50,000 deduction or exclusion, and had a tax of 20 percent as an alternative tax, figuring the taxes the usual way, and they had to pay the highest, someone with $1 million adjusted gross income, in that case, they would pay $190,000.

Mr. Shapiro. Senator, you would have the results that were discussed here. Senator Byrd's concern he raised with respect to state and local deductions, the taxes, would have the same problem with this type of proposal.

You are starting with adjusted gross income, meaning that you would get no deductions. At 50 percent, you would presume that is deductions, but this individual had $1.2 millions in deductions. That $50,000 is far less than $1.2 million.

Senator Curtis. But you started off, in that illustration, with $4 million instead of $7 million.

Mr. Shapiro. $4 million, not giving the taxpayers the benefit of itemized deductions. From the standpoint of simplification, whether or not you start off with adjusted gross income or taxable income and then add back items, I am not sure if it affects the simplification. The principal effect is what do you with itemized deductions. When you start off with adjusted gross income, you get no credit for itemized deductions. When you start off with taxable income and add back a portion of itemized deductions, you are giving no credit for all the itemized deductions and adding back just a percentage of all itemized deductions.

The total difference is --

Senator Curtis. I think our problem is complicated. Very unfortunately, because we set a goal to raise a certain amount of revenue, and what we should set as a goal is to catch those taxpayers who, by conscious manuveuring juggle their transactions so that they pay little or no taxes, and write a tax that incorporates those, but doing it in a just way, that did not hurt anybody else.

It seems to me that this is one place that we cannot very well adopt the criteria that we ought to raise a certain amount of revenue. What we ought to do is do justice here and stop someone who is manuveuring and paying no taxes and raise our revenue in the regular way.

The Chairman. Let us keep in mind, Senator, that what we are talking about here, this minimum tax that we are talking about now, compared to present law, will raise less money than the present minimum tax would raise. Is that right?

Mr. Shapiro. Less, yes, Senator.

The Chairman. What we are talking about here provides a great deal of relief from the minimum tax for people who are already paying us a substantial tax. Is that not correct?

Mr. Shapiro. Yes.

The Chairman. So we are talking about a situation where a lot of people who are already paying, let us say, 25 percent or even less than 25 percent, but if you take the 75 percent of those taxpayers on that study who are already paying 75 percent of expanded income in taxes, or 75 percent of adjusted gross income in taxes, for those people, this represents a tax cut. Is that not right? Compared to existing law?

Mr. Shapiro. Yes, that is right.

The Chairman. All I am saying is when you start substituting one thing for another, I think we should try to be fair in every step of the way in what we are doing and, to a very considerable extent, this does deal with what Senator Curtis is talking about, to reach those people who, by a lot of tax planning and conscious effort do manage to get their taxes very, very low.

How about discussing the next one? Why do you not put it up there where we can see it and talk about the other one.

Senator Curtis. If I may ask one brief question, on your capital gains, where do capital losses return to the minimum tax?

Mr. Shapiro. Before you get the capital gains, you net out your losses. For example, you offset your capital losses against your capital gains and only your net capital gains appear on your return, so your losses have already been taken into account before you get to your regular income tax.

Senator Hansen. There is not a 50 percent reduction on the losses, or a limitation on losses?

Mr. Shapiro. That has nothing to do with the minimum tax, but if your capital losses exceed your capital gains, there is a limitation on how much of your capital losses you can offset against your regular income, your noncapital gain income. That is a separate limitation. That has nothing to do with the amount of offset of capital gains, or against the minimum tax.

Senator Curtis. Is that limitation $1,000 or something like that?

Mr. Shapiro. $3,000. It used to be $1,000, then it was raised to $3,000.

Senator Curtis. You know, an operating loss would not be a capital loss, but it seems to me that there is a possibility that someone would create very large interest obligations in order to reduce taxes. If he has a portfolio of a great many investments, he can pick out a block of that and sell that at a terrific loss and turn around and buy a comparable stock at the depressed stock and he still has the equivalent ownership, but he has reduced his taxes by a sizable amount.

Mr. Shapiro. You have to have capital gains before, in order to offset the capital losses against your capital gains, and then to the extent that your losses exceed your gains, there is a $3,000 limit that you can use to offset losses against other income, so present law does have limitations to prevent large capital loss offsets against regular income.

The Chairman. Senator Danforth?

Senator Danforth. One observation. I think this is exactly the right track, this notion of an alternative tax. It would seem to me to be important to keep it simple in concept.

There is a possible trap in trying to be too precise in defining what is expanded income, that if we start increasing the number of items that are excluded from expanded income, you really have a possibility of a floodgate effect. Say, charities will be coming in and saying, let us be excluded from the concept of expanded income because these are some big givers involved here. I do not know what else.

I can just see the potential, and maybe the better approach, because we are dealing with a very small number of taxpayers, would be to keep a very broad concept of expanded income and either altering that rate or having a fixed percentage off of it rather than a fixed number of items off of it, so that you do not create this kind of an invitation year after year for one group after another just as the charities are doing now with the standard deduction.

The Chairman. You have a good point.

We should keep in mind when we are talking about a minimum tax that you are not talking about a tax on that income. When we talk about a minimum tax and you are going to fix something so that a person just cannot avoid paying you any tax, after all, keep in mind that he can defer income. He does not have to make these contracts. There are all kinds of elections that he can do that can run up his expense.

So when you take on the other end of that game, you cannot tax that fellow on the basis you are only going to tax net income in a true, net sense and be sure that you are going to collect the tax.

He has the option to put this money into a foundation and to run up his interest expense and do all kinds of different things that are available to him, some of which just absolutely defy the imagination.

After all, we work on this minimum tax a few days a year. Those fellows are planning against this all year round, including Sundays. If you are not going to tax on some basis where you are taxing more than just your net income, they will whip you. I will guarantee they will beat you. If you want to come up with nobody avoiding to pay a tax, you are going to have to work on the basis that you are not going to tax net income, but you have some items in there as necessary expenses that he cannot deduct, otherwise he is going to whip you for sure.

You have to think in terms of saying well now, there will be a low rate and we are going to take out these things that completely belong to his control, but there are some things that are not beyond his control that fall into that minimum.

Suppose you explain how the second one works. Apply the same concept.

Mr. Shapiro. Number two, you should have this sheet. It has been distributed to you as well.

Under present law, this individual has expanded income of $237,000 which includes capital gains plus other preferences. The capital gains portion of it is $86,000; as you can see on the third line there is the $43,000, which excluded one-half of $86,000 as capital gains and other preference income plus other income. Total, $237,000. Adjusted gross income is less the $43,000, which gives you $153,000 of adjusted gross income.

This individual had itemized deductions of $114,000. That $114,000 itemized deductions is made up of $31,000 of charitable contributions, almost $5,000 of interest, almost $7,000 of medical, no casualty, $58,000 of taxes and $13,500 of miscellaneous expenses. So that is the make-up.

The Chairman. How much taxes?

Mr. Shapiro. $58,000.

So of the $114,000 itemized deductions, $58,000 was taxes.

The taxable income is $35,000 and that leaves a regular tax of $2,200. The reason that the regular tax is small is that this individual had paid foreign taxes and the foreign taxes were $7,400. That is creditable.

That means the total taxes before foreign taxes was almost $9,700 but the individual had almost a tax credit of $7,400 of foreign taxes that were paid and allowed as a credit, which left a regular tax of $2,200.

Under present law, this individual paid an add-on minimum tax of $15,000 and therefore the total tax of $2,200 plus $15,000 is $7,200 and therefore this individual had an effective tax rate of 7.3 percent.

That is just Federal taxes. This individual also paid foreign taxes and also paid $58,000 of state and local taxes. Under the House bill, there is no change down to taxable income. There is an adjustment, and therefore $34,000. The regular tax in this case is $1,600. The add-on minimum tax is $750. The alternative tax in the House bill only on capital gains is $3,300. That is compared to the regular tax of $1,600 and since the $3,300 is greater, this individual pays the $3,300 plus the add-on tax of $750 and therefore the total tax is $4,050 or 1.7 percent of the expanded income.

And that is compared to the 7.3 percent.

Senator Curtis. What changes in the present law did the House make to come up with that result?

Mr. Shapiro. The House took capital gains as a preference on the minimum tax so that there is no longer a preference on capital gains. There is no longer a preference.

The House repealed the alternative tax -- that is the 25 percent tax that was only on the first $50,000 and the House had an alternative minimum tax on capital gains.

The point that you are making, what was the major item that reduced the 7.3 percent in present law to 1.7 percent, thus effectively taking capital gains out of the minimum tax as a preference item.

The other two items I suggested had the effect of adding more taxes to the individual.

Senator Byrd. The capital gains were taken out as a preference item but the state and local taxes were considered a tax shelter?

Mr. Shapiro. That is correct.

Senator, on this particular individual, he had other tax preferences. Not only that, but this individual had other preference items of $84,000 and that $84,000 included part of the itemized deductions that included state and local taxes that you have reference to.

Senator Byrd. The state and local taxes under this proposal and the House proposal and under the one that you have submitted, in either case, state and local taxes are considered a tax shelter, preference income?

Mr. Shapiro. Part of the itemized deductions included in the preference items, that is correct.

The Chairman. Could you tell me how that would work? Suppose you take out from this state and local taxes. Where would you come out then?

Mr. Shapiro. I have it. I will show it to you both ways. As we go down the proposal, let me show you how the proposal would have it with state and local taken out.

You would have your same expanded income of $237,000. Since the proposal has a 70 percent exclusion on capital gains and only 30 percent excluded, you would have adjusted gross income of $136,000. You excluded capital gains which is 70 percent, $60,000. You itemized deductions all the same, which is $114,000, which included the $58,000 of state and local taxes and other taxes.

Your taxable income in this particular case would be $17,000 and --

Senator Curtis. How do you arrive at $17,000?

Mr. Shapiro. $17,000 is adjusted gross income of $136,000 less the itemized deductions of $114,000 less personal exemptions. This is the amount that would be allowed for that.

That gives you a taxable income of $17,000.

The tax on that would be zero, because this individual would have almost $7,500 foreign tax credits and therefore the $7,500 tax credit would eliminate any taxes that he would have had on the

$17,000 so there is no regular tax. There is no add-on tax.

Where you see the alternative minimum tax, the $16,500, that would include considering taxes as a preference item. If you take taxes out, that $16,500 would be $7,400 and therefore, the total tax would be $7,400 and the effective tax rate with these taxes would be 3 percent instead of 7 percent under the proposal on the board.

The Chairman. 3 percent?

Mr. Shapiro. 3 percent.

The Chairman. 3 percent of expanded income?

Mr. Shapiro. That is correct.

The Chairman. Were you including the taxes?

Mr. Shapiro. If you included all taxes, this individual would pay a 28 percent tax of expanded income, including all taxes.

The Chairman. Are you including state and local?

Mr. Shapiro. That includes the taxes.

The Chairman. If you are thinking in terms of an eligible sovereign, it would not be that much. If you are thinking in terms of a foreign tax credit, and the Federal income tax, where would it come out that way?

Mr. Shapiro. We have to add the 78 percent, which includes United States taxes: 3 percent Fed, 25 percent state and local and other taxes, to get a total U.S. tax of 28 percent. And then you would have to add to that the foreign taxes, and we are getting to that right now. I would assume this individual would pay over

30 percent of his expanded income in taxes, which include foreign taxes, Federal taxes and state and local taxes.

The Chairman. It seems to me that it is fair to use the state and local tax as a deduction, but I think that the tax he pays to a foreign government just following the theories of the tax treaties we bring in here, usually coming out of the other Committee, the Foreign Relations Committee, give a person credit for the taxes he pays in the other country, and we agreed to that. We agreed to pay that just as though it were addressed to our government, and they do too.

It seems to me, for that purpose, where you are talking about taxation between equal sovereigns, you give a credit to what is paid to the other sovereign. That being the case, it seems to me we are thinking in terms, for comparative purposes, so all you add is the foreign tax to what the U.S. tax is. What would you come up with then?

Mr. Shapiro. 31 percent, Senator.

The Chairman. I am not talking about including state and local taxes. U.S. tax and foreign government tax.

Mr. Shapiro. About 6 percent. 3 percent Federal, 3 percent foreign.

That means the foreign government tax and the United States government tax would total 6 percent of this individual's ec-nomic income.

The Chairman. If you take out the state and local taxes from this illustration, this person would pay less tax than he would under the existing law, would he not?

He would pay, comparing that 1.7 you have there, he would pay 3 percent?

Mr. Shapiro. That is correct.

As you can see, just picking out a couple of examples does not give you a full feel for the application. That is why we are going to try to pick out a whole series of exhibits for you, because you are going to have varying results. The examples that we have here are the ones that Treasury used to show the so-called horror cases with the House bill approach. That is why we are using these examples, because they have already been picked out as a simple sample.

We will try to prepare for the Committee a series of examples to give you some range of samples as to how it would apply in a number of cases.

Senator Curtis. Would your result be any different, instead of removing taxes paid from itemized deductions and add-on, that after you figured your alternative tax, you gave credit for taxes paid?

Mr. Shapiro. A dollar for dollar credit in most all of these cases would greatly reduce the amount of tax.

Senator Curtis. Reduce it further?

Mr. Shapiro. Greatly reduce it, because it would be a dollar for dollar credit.

The Chairman. It seems to me if that example there is to illustrate tax justice and tax fairness, the failure to put in that $58,000 of state and local taxes in that $238,000 example tends to give a misleading impression and also if you reduce that down by $58,000 to $198,000, when you talk about the tax to make it meaningful, you reduce it below the $16,500, you ought to add that foreign tax into it. And that would show you where you really stand.

It seems to me that that would be a more meaningful comparison.

I can fully understand how, from the point of view of a taxpayer, he feels that taxes are taxes whether you pay it to a state government or pay it to a Federal government, but I think it is a pretty well-established theory that we will allow deductions for state taxes and we will credit what you pay to a sovereign nation.

That being the case, that that would work out to a pretty fair illustration. It would not work out to a 1.7 percent tax. It would work out -- it would be 1.7 percent by the House bill, but if you add the foreign tax back in, you get back to 6 percent.

Mr. Shapiro. Under the proposal you are discussing, that is correct.

Senator Byrd. If you add a tax back in, it would be a lot more than that.

Mr. Shapiro. If you added state and local taxes back in, it would be 31 percent.

Senator Byrd. It seems to me to be damned foolishness to say for a person to pay state and local taxes, that he is not utilizing a tax shelter.

Senator Hansen. I agree with you.

Senator Curtis. You make it vulnerable in the Administration.

The Chairman. It creates no problem for me as far as I am concerned, to leave out the state and local taxes. The minimum tax, as it stands now, it is medical and casualty. The 60 percent rule.

It gives me no problem about state and local taxes in that there is something that he has no choice about, no option.

Senator Hansen. That is the way I feel, Mr. Chairman.

The Chairman. From whatever income you want to assess your tax, I think even if it is not adding some figure, it should not include the state and local taxes, and I think that he ought to be credited to the tax he pays to a foreign government because that is the way we do business.

To me, for example when somebody pays 90 percent of his income to a foreign government, for somebody to come up here and say that fellow paid no tax without mentioning that he paid 90 percent of his income to a foreign government, it is a very misleading and rather demagogic statement.

Why do you not get out your illustration and make it available to the Senators. I think they would like it studied, and see how this would work.

As far as I am concerned, the Floor is open for discussion of other suggestions that people might make.

Is there something you wanted to explain to us?

Mr. Shapiro. There is nothing else that we have this morning.

The Chairman. If there is one particular item that one person wants to discuss -- I will tell you one thing that I would like to discuss with Senators, and we will have to discuss it further.

There is a substantial feeling among many Senators on this side of the aisle that rather than have a second year reduction in the income tax, the corporate income tax, some have suggested it -- Mr. Danforth has suggested it, for example -- that we ought to have an increase in the fast tax write-off, the so-called accelerated depreciation.

About how much, compared to going down from 46 percent to 44 percent, how much additional tax cut, how much better could we do on the accelerated depreciation, Mr. Shapiro, with the same amount of revenue?

Mr. Shapiro. It is very difficult to put it into exact context, because your rate cuts apply close to even each year. It is about $1.8 billion for each point you reduce the rate, so if you increase the depreciation, for example, ADR from 80 percent to 20 percent, it starts off small because you have a little bit the first year. You have those assets increasing as well as new increasing assets coming on in your ADR.

Presently, a 20 percent depreciation of ADR range, about $500 million for 1979. By 1983, it goes to $3 billion.

If it were a 40 percent range, it is approximately $1.1 billion in '79. It goes up to %6 billion.

So the fiscal year effect, you would not have the problem from the standpoint of having the ADR increase, but the long range of increases to high levels, once it reaches a peak, then it will turn around and come down a little bit, because if the assets get a faster write-off in earlier years, in latter years it has a lesser write-off, so it would come down.

In order to be fair, we should show you the long-range effect, because it shows the peak going up and then coming back down and your corporate rate reductions, it is more of a stable situation where, even though it increases, it does not have the bigger jumps that depreciation has.

Senator Byrd. Let me throw in another proposal, if I may.

The Chairman. I thought that it would be well to have some discussion on this today, that there is more than one side to this.

Senator Byrd. Let me see what the revenue situation would be in this regard.

Senator Curtis. Are you talking about the minimum tax?

Senator Byrd. No. This is a business tax now, corporate tax now. If you went from zero to $75,000 at 18 percent and all income above that at 45 percent, and then you had a depreciation, a three-year write-off for the first $100,000 of equipment, that is roughly what Senator Nelson has proposed, and a six-year write-off of all above $100,000.

Now, with mandated equipment, government-mandated equipment, you could give the option of 100 percent write-off that the company could take.

What sort of revenue situation would that be?

Mr. Shapiro. That first one is almost $7 billion. That is the 18 percent of the first $75,000 and 40 percent thereafter. That is compared to $5.1 billion under the House bill.

Now, we will get a refined estimate for you. When I say almost $7 billion, we have an estimate of 17 percent on the first $75,000 and 45 percent thereafter, would be $7.3 billion.

So we have to get the exact estimate on the 18 percent because you can go up from that.

Senator Byrd. The House bill provides 17 percent. This would be 18 percent?

Mr. Shapiro. That is correct. We are assuming that it would be close to $7 billion.

We are checking on the depreciation one, but the option to have the write-off on all government-mandated equipment is very expensive. It is in the neighborhood of $3 billion. We are checking that because we have to be sure that we have a list of all the government-mandated equipment, but that could be as high as $3 billion, as we understand it.

We are trying to get the rest of the estimates.

On the first one, with rate cuts, it is approximately $7 billion compared to the House bill. Your government-mandated write-off, we have approximately $3 billion, although that is not firm now, because we are making sure that we know all the government-mandated equipment, but it is a high figure.

And then the depreciation alternatives, a three-year write-off for the first $100,000, a six-year write-off for all others, we are checking that right now. We will definitely have that for you by tomorrow and possibly by today.

Senator Byrd. As you can see, I was trying to work out something that would compromise between the tax rates, the continued reduction of the tax rates, and the beneficial effect that the Secretary of Treasury feels we are going to get and the Chairman of the Federal Reserve Board by accelerating depreciation.

Accelerated depreciation has a lot of advantages but, as Senator Danforth pointed out, most companies would prefer a reduction in tax rates.

This is a little bit of a cross between the two, I suppose.

Mr. Shapiro. I can give you a figure on the first part, which is the three-year write-off for the first $100,000 of equipment. On a calendar-year basis, it is approximately $700 million in '79 and that builds up to $4.4 billion in '83. All of the depreciation starts off small and builds up over the years and kind of has a little curve and comes back down a little bit.

Your six-year write-off, it would be a little bit more than that. We are still getting a figure.

Apparently, when I gave you the figure of $3 billion on the government-mandated equipment, it is very rough and we have seen a couple of figures that that is really too high, so I would like to refine that estimate, have it refined by staff, before we give you a permanent figure.

Senator Byrd. There is no rush on it.

Senator Matsunaga. Mr. Chairman, what is the dividing point between small business and big business where income is concerned, or is there such a demarkation?

The Chairman. Let staff answer that. I think you had just better tell him what the brackets are. Senator Matsunaga wants to know.

Senator Danforth. It goes up to $50,000 now and gets removed after $50,000 of corporate income. The surtax exemption is removed and you are at the maximum rate, 48 percent.

Mr. Shapiro. The rate schedule applies across the board in the House bill; the low rates would generally go to the smaller business.

The Chairman. He wants to know what it is now. You want to know what the law is right now.

Senator Matsunaga. Right now.

Mr. Shapiro. Do you want to know the corporate rates?

The Chairman. Yes.

Mr. Shapiro. I am sorry.

Senator Matsunaga. No. What I am driving at, we talk about small business because we tend to separate small business from big business. As this proposal applies, the proposal of the House, the proposal of Senator Byrd, as they apply to small business, which would be more beneficial?

And how many percent of so-called small businesses would be affected by the proposals, affected in the sense of having the benefit of a lower rate? This is what I am concerned about, because I noticed if we were to accept Senator Byrd's proposals, not considering the depreciation at all, we find that those presently paying from the $50,000 to the $75,000 would have the greatest reduction. They would have a reduction of 30 percent, whereas those below would have an earnings income of less than $50,000 and would be getting a reduction of only 2 percent.

Mr. Shapiro. Senator, between the House bill and Senator Byrd's proposal, the businesses that have less than $25,000 of income would be better off under the House bill by 1 percentage point, 17 percent and 18 percent; based on $25,000 income at the 1 percentage point, they would save $250 under the House bill. The $250 is on the first $25,000.

However, between income of $25,000 and $75,000, they would be better off under Senator Byrd's proposal than they would under the House bill.

Senator Danforth. Mr. Chairman?

The Chairman. Senator Danforth?

Senator Matsunaga. I see, because the House proposal is 30 percent?

Mr. Shapiro. 20 percent, 30 percent, then 40 percent. So the maximum amount that someone would be disadvantaged under Senator Byrd's proposal would be $250 and that is the maximum amount.

Senator Matsunaga. So comes now my question: what, if any, point of demarcation is there between small business and big business as defined by the Internal Revenue Service, if any -- by way of income that is, or is it simply by size of number of employees, or amount of capital? What is it?

Mr. Shapiro. The SBA has a definition they use which, as I understand, is generally less than 500 employees and less than $10 million in gross receipts.

I was told that is the definition they use.

But then again, this may vary by industry and this is the SBA definition, not for tax purposes. As I understand, this follows the definition SBA uses for purposes of their loans and some of their regulations.

Senator Matsunaga. The Internal Revenue Service does not follow that.

Mr. Shapiro. There is nothing in the Internal Revenue Code that would require a definition of small business for the purposes of their recordkeeping.

Senator Matsunaga. They simply follow the rate tables?

Mr. Shapiro. That is correct.

Senator Byrd. Small business would benefit considerably, would it not, by the three-year write-off?

Mr. Shapiro. That is correct.

Senator Byrd. Probably much more.

Mr. Shapiro. Senator Byrd, what the small business people tell us that although ADR, the additional 20 percent variance is available in present law, the regulations and the paperwork is so burdensome to them that they do not bother with it and therefore, they do not even take advantage of the present 20 percent, and the three-year write-off would be -- not only would it be more generous than the 20 percent, but it would help them more because they do not take what is presently available to them. They cannot cope with the regulations and the paperwork that it involves.

That is why they have been advocating a three-year write-off.

Senator Byrd. The faster write-off would benefit small business proportionately much greater than large business.

Mr. Shapiro. That is correct.

Senator Matsunaga. Would this apply to old equipment as well, not fully depreciated, or only new equipment, the three-year and six-year?

Senator Byrd. I would assume -- I had not thought about it.

Mr. Shapiro. There are two parts. Any new equipment that a business would buy would be covered, whether it is new or used. Your question is, what about a business that is depreciating equipment, for example, that has a ten-year life and you bought it two years ago and you have eight-years left. Would you be permitted, instead of depreciating the rest of it over those years, switch and start three years. That is a decision that the Committee would have to decide.

Senator Matsunaga. That was my question. That is not included in your proposal?

Senator Byrd. No. I had not thought of that.

Mr. Shapiro. In the past, Senator, when these proposals come to the Committee, generally speaking, we did not permit those adjustments for the reason that your proposals are usually provided as incentives to induce taxpayers -- for example, the investment credit is to induce them to make an investment, or depreciation would give them a faster write-off to encourage them to make an investment they otherwise would not make and generally speaking, because of the revenue restraints that are generally before the Committee, the taxpayer has already made an investment, has the schedule, has adjusted for that. You would not be giving an inducement to make an investment that he otherwise would not make.

So in the past, you generally have not applied it to their existing situations. That generally has been because of the revenue restraints.

Senator Byrd. That would be the appropriate way to go.

Senator Danforth. Mr. Chairman?

The Chairman. Senator Danforth?

Senator Danforth. Let me just state what I consider to be the underlying concept and then how I think we should reason from that concept.

It seems to me that the underlying concept should be in a tax bill in addition to trying to do equity, how do you have the maximum beneficial effect on the economy? If you assume that the economy is now sluggish -- and I think that is manifestly true -- then it seems to me that when you are dealing with a tax bill, you have to address the question of how, in additoin to offering relief and furnishing equity for individuals and for business operations, how can we have the most and the best possible effect on the economy.

And that is particularly true with respect to business taxes.

So we have had one witness after another come before the Finance Committee and that was sort of the line of questions that I was asking them.

It turns out that they say that the most benefit that we could have for the economy is the corporate rate reduction. I could not care less. I have introduced bills six months ago that did everything -- reduce rates, expanded accelerated depreciation, increased the investment credit. It does not matter to me a bit.

But it seems to me that if you are trying to help the economy, then you have to ask people who know something about the economy which approach they want to take. If you cannot do everything at once, if you cannot just follow every course that is possible at the same time, which course does the most good?

So we put the question to the witnesses here. Beyond that, we put the question to people who were not before the Finance Committee as witnesses -- business people, economists. There was a difference of opinion. Some people would rather have tax relief in the form of accelerated depreciation. Some people would rather have it in the form of a good investment credit.

There is absolutely no doubt that the preponderance of opinion is that most people who have thought about would rather have had tax relief in the form of corporate rate reductions, and that is most business people and it is most economists. It is not universally the case.

Chairman Miller of the Federal Reserve made a very good case for accelerated depreciation. He was very, very persuasive. But for everybody who makes that case, there are two or three who make the opposite case, and they also appeared before the Finance Committee. Alan Greenspan was one, Murray Wietenbaum was another, and Reg Jones with General Electric was another.

So, it seems to me that, if we agree with the principle that a tax bill should try to help the economy along, then, instead of just sort of grabbing a concept out of thin air as to whether to us it seems more reasonable to have accelerated depreciation or a rate reduction, the best reason to make that decision, whether they are business people or economists.

It happens that in this particular case their situation is the same as the Administration's. The Administration favors rate reduction. The Administration does not favor putting in the tax relief in expanded depreciation.

What I am concerned about, if we go off kind of on our own notion, ADR sounds good, despite what the preponderance of what the experts tell us, we have done two things. We have gone to conference with a 46 corporate rate, and there is no room for compromise. If ADR gets wiped out in conference, that is it. We have had it.

Secondly, if we are trying to put together a total package that the President will sign and I think that is important, then it seems to me that where you can stay close to the Administration, you should stay close to the Administration, and the whole corporate tax thing is an area where you can do that.

So that really, without any sense -- I have been pushing all of them, but it just seems to me that if we wanted to follow the best advice that is available, if we want to have something where we can come out with a decent bill after we come out from conference, that the President will sign it, then the thing to do is really concentrate on rate reductions.

Senator Byrd. I do not disagree with what you say at all.

You made a good statement.

As I understand it, maybe I had better ask the staff. As I understand it, you could not hardly go below 45 percent, which is what I suggested, without the revenue loss being so great that you could hardly sustain it.

Senator Danforth. The testimony was that you need not do it all of a sudden, that you can phase it down over a period of time. And, from a standpoint of business investment, they are not looking to next year's tax rate or to the year after. They are looking at what their rate of return after taxes is going to be five years down the road, six years down the road.

So what you can do, and what, in fact, the Administration has proposed, is a two-step phasedown to 44 percent, so they would have you starting out at 45 percent down to 44 percent. I would rather go further, maybe start slower, start at 46 percent, and then phase down to 44 and then phase down to 42, so that you trigger the immediate investment that comes from the long-term certainty of what the return is going to be down the road without the substantial, immediate revenue effect and just a rapid reduction of the rates then. And then hopefully, when we get the economy moving a little better down the road, then we have a broader base against which the rates apply. That is the theory of doing it.

The ADR, as a matter of fact -- as a matter of fact, the concept of accelerated depreciation is not so much a total reduction forever, but is a squeezing of tax relief into a period of years and that is what accounts for the sort of bell effect of the curve of reductions that Bob is talking about.

I am sure that the corporate rate reductions are going to be more in dollars than ADR, but I think that it can be worked out in a way which is supported by the Administration, in a way that is supported by the preponderance of economists and businesspeople, so that you can phase the corporate rate reduction in such a way so that it will not have a catastrophic effect on revenues.

Senator Byrd. My suggestion of 45 percent is what the Administration suggested, is it not?

Mr. Shapiro. That is correct. Their proposal had 45 percent at lower than $75,000 on income above $50,000. That was based on a $25 billion tax cut package.

When that $25 billion figure was reduced in the House to the neighborhood of $15 or $16 billion, the House made other adjustments to it which reduced the total revenue to the business sector in as comparable a manner as it was in the private sector.

It was 25 percent, and in the future, it was open to 45 percent, one year later.

Senator Byrd. My suggestion was to leave it at 45 percent but then to accelerate the depreciation. I cannot help but believe you are going to get a great deal of activity if you permit fast write-offs for equipment. That is, as Senator Danforth says, you want to consider what is best for the economy as a whole, and there is a difference of viewpoint on it.

Senator Danforth. I think that is the issue, Harry. I think that is exactly the issue. It is what does the best. Is it ADR or corporate rate reductions, and how much can we put into it?

There are several points of view that are available.

The Chairman. Then I would suggest that we recess until 10:00 o'clock tomorrow morning.

(Thereupon, at 12:10 p.m., the Committee recessed to reconvene at the call of the Chair.)

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