EXECUTIVE SESSION

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MONDAY, SEPTEMBER 25, 1978

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

The Committee met, pursuant to notice, at 10:50 a.m. in room 2221, Dirksen Senate Office Building, Hon.Russell B. Long (Chairman of the Subcommittee) presiding.

Present: Senators Long, Talmadge, Ribicoff, Byrd, Nelson, Gravel, Bentsen, Matsunaga, Moynihan, Curtis, Hansen, Dole, Packwood, Roth, Laxalt, Danforth.

The Chairman. Gentlemen, I have written to the people who served with distinction in this government and I will make available to you, and also to the Press, their response in relation to a cut in capital gains, such as we have voted on, to have a positive or negative impact on government revenues.

This was done -- I sent a letter and asked that question of these gentlemen, and I enclosed the statement of Henry Fowler, former Secretary of Treasury, and also I enclosed the statement of Dr. Martin Feldstein before the Committee, and I asked those gentlemen to give us what their reaction is.

We heard these gentlemen listed here on the table of contents, for example, Former Secretary of Treasury William Simon;

George Schultze; Joseph Barr; Douglas Dillon; Robert Anderson. All responded that they thought that the tax cut in capital gains, for which we have voted, would have a positive impact on government revenues. They thought it would bring more money than it would cost us in a tax gain -- as a result of cutting this capital gains rate would bring in more money than it would cost. A net revenue gain.

We had Mr. Arthur Greenspan and Mr. Herb Stein who wrote in and assumed -- they thought that we should put it in the budget at zero on the theory that they thought you would make money on it but they thought, because of the speculative nature of this, that they thought that you should estimate neither gain nor loss, but they do think there would be a great deal of feedback.

You notice John Snyder wrote us. He thought it would cost some money to the Treasury but you ought to do something along this line because the economy needs it, if the economy is going to keep moving. And the jury has indicated, if you look at the Table of Contents, which is the third page, overwhelmingly they estimate that there would be a positive impact from a cut in the capital gains rate in the area that we have acted.

Now, I might want to propose that we amend this section and start out stating what I believe to be the case, that it is the sense of Congress that this reduction in capital gains will actually have a positive impact on government revenues.

I think Treasury is trying to be cooperative. They have

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indicated that they will modify their static estimate -- and it looks to me as though it would split the difference, from their point of view. But I would not be voting for this cut in the capital gains unless I did not think that it was going to actually generate revenues rather than lose revenues to the government.

If I thought that we were going to lose revenues to the extent that that static estimate puts it without the kind of feedback that I think this would have, I would not be voting for it.

That being the case, I might want to ask the Committee before we report this bill to agree with an amendment that we state that, according to our estimate, this would bring a net gain in revenue.

Senator Hansen. Mr. Chairman, I want to compliment you for the diligent work that is reflected in the material that you have just handed out here. I am disturbed about several things, the first of which is that the perception that the typical American has in reading press accounts of the action of the Finance Committee suggests that our only concern is to relieve the burden of taxation from those very wealthy individuals or those with enormously high incomes, and that comes about because of the use of the term "expanded income."

A person may be making only $10,000 to $15,000 to $20,000 a year throughout the most productive years of his life and he happens to sell that one piece of property that he owns under the expanded income concept, he becomes a $75,000 or $100,000 or $200,000 taxpayer and, as a consequence, a very distorted impression of what the facts are is reached by the typical American.

Secondly, I think it is important to understand that practically every witness we have had before Senator Byrd's Subcommittee indicates that there is no question at all about the direct relationship between cuts in capital gains taxes and the accumulation of venture income which has a direct relationship to the creation of new jobs.

Secondly, the point was made repeatedly because of our oppressive tax laws, new companies who have the greatest potential to hire new employees have been forced to go abroad. This has been true of the electronics industry and other industries as well, and I would hope that this will tend to allay the concerns and put the facts straight that I think so far are not very clearly discernible to the average American.

The Chairman. I would just hope that every member of the Committee and every member of the Senate -- I will be happy to provide this to every Senator -- would read what these great Americans have responded to these questions, and I hope that the media, which is ably represented here, will find the time and read this.

I must say that it has had a major impact on this Senator and it has helped me with my thinking on the matter, and I would think that it would certainly be useful to all. What I stated is not, by any means, the unanimous view. The Senators will find that there is a difference of opinion, just as they will find a difference of opinion on a great many other things.

You will find Professor Hill does not completely agree with the others. He takes a different point of view. You will find a different point of view of Arthur Okun. I have another letter from him raising an interesting suggestion that we ought to give a tax cut of those in the large corporations to comply with the President's guideline on prices, and I find a lot of appeal to that.

I want to raise it before we conclude consideration of this matter. If it is not here, I will be glad to provide it.

Senator Curtis?

Senator Curtis. Mr. Chairman, I want to commend the Chairman for this compilation in one document what we have heard about. It seems to me that there are two factors which this Committee has to take into account. One is what we are trying to do is compete with foreign producers and capital is just as important as it ever was -- more so in capital-intensive industries, and we should not have a tax policy that gives the American producer a disadvantage or drags ownership out of the country.

Secondly, I think that we should handle with care any conclusions about how this affects any particular income bracket, because it may be that a once-in-a-lifetime sale of a capital asset could put a taxpayer in a bracket far out of proportion to his lifetime earnings.

I can think of some situations where farmers are not large landed gentry but have a farm that they, themselves, live on and operate but, due to inflation, the capital gain on paper would be exceedingly high and it would put them in a bracket for interpreting the benefits of capital gains that some people might contend that you are helping a higher bracket individual.

It would not be. It is an accidental high bracket, once-in-a-lifetime. Perhaps the individual has had a rather modest income all these years.

Thank you.

Senator Ribicoff. Mr. Chairman, I suggest that you might consider having the staff get together a summary of the basic positions for and against your thesis to be used on the Floor and to be made available to the members of the Senate. I would doubt that they would read all the details.

The Chairman. Senator, I would think that one may be confused, if you look all over that list.

Senator Ribicoff. A summary of the conclusions that are generally made by the people for and against it.

The Chairman. Yes. But, Senator, if you look down over that list and -- for example, I would definitely want to read what William Simon said and what George Schultze had to say about it and what Douglas Dillon had to say, just to mention three. But if you are like I am, you do not read every single speech, you read the statements of the people who you most often agree with about matters of that sort.

So you can pay your money and take your choice, you might say -- who the fellows in that group that you most consistently respect and see what they think about it.

I will try to get you a summary, if you would like it.

Senator Byrd?

Senator Byrd. I had an interesting experience Saturday evening. I spoke in the city of Norfolk and took a taxicab from the airport to the hotel and the taxi driver recognized me and we chatted awhile and before we got to the hotel, he said, "Senator, I have been reading about this thing called capital gains, taxes on capital gains." He said, "I wonder if you would let me know whether you feel that the capital gains tax is about what it ought to be, or is it too high or should it be reduced?" It was a very neutral question.

I explained to him the situation as I saw it, and he said, "You know, I reached that conclusion myself, but I don't pretend to be an expert on any of these things, but I was concerned about my wife, and I have talked about it, and we have reached the conclusion that the capital gains tax should be reduced." That was a taxi driver in the city of Norfolk.

The Chairman. You get a lot of wisdom from those taxicab drivers. I find they are a great source of information.

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Senator Nelson, you have a suggestion. Maybe we ought to vote on it, to substitute what the Committee had previously agreed to. If you want to, we can vote on it today, to see whether we want to take the small business approach or the Bentsen amendment with regard to the depreciation.

Senator Gravel. May I suggest that we also make this available to the members of the House Ways and Means Committee? It may really help in conference.

Senator Hansen. Could you use your microphone?

Senator Gravel. I was suggesting that we make this document available to the House Ways and Means members. It may plow the ground for a good conference.

The Chairman. It seems to me it is an entirely different situation when you are voting to remove a counter-productive feature of the tax law, one that is costing you more money than it is making you, and you tax people beyond the point of diminishing returns and you actually gain revenue for the government by dropping the tax rates back where you are no longer projecting a completely counter-productive tax.

That is what I believe that this Committee is trying to do in reducing the tax on capital gains.

Senator Nelson, you might like to speak to your proposal because, as far as I am concerned, I think we could do one or the other. I do not believe that we can do both. I think that the revenue impact would be too heavy to do both. Why do you not explain what your view is with regard to the depreciation matter?

Senator Nelson. Well, last week Senator Bentsen submitted his proposal on ADR. I will be offering this as a substitute to that proposal on expanding the ADR.

This proposal aims at providing a three-year straight-line depreciation on any asset bought by any business at a cost not in excess of $25,000 in one year.

It would not change the provisions in the current law, however, on investment tax credit If it is a seven-year asset, they could depreciate this seven-year asset on a $25,000 purchase, capital purchase, in one year, depreciate it in three years and get the full 10 percent.

If they had an asset that was five to six years, they would get two-thirds of it. If they had an asset that was three to four years, two-thirds. Four years, they would get one-third.

I think that you can argue -- certainly Senator Bentsen vigorously does -- as to which one does the most good for the economy and for industry, business and for capital accumulation growth and so forth; and both sides can make a critical case for it.

The obvious case here is that smaller business, which represents about 14 million people in this country -- 14 million businesses, counting two million of those as being agriculture -- that small business does much more broadly benefit from this provision.

Small business, the statistics show businesses with 2 million or less do not use ADR. In fact, the largest corporations use it most, but the statistics are that even the billion dollar corporations, only 63 percent of the corporations in this country with assets of $1 billion or more use it.

Obviously, double-declining balance or some other method is more attractive to them.

Senator Packwood. May I ask you a question? You said this is straight out, basically a substitute for Lloyd's provision. You are not changing the present investment tax credit at all?

Senator Nelson. No. In other words, they can have an asset and depreciate it in three years regardless.

Senator Packwood. Up to $25,000?

Senator Nelson. Up to $25,000 of purchasing, if it were a ten-year asset, seven-year asset, five-year, four-year. Of course, in the current law, if it is three, they can anyway. They can depreciate it in three years. But the current law as to getting credit as an investment tax credit would remain. If it is a seven-year asset, you would have to hold it at seven years.

If it were a seven-year asset you can get the full investment tax credit of 10 percent. If it were a five-year asset, you can only get two-thirds.

Senator Packwood. If you have an asset that has seven years life or longer, $100,000, do you depreciate the first $25,000 on a three-year basis and the other $70,000 on a different basis?

Senator Nelson. You could.

Senator Curtis. May I ask a question?

Does this $25,000 apply to one piece of equipment, or is that an aggregate?

Senator Nelson. It is $25,000 accumulated capital investment in any single year. If you bought five machines worth $5,000 each, that is $25,000 worth of capital investment. You can depreciate it in three years.

Senator Curtis. The matter that strikes me, if that is the case, if this $25,000 is really adequate to do any good to small business, can they buy much capital assets for $25,000?

Senator Nelson. Well, a farmer can buy a tractor for it.

Senator Curtis. A small one.

Senator Nelson. There are all kinds of capital investments by small companies and corporations. My staff just reminds me that 80 percent of all capital equipment purchased annually is less than $25,000, by all businesses.

Senator Curtis. Do small businesses purchase capital assets that are low in price, or do small businesses have to, at times, buy expensive pieces?

Senator Nelson. I do not know if I understand your question.

Senator Curtis. The paper in my home time -- a little smaller than the New York Times -- he has to buy a printing press once in awhile. To get the most modern and labor-saving machine, he may have to pay -- he does not buy as many of them, but he has to pay a tremendous sum, the same amount that he might pay --

Senator Nelson. Excuse me. They are waiting for me on the Floor to offer an amendment. Excuse me.

Senator Curtis. My only point is, I think the $25,000 annual cap is too small.

Senator Nelson. I would like to see it at $100,000. One of the factors in determining -- two of the factors were -- one of the factors was the cost. That was part of the question.

Nevertheless, still, you are covering the purchases of most of the small or a substantial part of the small businesses and when you look at the statistics and find out that they cannot use the idea. They do not use it. Nine-tenths of 1 percent of all of the businesses of this country are of a $500,000 or less. Only nine-tenths of 1 percent.

As you go up the ladder, it goes up a little, but it is a very small percentage because of the complications of it.

Senator Curtis. My interests are, like yours, with the small businessman but I think that this has two aspects: one, what does it do for the individual taxpayer but secondly in the public interest, what does it do in the way of modernizing equipment and our ability to compete with the rather large industrial giants in other countries.

Senator Ribicoff. If the Senator would yield, I think that is the whole key. If you consider the productivity increase per year in Japan, it is 8 percent and in West Germany 6 percent, and in the United States it is down to zero.

The whole problem of inflation and export and our ability to compete with Japan and West Germany is the productivity growth that we do not get. It has something to do with the small businesses and the farmer. The farmer is able to compete pretty good with his exports because he is much more efficient than any other nation, but in our industrial plants we are the least efficient of all industrial countries in the world. And unless we bite that bullet and do something to increase American productivity, the value of the dollar is going down, inflation will stay high, and our balance of trade will continue to be adverse in fantastic sums.

Whether we like it or not, it is big business generally that are the exporters. They go into world trade.

Unfortunately, their are opportunities in small business, but they have been unwilling to go to the uncomplicated matters of export business. If we are going to turn around the trend of exports and the dollar, we are going to have to do something in this country to encourage capital investment and increase American productivity. Otherwise, it is really a long goodbye to American industry.

The Chairman. Senator Bentsen?

Senator Bentsen. If I may respond, I, too, share Senator Nelson's concern for small business. We have expressed that concern in a very major way in this bill, and so has the House.

The House provision calls for a substantial increased credit in first-year depreciation for companies under $1 million depreciated assets. That costs $400 million in the first calendar year and, in addition to that, small business wanted very much to have a graduated corporate tax rate and that is what the House has done. They put it in, and apparently this Committee is supporting that position, and this was a major point for small business.

In addition to that, they want to have a further simplification on Subchapter S, and that was done, and apparently this Committee is supporting that.

If you look at the proposal made by Senator Nelson, if we were to adopt it, I promise you at the next consideration of the tax bill, we would repeal it, because Treasury would be here telling us how that loophole had been utilized. Every wealthy doctor of lawyer could start himself a small leasing corporation, put $25,000 a year into it and take his depreciation over those three years and then turn around and lease it to small business. Then you would see a proliferation of small corporations created. You would see businesses dividing up their operations into generic operations to the extent that they could and could justify it so, again, they could take advantage of each of those

$25,000 of depreciable assets each year over three years.

I think that it would be a serious mistake -- a well-intentioned one, but one that would be very substantially abused.

Senator Curtis has made a major point, and so has Senator Ribicoff. What we are trying to do is make a substantive change in the productive capacity of this country to try to get the modernization of our manufacturing capacity. Productivity in this country has been going downhill.

In 1978, the productivity increase in this country will be less than 1 percent. We are putting less money into manufacturing capacity of this country as a percent of GNP than any industrial nation of the world. The one next to us is Britain, and we are going to face the problems of Britain in the early 70's unless we can make the changes that are necessary to get these businessmen to modernize the manufacturing capacity, and taxes are going to have a lot to do with it.

Some of these very, very small businesses -- whether they be a hamburger stand, or whatever they might be -- really does not do much about our trade balance, and that is what we are trying to turn around here.

Some of my friends tell me that business would really prefer a tax cut. I understand that. But Mr. Miller testified before us that the greatest correlative effect that we could get would be on accelerated depreciation in trying to get the money back in modernizing the manufacturing capacity of this country.

I just do not believe that under this window we have to put this through on this budget resolution that we can take both of them. I know Treasury has something else that they are proposing in the way of a simplification for small business on depreciation, but you see, in my amendment -- and Gaylord is right when he says small business has not taken advantage of this -- but one of the reasons they have not is because of the complications of it.

You have an affirmative action that you have to take before you can use accelerated depreciation. You have a very complicated government form that you have to fill out each year before you can do it.

Treasury staff -- or rather, the staff of the Committee -- have drafted part of the amendment to do away with that. They say it is really not effective, and it is not helping. So, in my amendment, we did away with those two forms to try to get small business to use this more, and I think it will be of very substantial help in getting them to utilize it.

I believe that what I have presented in my amendment is a balanced approach that will help increase productivity in this country and, in the long run, help us in this balance of trade.

Senator Nelson. Mr. Chairman, I do not want to prolong the argument here. One-and-one-half percent of all the corporations in America, only 1.5 percent, use the ADR. Now, how much the 98.5 percent who do not use it in this country -- we have all kinds of vigorous, small, independent enterprises that are trying to grow. We ought to be addressing, of course, our tax policy to increase productivity. We ought to be addressing our tax policy to insure that independent small enterprise can start and grow vigorously and become competitive. That is where the competitive marketplace is in the small businesses who are out on the front line -- not just General Motors. The only competition they have is from overseas, and when you talk about what we are doing to big business, all right, the 10 percent investment tax credit. So what does that do?

Without the investment tax credit, General Motors will be modernizing just as fast as they are now from internally-generated funds. It is not changed a bit. They are getting the 10 percent. AT&T, they have their ten-year projections out. They are going to modernize and put in additional phones, equipment, whether you have ADR or not.

When we first passed the ADR -- in other words, the investment tax credit -- that was one of the comments, whether or not the distinguished lawyers, we are glad to have the 10 percent, but it does not change by $1 -- by $1 -- our investment expansion policy because we have to serve the country, we know what the growth is, we know where it is. We know what we need and we are going to buy it, and we are going to take the 10 percent.

This is not well-targeted either. Nothing is perfect about it, but we are dealing in a country here where we do very, very little for small business. They get clobbered by all the government regulations. They get wounded the worst with OSHA, tax forms, lawsuits, everything else that you can think of. They represent, however, 52 percent of all the employment in this country and 40 percent of the Gross National Product. If there is anything we want to keep going in this country, it is a bigorous, competitive independent business community where people can start out and, on their own, take their chances and try to go somewhere.

300,000 of them a year fell, but they are out there in the marketplace trying to start. Who are the competitors in electronics? Small, independent corporations are now being bought up by Japan and Germany because they cannot get the capital in this country. We have had testimony on that in the Small Business Committee where one of our finest ones went to eighty-three sources in this country and could not get a single nickel, so Japan bought in.

This gives a benefit to these small, independent operators who are an important part of the economy in this country.

I am not saying that ADR is bad and would not increase productivity. How do you measure it? Does it increase productivity more than giving a break to small business on a three-year depreciation? I do not think anybody can prove it.

If we can have both, that might be fine, but there is no way that you can have them both together, because you are talking about in four out-years you are talking about $5.2 billion. So it must be one or the other.

The Chairman. Senator Packwood?

Senator Packwood. Have we yet voted on whether or not we are going to adopt a 44 percent corporate rate at some time in the future?

The Chairman. At this point, we have not done that. We will be voting on that again, I assume, before we are through.

Senator Packwood. Before the day is out, I would hope.

The Chairman. Before we are through considering this bill, I will.

Senator Packwood. I would hope we could do it before the day is out, if we could.

I am impressed with Gaylord's arguments. I am most impressed with what almost every leader of business has said who has come here to testify -- more than ADR, more than investment tax credit, the thing that would make them most competitive in exports and creating productivity woqld be lowering the corporate tax rate.

There is no question that the ADR and tax credit are capital formation devices, but not as good as reduction of the corporate rates.

If I had my choice, if we could reduce the corporate rates to 44 percent, I would vote for Gaylord's over Lloyd's, that we have given the corporation the best single incentive they could have. If we have not voted on that, then I am not quite sure where

I come down, because Lloyd's provision is going to be more helpful to the major corporations of this country than Gaylord's.

So I am wondering if we could consider the 44 percent, unless Gaylord wants to go ahead on this, 44 percent first, so I might know what kind of aid we are giving to the larger corporations.

The Chairman. Let me just ask Treasury. I believe Treasury's view is we should not have any one?

Mr. Lubick. Yes, Mr. Chairman, I think you are correct. I think we would like to leave the question of the rates, the depreciation of all the provisions dealing with the out-years to further consideration. I think that we want to see exactly what our budget restraints are in the next year and I think we are very seriously concerned that the bill already is going far beyond the allowances that have been made by the President in his planning for all those years.

Having said that, I might like to mention that while we would prefer that you did nothing with respect to corporate rates for the out-years beyond the 46 percent with respect to ADR -- and we are, indeed, studying all these matters and hope to have a report early next year on that -- we do think that there is something that can, and should, be done for small business to enable it to take advantage of ADR.

Senator Nelson is correct. In fact, I think our figures indicate that less than one-half percent of all corporations elect ADR, and we met with a number of the small business groups and they indicated to us it was because of the complexity, the pages upon pages of tables and figuring out the election forms and the like. Therefore, we sat down with some of the best small business groups and we worked out a program to enable them to have the advantages of ADR without the complexity disadvantages and we worked out a one-page schedule which I would be glad to pass out and we have the ADR classes down to about 15 classes, all on one page. And our proposal would be that, for small businesses -- let us say those that have an adjusted basis in their assets of a quarter of a million dollars or less, would be eligible to elect straight-line depreciation on the basis of that table, and the table would take the ADR lines and take the lowest limit of the 20 percent variation and assume that those lives are used on the basis of rapid depreciation, double-declining balance, and then convert the lives to a shorter life -- that would be the straight-line equivalent of those lives.

In other words, on ADR, if you had an eight-year life with a 20 percent variation for office furniture and fixtures, the straight line equivalent would be a five-year life on a straight line, so we would propose to shorten all of those lives for small business and allow them to use straight-line depreciation on the basis of the simplified list. The small business people we met with indicated to us that this would be very useful to them, and then they would be able to take advantage of the same rates of ADR as big business.

Our revenue estimates on the effect of this would be for fiscal '79, this would involve a revenue loss of $5 million.

The Chairman. How much?

Mr. Lubick. $5 million, but by 1983, we estimate that in calendar '83, this would benefit small business to the tune of $542 million.

In other words, as small business starts to use this, it is really getting nothing more than the advantage that a large business is getting in ADR, as they become familiar with it and take advantage of it. We feel it would be very beneficial to small business and I would like to submit that for your consideration.

Senator Bentsen. Mr. Chairman, I would also like to hear Treasury on the point that I have made, that I think that this proposal for $25,000 to be written off in three years can lead to some very substantial tax abuse.

Mr. Lubick. We are concerned that there could be some tax shelter arrangements formed in order to exploit these write-offs. A person could form a tax shelter and lease the appreciable property off for three years and then sell it in the fourth year, and there could be some very serious problems. We are concerned with the possibility of distortion of business behavior, of businesses being forced to schedule their investments by spreading them over several years rather than making them in one year, to take advantage of getting the special depreciation for each year.

Senator Bentsen has also alluded to the multiple business problem, and I think all of those things do concern us with this problem and I think that the approach that is working within the existing framework of ADR does seem to us to have more equity and appeal.

As I say, we did work it out with small business. That was before, I think, Senator Nelson's proposal. It was a possibility. I am not saying they preferred Senator Nelson's, but they did find it a very substantial improvement over the existing situation and one that might enable them to take advantage of ADR.

We wanted to avoid this problem where only a half percent of all corporations were using ADR, by making this simple and utilizable.

Senator Bentsen. I would say too, that my amendment applies to all business -- small and large -- and I am concerned, just as everyone else is, with the small number that use it in small business. And that was the reason for the simplification, doing away with the affirmative action form, and a very complicated government form that they have to file every year now.

In addition, of course, the House has provided a $400 million increase in first-year depreciation for small business. That is in the House bill now, plus that made a very substantial graduated cut for small businesses.

Senator Nelson. Mr. Chairman, I do not want to prolong the argument, on this question of use, we are dealing with 14 million independent enterprises. I do not care what rule you draft, somebody will find some way to be a beneficiary of an action you took that we did not intend to be beneficiaries. What is new about that?

I notice, for example, I have not heard anything from Treasury on the investment tax credit. I happen to notice people that I know of who are practicing law and individuals with money now buying -- I noticed one this summer, somebody I knew -- now buying capital equipment for little laundries, where the owner builds the shell, this person buys the capital equipment, gets the 10 percent investment tax credit. It is a fast write-off. It reduces his obligation. It is going on all over this country.

That abuse, if it is an abuse, is a whole lot greater than the abuse of somebody postponing buying capital equipment or setting up a little business to buy capital equipment and get the benefit of a three-year write-off instead of the life of the item.

That does not impress me very much.

Mr. Chairman, I am prepared to vote on the question.

The Chairman. Call the roll.

Senator Hansen. What are we voting on?

The Chairman. Mr. Nelson is offering his proposal as a substitute for the Bentsen amendment. The Bentsen amendment is the amendment to make the ADR somewhat more attractive.

Mr. Shapiro. Make the ADR increase from 20 percent to 30 percent. The Committee had previous agreed to that.

Senator Nelson's amendment to substitute in lieu of Senator Bentsen's ADR increase a $25,000 additional write-off depreciation over three years.

Senator Byrd. May I ask a question? Senator Bentsen's amendment would apply to all businesses?

Mr. Shapiro. That is correct.

Senator Nelson. So would this one that I am offering. General Motors can use it if they want to.

Mr. Stern. Mr. Talmadge?

Senator Talmadge. No.

Mr. Stern. Mr. Ribicoff?

Senator Ribicoff. No.

Mr. Stern. Mr. Byrd?

Senator Byrd. No.

Mr. Stern. Mr. Nelson?

Senator Nelson. Aye.

Mr. Stern. Mr. Gravel?

Senator Gravel. No.

Mr. Stern. Mr. Bentsen?

Senator Bentsen. No.

Mr. Stern. Mr. Hathaway?

Senator Hathaway. Aye, by proxy.

Mr. Stern. Mr. Haskell?

(No response)

Mr. Stern. Mr. Matsunaga?

Senator Matsunaga. No.

Mr. Stern. Mr. Moynihan?

Senator Moynihan. No.

Mr. Stern. Mr. Curtis?

Senator Curtis. No.

Mr. Stern. Mr. Hansen?

Senator Hansen. No.

Mr. Stern. Mr. Dole?

Senator Dole. Aye.

Mr. Stern. Mr. Packwood?

Senator Packwood. Aye.

Mr. Stern. Mr. Roth?

Senator Roth. Aye.

Mr. Stern. Mr. Laxalt?

Senator Laxalt. Aye.

Mr. Stern. Mr. Danforth?

Senator Danforth. No.

Mr. Stern. Mr. Chairman?

The Chairman. No.

Six yeas, eleven nays.

Senator Nelson. Mr. Chairman, I have one that I would assume we could act on very quickly. I think it is generally agreed that the corporate tax rate adopted in the House which was a modification of what was developed by the staff of the Small

Business Committee setting a rate of 17 percent on the first $25,000 and up to $100,000 at 40 percent to the next rate thereafter, whatever it may be. That was agreed to on the House side. We talked about it.

The Democrats met. I know of no objection to it. I would like to have it in the bill, elsewise I think that we may end up with something else coming at us from the Floor. So I propose that we adopt it.

It is not as high as I want it; it was scaled down by the House, but I think it is a good, sound measure and I will move that we adopt the House provision on the corporate rate proposal respecting the graduated rate on the first $100,000 of taxable income.

The Chairman. All in favor, say aye?

(A chorus of ayes.)

The Chairman. Opposed, no?

(No response)

The Chairman. The ayes have it.

I think we might discuss this minimum tax at this point. We are going to have a minimum tax. Maybe we could zero in on that and, at least on a tentative basis, decide what that minimum tax would be at this point.

Mr. Shapiro. We were asked to prepare materials for examples and we have done so and have had those distributed to the members.

Let me make a statement for drafting purposes. Based on the decision you just made, for drafting purposes we are assuming you are preparing a substitute bill. In that substitute, you have to make all the decisions to go in that for drafting purposes. We are just preparing it from your decisions rather than working from the House bill.

Senator Curtis. Mr. Chairman, I have no desire to change the order of things here, but there is one question in my mind that bears upon the minimum tax, and that has to do with the provision in the House bill for a once-in-a-lifetime exemption of $100,000 from capital gains tax on a residence.

That has very great appeal, but it bothers me. Two taxpayers of equal opportunity in life and equal endeavor and income, the husband and wife in one instance can buy a home and put everything they have in there and realize they are buying it for investment; and another couple of a like situation could plow their money back into a small business or into a building, into a farm and evey to farm. The actual dwelling part may have a very low value because they live in modest circumstances.

It seems to me that applying the minimum tax and including the capital gains, that we should examine the fairness of allowing a sizable exemption from capital gains for a particular type of property and not apply an exemption to all taxpayers.

I wonder if the staff has examined the application of this $100,000 one-time exemption. Have you looked into how it would apply as far as treating taxpayers alike?

Mr. Shapiro. Senator, there are varying factors, as you indicated from the discussion now, and the concern you expressed in an earlier meeting as to the effect of this once-in-a-lifetime personal residence exclusion.

For example, one of the concerns the Committee has expressed so far is to provide increased productivity and to encourage people to put their investments in areas that would increase productivity. One of the concerns that has been raised to the House provision on the $100,000 once-in-a-lifetime exclusion is that they would encourage people to put more of their investment income into a home, a larger home. Not only does it appreciate tremendously in most areas, but in addition, when you sell it you can take advantage of an exclusion up to $100,000, where if you put your investment into another field, it may not appreciate as well as a home and at the same time there is not as large an exclusion. So that has been one of the concerns over the House bill.

What you have referred to in the past as well is how do you define residence? For example, you have an individual in the Midwest that happens to live on a farm and their residence is a farmhouse but, in addition, they have a large tract of property that makes up the farm. How much is that property is attributable to the personal residence and how much to the farm?

So when that family, for example, would sell that farm, to what extent would that $100,000 exclusion in the House bill go to the residence and what is allocated to the farm?

Senator Packwood. How do we solve that problem now when we roll over the sale into the new residence?

Mr. Shapiro. I would assume the facts and circumstances would be taken into account and attribute so much of that property to personal residence and a part to the business and farm land.

Senator Packwood. It would be no different under the House bill than it would be under the present law.

Mr. Shapiro. I do not think it would.

Senator Curtis raised that concern. I would anticipate that there would be no change, that the present rules that apply to rollover would apply.

Senator Curtis. Do you have any figures as to what $100,000 one-time exemption in the House bill would cost and, of that amount of revenue, how much of an exemption it would give to everybody, regardless of how much property they sold?

Take the revenue loss and put it in a manner that everybody can share it.

Mr. Shapiro. If I understand what you are saying, you are saying that the $100,000 once-in-a-lifetime would not be limited to residences, it would be any sale of any asset, and I am not sure that we have that right now -- they are checking -- but I would anticipate that to be a very large figure.

If I understood what you were suggesting, that instead of having a $100,000 once-in-a-lifetime exclusion apply only to personal residences you would say that it would apply to any asset.

Senator Curtis. No. My question is this. Take the amount of revenue that you would lose under the House provision. How much relief could that be granted to everybody, not at the $100,000 figure, but coming down to $25,000 or whatever it was.

Mr. Shapiro. You are saying since the House bill has $125 million, what would that be reduced to, to have it for everybody?

Senator Curtis. Yes.

Mr. Shapiro. Just to give you a rough estimate, it would presently provide an increased exclusion of approximately 5 percentage points. For example, you presently have a 50 percent exclusion. You could raise that to 55 percent or what the Committee previously agreed to, a 75 percent exclusion, raise that to 70. A 5 percent exclusion would cost the same amount as a $100,000 once-in-a-lifetime personal residence.

Senator Curtis. I will not offer any substitute at this point. I am disturbed about the unequal treatment that this would have.

The Chairman. Let me just point out two things. One of them, we first, I think, ought to try to see how much we want to tax capital gains and what minimum tax we want to apply. The minimum tax raises most of its money on capital gains -- about

75 percent of the minimum tax revenues come off the capital gains. You need to relate the two to see: one, what the law is, what law you want. When you get your general rule, one, your capital gains and then your minimum tax. You can talk about and see where you stand with regard to residences or some specific problem.

The first order of business ought to be where do you want your capital gains; then, what do you want to do about your minimum tax. having done that, if you want to say, we would have more favorable treatment, that is something else.

But it seems to me that the House approach is not necessarily the best. They started out and they could not get together and they were at loggerheads, the contending sides, so somebody came up with the idea that on a residence, you would not pay a tax at all. That is basically what they are talking about -- no tax on a residence.

Now, some of the capital gains just go ahead and theoretically pay a high tax, and that might very well discriminate against people making investments that benefit the whole community.

The second thing I am concerned about is the scorekeeping. If we say here that people can have a $100,000 capital gain on a residence and pay no tax at all, I could anticipate that once we have got it so that people who make $200,000 pay out some tax, then for scorekeeping purposes, Treasury or liberal groups, or whate-er, public-interest groups, would say, let us look at

$100,000 level and see what we are doing, and they would want to keep score on how many taxpayers made $100,000 and paid no taxes, and then we will have thousands of them that made $100,000 and paid no taxes because of the residence provision.

It seems to me that it is well to avoid, as we are talking about a charitable contribution, it is just a small tax, at least to have those people paying a tax rather than paying no tax at all. And that is why it seems to me that we ought to think long and hard before we say that even the minimum tax does not apply to the first $100,000. Maybe the first $50,000 -- the first $100,000. And I think some part of that should be subject to the minimum tax.

We should talk about the minimum tax apart from the housing and then if we want a special exception on housing, make it -- why do you not explain how these tables work out?

Mr. Shapiro. First of all, let me review for you the way your minimum tax proposal is suggested and that is your first page there, the add-on minimum tax would be repealed and then you would substitute this alternative minimum tax that we have been discussing and the way it works is, in the alternative, it only applies if this alternative minimum tax would exceed the regular income tax that the individual would compute.

For purposes of the alternative minimum tax, you start with taxable income -- the same taxable income that you computed under the regular method. You add to that preferences. The tax preferences under existing law would be added to that with a few modifications.

One of those is Senator Bentsen's amendment on intangible drilling costs. Also for the excised itemized deductions. You exclude not only medical and casualty, but the Committee wanted to exclude all taxes, so the itemized deductions would only be included as a preference item to the extent that it exceeds 60 percent of adjusted gross income reduced by medical expenses, casualty and all taxes.

After you get that total, you subtract $20,000 and then you apply your tax rates. Your tax rates are set forth in the last paragraph on that sheet. On the first $40,000 of this income there would be a 10 percent rate. On the next $40,000 there would be a 20 percent rate, and that gets you up to the first $100,000, and all income above $100,000 there would be a rate of 25 percent.

Also, the foreign tax credit would be allowed to offset this alternative minimum tax to the same extent that it offsets the regular tax.

On the next page are set forth the assumptions that are made with respect to the examples. Just to show for anyone who follows the computations as to what the staff used for the basis of these computations, there would be no general tax credit that the taxpayer is married and filing a joint return. Personal exemptions are not taken into account. That is for simplicity, so you can see round numbers, and that the zero bracket amount is $3,200 and the present law rates were used, and the maximum tax on personal service income does not apply.

So you can go on. Example one, and you have adjusted gross income in this particular case of $4,358,000 and then, of that, the excluded capital gains is $2,834,000. That individual had over $5,600,000 capital gains and half of them were included under present law.

The other preference income is one making $583,000 and that is completely made up of -- almost all of it is made up of excess itemized deductions. The total itemized deductions in this particular case is $4,195,000. The regular tax paid was $29,420. This individual also had a foreign tax credit of $2,300 and an investment tax credit of $3,900 and that was also taken into account in reducing the regular tax to that level.

The add-on minimum tax under present law -- which is essentially on capital gains, and the excess itemized deductions adds an additional $656,000 and $600 means that there is a total tax, in this case, of $746,000 and $20, which would have an effective tax rate of 10.2 percent.

I am not going to go over the House bill example but just to point out that the House bill just had a 10 percent tax on capital gains, the excluded portion of capital gains, and, in fact, continued the add-on minimum tax on the excess itemized deductions. And, with those changes, that has an effective tax rate of 7.1 percent.

The alternative proposal with the asterisk in the far right-hand corner assumes a 7 percent capital gains exclusion -- an exclusion the Committee has already tentatively agreed to. Therefore, the adjusted gross income in this case is reduced to $3,224,000. The reason why the adjusted gross income is reduced is because of the additional capital gains exclusion of 70 percent where present law is 50 percent.

The excluded capital gains is $3,968,000. The other preference income in this case is $1,221,000.

This individual paid no regular tax. The two major reasons for that are the 70 percent capital gains exclusion and the itemized deductions, which excluded any taxable income. However, applying the alternative minimum tax, which you include this 70 percent excluded capital gains plus the itemized excess deductions, you have an alternative tax of $1,181,500, which is an effective tax rate of 16.4 percent.

Senator Curtis. May I ask a question right here? I would not interrupt your comparison, but if somebody else on the staff would work it out, I have scanned the sixteen examples you have here. They are all rather high income. I want to know what the effect of this minimum tax would be on this hypothetical case.

A man has a $35,000 adjusted gross income. We will assume his tax bill and his other preferences are awash, but he has a

$200,000 capital gains on the sale of his farm. What would be the consequences?

If somebody would work that out, and then you may proceed with yours and give it to me, or later. Maybe you can give it to me right now.

Mr. Shapiro. It is being computed right now. What you are saying, if he pays no tax, there are no other preferences other than capital gains?

Senator Curtis. He subtracts his real estate taxes.

Mr. Shapiro. Itemized deductions?

Senator Curtis. Suppose whatever he has coming out in additional preferences and his local and state taxes are awash. His adjusted gross income is $35,000.

Mr. Shapiro. Is he paying any tax on that? Not that he is paying zero tax. He does not have any other shelters?

Senator Curtis. No other shelters, just an ordinary farmer that makes about $35,000 a year but once in a lifetime he sells his farm.

Mr. Shapiro. What you want us to do is say $35,000 of taxable income?

Senator Curtis. In your example, when you eliminate personal exemptions and so on for the most part, the adjusted gross income becomes taxable income.

Senator Hansen. He has capital gains of how much?

Senator Curtis. $200,000.

Mr. Shapiro. We are working that out right now.

Senator Ribicoff. May I ask, Mr. Chairman, what is the revenue gain on the Long minimum tax proposal, the overall minimum?

Senator Hansen. What is your question?

Senator Ribicoff. What is the revenue gain on the Long proposal on the minimum tax?

Mr. Shapiro. You look at this as a packet. As Senator Long indicated, you start off with your capital gain. Having made that decision of the 70 percent exclusion, the alternative minimum tax with that decision made, raises approximately $1.2 billion.

Senator Ribicoff. More?

Mr. Shapiro. $1.2 billion total. The present law is $1.4 billion. You are comparing $1.4 under present law to $1.2 billion under this proposal.

Present law assumes a 50 percent exclusion of capital gains and this proposal has a 70 percent exclusion.

Senator Ribicoff. What would the difference be between the House proposal and this proposal?

Mr. Shapiro. The House proposal has a $150 million alternative -- their alternative minimum tax. However, that is based on a 50 percent exclusion. When I say that, let me make one thing clear so as not to confuse you. As Senator Long pointed out, the large portion of any revenue raised on the minimum tax is from capital gains. It is in the neighborhood of 80 to 85 percent.

Therefore, when you have a large exclusion -- for example, a 70 percent exclusion -- that means that70 percent of the capital gains goes to the minimum tax. That is how you raise more money from the minimum tax, because you are putting a larger portion into the base for purposes of that minimum tax.

Senator Ribicoff. The Long proposal will bring in substantially more revenue than the House bill?

Mr. Shapiro. That is correct.

The reason for that, Senator, is because it is combined with the 70 percent exclusion. You are picking up more money from this proposal because the exclusion is larger. You are giving a larger capital gains rate, but those individuals who are receiving that tax rate would be paying more minimum tax.

Senator Talmadge. Mr. Lubick?

Mr. Lubick. If I may follow on your question, Senator Ribicoff, if you take the alternative minimum tax and apply it to existing law in the House bill, I think the revenue pick-up would be perhaps only $300 million. In other words, in measuring whether this is a strong minimum tax, I think that you have to take into account the fact that, as a minimum tax, that is not too much more than the House bill.

What happens is, given a 70 percent exclusion for capital gains, you would increase by that Act the amount of preference income. Instead of 50 percent of capital gains being a preference, 70 percent is.

So the effect, then, is that some of what you have granted by the 70 percent exclusion in capital gains you are recouping through this tax, and our concern with the minimum tax is twofold.

First of all, since it applies throwing all preferences -- the noncapital gains ones, the accelerated depreciation, the depletion and so on.

Senator Talmadge. If you would yield at that point, we do have a live quorum at the present time. I suppose we ought to go over there and make up a quorum.

The Chairman, by the time we get back here and going again, it will be pretty close to 12:30. The Chairman suggested that we meet again at 2:00 o'clock.

That is a vote. Do you have a room in the vicinity in the Senate Chamber that we can use?

Mr. Stern. We were unable to get any room off the Senate Floor.

Senator Talmadge. All right.

I have been instructed that the Sergeant-at-Arms has been instructed to get the absentees, so if there is no objection, we will meet again at 2:00 o'clock.

(Thereupon, at 12:00 noon the Committee recessed to reconvene at 2:00 p.m. this same day.)