EXECUTIVE COMMITTEE MEETING ON PROPOSED TAX REFORM ACT OF 1986

TUESDAY, APRIL 8, 1986

U.S. Senate

Committee on Finance

Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Durenberger, Armstrong, Grassley, Matsunaga, Moynihan, Baucus, Boren, Bradley, and Pryor.

Also present: Roger Mentz, Deputy Assistant Secretary for Tax Policy, Treasury Department; Dennis Ross, Tax Legislative Counsel, Treasury Department.

Also present: Bill Diefenderfer, Chief of Staff; David Brockway, Chief of Staff, Joint Committee on Taxation; Randy Weiss, Deputy Chief of Staff, Joint Committee on Taxation; Maureen Gorman, Mary Levontine, Joint Committee on Taxation; John Colvin, Chief Counsel; Bill Wilkins, Minority Chief Counsel; Greg Jenner, Tax Counsel, Majority; Paul Strella, Tax Counsel, Majority; Barbara Groves, Tax Counsel, Minority; Jeff Gates, Tax Counsel, Minority; Susan Taylor, Executive Assistant.

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The Chairman. The Committee will come to order, please.

We have a nomination before us of Donald Newman to be under secretary of Health and Human Services, and when we have more members here, I will ask the Committee to report that. I know of no opposition to it, but I will wait until there are a few more members here.

Let me make a few announcements, and I will repeat them from time to time during the day for other members. We are going to have to start meeting both morning and afternoon starting tomorrow to finish the subjects in the time that I would like to finish them in. There will be no votes today.

But starting tomorrow, I think we will be ready to start voting, hopefully, on the ACRS section and the energy and natural resources section and complete those except as to the agreement we have made at the end -- if we are dramatically short of revenue or dramatically over on revenue, we would come back and revisit a number of sections.

But it would be my hope to be able to finish trusts and estates and possibly pensions and employee benefits today; then move back to energy and natural resources and depreciation tomorrow, and accounting on Thursday, with votes on accounting. And then tomorrow afternoon, if we have not finished pensions, finish it up in terms of discussion; not in terms of voting. On Thursday afternoon, move to the foreign section, foreign taxation, for purposes of discussion, and carry on with it on Monday morning if we have to; move to the discussion of bonds, municipal bonds, on Monday afternoon, and then discussion of the individual tax section and insurance on Tuesday; then perhaps ready for some votes on Wednesday and Thursday on the foreign tax section on insurance and on the bonds.

Now I will try to keep the members advised. I realize I have rattled that off fast, and we will try to keep them advised in writing as far ahead of time as we can.

When we have gone through a section, however, or two or three sections and the members have indicated that they might have some amendments, and they have passed them in, I see no reason not to wrap up those sections, if we can.

Senator Moynihan.

Senator Moynihan. Thank you, Mr. Chairman. I would like to clarify the fact that there will not be votes.

The Chairman. There will not be votes on Monday or Tuesday afternoons. We may have some votes in the morning from time to time. It depends on how fast we go. But there will not be initially votes in the afternoon. And on Monday morning, I currently have scheduled discussion of the foreign tax section, if we have not finished it on Thursday afternoon. Otherwise, we may try to start that morning on --

Senator Moynihan. Mr. Chairman, I am the only member here besides yourself, and I wonder if you really wanted to agree to this because this comes very suddenly, and it is alas not all that difficult to do nothing in this Committee. And if you want nothing done, that would be the response of some people who did not want things done on Monday morning or Tuesday afternoon. If you could stick to Tuesday to Thursday, say, next week and then after that, on proper notice, they should be willing to accommodate you.

The Chairman. At the moment, on this Friday we have scheduled the hearings on the Canadian free trade agreement, don't we?

Senator Moynihan. Yes.

The Chairman. So for Friday we would move off of that, and we will not have any votes that morning. And I don't plan to that afternoon.

Senator Moynihan. We know that. That is part of the schedule.

The Chairman. And then starting next week it is my intention to try to meet Monday, Tuesday, Wednesday, Thursday mornings and afternoons.

Senator Moynihan. I have been 10 years on this Committee. Could I speak to the possibility that you not meet next Monday?

The Chairman. No.

Senator Moynihan. Fine, fine.

The Chairman. That we have announced before, that starting next week we would meet every day Monday through Friday.

Senator Moynihan. Fine. Well then, Mr. Chairman, you are the Chairman. As we have learned to our sorrow on more than one occasion --

Could I ask another question?

The Chairman. Yes.

Senator Moynihan. The Gramm-Rudman bill was passed not long ago 75 to 24, and it solemnly requires the United States Senate to have a budget resolution adopted by April 15, which I believe is Tuesday of next week. And that budget resolution -- I represent the minority members on budget of the Committee, and I can report to you that we have a number of provisions that require acts. Are we going to keep our solemn vow to Gramm-Rudman or are we just going to forget it?

The Chairman. I am not sure what your question is.

Senator Moynihan. Doesn't this Committee have to do something?

The Chairman. Well, do you mean do we have to --

Senator Moynihan. If Mr. Diefenderfer thinks we have to do nothing, and that is --

The Chairman. Do we have to meet? Will we have to produce revenues if we are ordered to produce revenues, yes. But until we have a budget through the Senate, through the House -- the President, of course, does not have to sign it because it is a congressional budget resolution -- until it is through the Senate and through the House directing us to produce revenues, it was not my intention to try to have this bill be other than revenue neutral.

Senator Moynihan. Well, the budget resolution thinks you are going to have to raise lots of facts.

The Chairman. Well, that is the Senate budget resolution as it has come out of Committee, which is as far as it has gone at the moment.

Senator Moynihan. As far as it is going as far as I can tell.

(Laughter)

Senator Moynihan. Gramm-Rudman lasted four months.

The Chairman. Even in fairness, even the President's budget proposal has between $6 and $7 billion in revenues next year.

Senator Moynihan. Not in taxes. In some vague --

The Chairman. Revenue enhancers.

Senator Moynihan. Revenue enhancers.

Well, Mr. Chairman, I didn't vote for Gramm-Rudman, but I would like to say it seems to me this Committee could meet to ask ourselves do we think we would do what is in the budget resolution.

The Chairman. Well, I feel quite confident that if the budget resolution passes in the House and the Senate, and clearly there will be debate on it on the Floor and clearly there will be efforts to strike out any revenues in it on the Floor -- I have no idea what the Floor may do. But if we are asked to produce revenues, this Committee -- or directed, I should say, to produce them, we will.

I have suggested to the Budget Committee Chairman, Senator Domenici, that if they want us to produce revenues, they leave it to our judgment and discretion as to where we think the revenue should --

Senator Moynihan. That is the case.

The Chairman. Yes.

Senator Chafee.

Senator Chafee. Good morning.

(Laughter)

The Chairman. I have indicated to Senator Moynihan that starting tomorrow we are going to have to meet both mornings and afternoons. And I will try to have as simple a schedule I can as to what I would like to be able to accomplish day by day in terms of hearings. We won't have any votes in the afternoons. The votes we will keep for a while in the mornings, although starting next week we may even have some votes in the afternoon.

But the schedule is tentative in the sense that if I think we can do a section on an afternoon and we don't finish it, we may have to carry it over to the next morning which may bump the morning session to the afternoon. But if we are going to finish this so that the staff will have time to get it done and all the members will have a chance to look at it and everyone who wants to comment on it outside the Senate will have a chance, we have got to finish this in early May, if we are going to hope to take it up on the Floor in June.

And that would be my hope -- that we could take it up on the Floor shortly after the recess, Memorial Day recess.

Senator Chafee. Well, Mr. Chairman, I subscribe to that schedule, and I will do everything I can to support you in achieving it.

The Chairman. Now why don't we start this morning on the trusts and estates and start in on Page 210 of the big markup comparative document -- present law, President's proposal, House bill and Chairman's proposal -- that we have.

Could I first ask Mr. Brockway: Is it my understanding that not only is the House bill and the President's proposal based upon different years -- they are 1986 to 1990 or 1987 to 1991 -- but on different economic assumptions from what my proposal is premised on?

Mr. Brockway. That is correct, Mr. Chairman. So that the numbers that we have passed out aren't exactly comparable for those two reasons.

The Chairman. And as a matter of fact, the economic assumptions might be a bigger part of the difference.

Mr. Brockway. Depending upon the particular provision, yes.

The Chairman. Yes. So I just want all the members -- I am hoping that by the time we get to final votes on this bill or even sooner if the members ask for it that we are going to be able to have comparisons so when we say what does the House bill lose or gain that at least we are operating on the same economic assumptions which I assume would mean that the President's proposal and the House bill would have to be reestimated because it is based upon earlier economic data than the present bill.

Am I correct? Or we can go back and estimate the House, the Senate -- my proposal on the old data, but it seems to me that would be --

Mr. Brockway. No, I don't think that would do. Certainly ultimately in the process we will have to estimate the House bill at the current economic assumptions, and it is simply a matter of giving first priority to the amendments that are coming up in the Finance Committee and then trying to work in the estimates of the House bill under the new assumptions.

One other thing you ought to point out about a difference between some of the numbers is that the rate structure is different in the House bill, President's bill and your proposal and so that any particular item might have a different revenue impact because of that.

The Chairman. All right. Let us start on the incomes of minor children.

Mr. Brockway, Mr. Colvin, Mr. Jenner, you want to start?

Mr. Colvin. On Page 210, the first issue is the unearned income of --

The Chairman. A little louder, John. I can hear you, but I am not sure everybody else can.

Mr. Colvin. On Page 210, the first issue is the taxation of unearned income of minor children. The Chairman's proposal would tax children with unearned income greater than $5,000.00 at the parents' top marginal rate. Under the House bill, the threshold was $1,000.00. The Chairman's proposal affects significantly fewer people and targets the provision to those at a higher income than the House bill.

The Chairman. Comments on that particular proposal?

Mr. Mentz. Mr. Chairman?

The Chairman. Mr. Secretary.

Mr. Mentz. Well, I would just like to say that I would like to defend the President's proposal. Particularly, the Secretary of the Treasury feels quite strongly that where a child happens to inherit or receive a donation from perhaps a grandparent or another relative or even a non-related person that the income on that fund should be taxable at his rate. That is, in effect, his money. It is not an intra-family transfer simply to get the benefit of a run up the rate bracket. And that is the reason that the President's proposal came out the way it did, and that is the reason the Treasury still supports it.

The Chairman. Senator Chafee.

Senator Chafee. I keep getting called on this morning, and I --

(Laughter)

The Chairman. Senator Moynihan, go ahead.

Senator Moynihan. Mr. Chairman, I think Secretary Mentz has made a perfectly clear statement of what in the distant past was known as a tax reform bill. These are rich kids who get money from rich grandparents and don't pay any taxes. And your proposal is they pay some. Is that about it?

Mr. Mentz. Well, they pay some. It is just a question of which rate you are talking about. And if they are really rich, you are talking at the top rate in any case so it doesn't really matter.

Senator Moynihan. And our principle is that if you are really rich, you ought to pay some tax.

Mr. Mentz. We strongly support that proposal, Senator.

Senator Moynihan. I mean only the really rich.

Mr. Chairman, why can't we accept the President's proposal as the House has done?

The Chairman. When the time comes to move that, we can. We tried to, without exempting the very, very rich, not bring it down to affect as many people as the House and the President did.

Mr. Brockway. Mr. Chairman?

The Chairman. Mr. Brockway.

Mr. Brockway. A couple of comments. One, on the Administration's proposal, Senator Moynihan, the proposal only applies with respect to amounts transferred from the parents. So in your hypothesis, for example, from the grandparents, the proposal would not apply. The Chairman's proposal,the reason for structuring it the way the Chairman's proposal is done it attempts to minimize the situations where it would apply, but the situation where there is a substantial amount of income or earning property in the hands of the child, then tax that to the parent's rate. But it is done through a simpler structure. And that is that you don't have to set up a separate account, a segregated account, for earned income of the child and for any other income transferred from people other than the parents.

Under the Chairman's proposal, simply a transfer to the child, regardless of whom it was from, would be a transfer that would be subject to tax if the income exceeded, under this proposal, roughly $5,000.00 in the hands of the child.

So the differences between the two is, one, it will hit more transfers than the Administration's for more different types of people and --

The Chairman. The Administration is limited to parents' transfers?

Mr. Brockway. Is limited to parents, but then it is the first dollar.

The Chairman. I understand.

Mr. Brockway. And so that your proposal would be transfers even from grandparents, but it gives them an exemption of $4,000.00.

Senator Moynihan. Mr. Chairman, I think this is a useful point. I know it would help all of us if as proposals of this kind came along we could get the numbers that are associated -- how many would be affected versus the effect of the President's proposal and the House proposal, our proposal.

Mr. Colvin. Senator Moynihan, with respect to this particular provision, there would be 1,500,000 affected by the House bill and 50,000 affected by the Chairman's proposal.

Senator Moynihan. Could we hear that again?

Mr. Colvin. One million, five hundred thousand by the House bill and 50,000 under the Chairman's proposal.

Senator Moynihan. Now, Mr. Brockway, we depend on your absolutely, but what you told me just then, sir, you didn't tell me that we went from one and a half million to 50,000.00? You indicated there was an equity from both sides.

Mr. Jenner. Senator, the threshold under the House bill is $1,000.00. There are substantially a greater number of children with unearned income above $1,000.00.

Senator Moynihan. I know that. I bet you --

The Chairman. But in fairness, either proposal catches the very rich, the very rich. The question is: You want to come down and catch the children whose income is between the $1,000.00 and $5,000.00 bracket, which does not take an overwhelming trust to be in an income bracket of earning interest of -- I mean an income of $1,000.00 to $5,000.00.

Mr. Jenner. That is correct, Mr. Chairman.

Our concern in drafting the proposal as we did was the comments that we received about the House bill which indicated that people would be able to avoid the House rule, rich parents would be able to avoid the House rule, simply by giving gifts to the grandparents which two years later would be given back to the children. Thus, avoiding the tracing to the parent.

So the House rule could be gamed effectively very easily. And that was the concern that we had.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee.

Senator Chafee. Mr. Chairman, let us, if we could, review the bidding here on this item. First of all, as I understand what we are talking about here, we are not talking of trusts or anything; we are talking of gifts. If you give to your child a $5,000.00 bank account or savings account, under the present law, obviously, that is -- the income on that is taxed to the child, whatever the child's rates are.

Now under the proposal, as I understand it, here, that would -- under the President's proposal, would tax unearned income of a child under 14 to the child at the top marginal rates of the parents. So that is as if you just hadn't given a gift.

Now stick with the President's proposal here. When the child gets -- with respect to -- what about when the child gets over 14?

Mr. Brockway. Then the present law, rule, would apply. The child under either proposal at that point would be taxed at his own rate bracket structure as under current law on all earned and unearned income.

Senator Chafee. Well, what is the philosophy here? What are we trying to -- I don't get it. What is going on?

Mr. Brockway. The concern of both the proposals is a practice that has developed under present law; is that parents or grandparents, what have you, might transfer income producing property to children to get a separate run up through the rate brackets qualifying for -- under present law, you cannot qualify for the standard deduction, but you do get the personal exemption, and then you get through the lower rate brackets all the way up. And so that if you can transfer property to the child, you can effectively average the income with each of the children you wish to transfer income to.

Senator Chafee. Yes, but it is gone. It is not -- there are not rights of reversion of the property. It is an outright gift, right?

Mr. Brockway. It may or may not be. Legally, in order for it to work, that would be the case. But, obviously, these are situations where you have children under 14, children that the parent has responsibility, legal responsibility, to take care of all of its expenses. And, obviously, the parent is the one that controls the finances of the child so that there is a certain enforcement problem as well under present law as to whether in fact it was a bona fide gift.

Senator Chafee. Are you saying that there is something different between a child under 14 and a child over 14?

Mr. Brockway. Well, I think the reason for switching it at 14 was that at 14 is the age you can start earning income legally generally; the earliest time you can earn income yourself as a child. So, therefore, there might be more likelihood that the income was generated by earnings of the child himself rather than as a result of a transfer from the parent in order to take the benefit of the difference in rate structures. Although it should be pointed out that all these proposals don't turn on the intent of whether there was a tax avoidance motive. They simply say that if the property, income earning property, is in the hands of a minor child then it will be subject to tax at the parents' rate.

Senator Chafee. I am sorry if I missed it. Did you give the revenue estimates here?

Mr. Jenner. It is $500 million, Senator.

Senator Chafee. Five hundred million. On the President's proposal?

Mr. Jenner. No. Under ours.

Senator Moynihan. Give us both.

Senator Chafee. Why don't we have both?

Mr. Colvin. The President's proposal is $1.2 billion, the House bill is $1.4 billion and the Chairman's proposal is --

Senator Chafee. Wait. Slow down. You are going too fast. The President's proposal is one point two.

Mr. Colvin. One point two.

Senator Chafee. That it picks up. All right.

Mr. Colvin. The House bill is one point four.

Senator Chafee. How can the House bill be more if it says the same as the President's?

Mr. Brockway. The problem is -- and I will have to get back to your numbers -- is that the revenue you have is for both one and two under the proposal. And there are different proposals under A2 under the House bill than under the

Administration's bill.

Senator Chafee. Oh, I see. You take -- you are taking one and two here and so two loses -- or two picks up $200 million.

Mr. Brockway. I will try and get the precise break-out.

Senator Chafee. So these figures you are giving us are for items one and two?

Mr. Brockway. That is correct.

Senator Chafee. Now what does the Chairman's proposal produce?

Mr. Brockway. The Chairman's proposal, unlike the Administration, which -- assuming you didn't qualify for the exemption for a gift from a person other than a parent, the Administration would tax you on the first dollar in amounts earned from property transferred from a parent.

Under the Chairman's proposal, you would be taxed only on unearned income, or the child would be taxed only on unearned income in excess of $4,000.00.

Now the child also would have a $1,000.00 personal exemption as well that would be applicable to unearned income. So a child under 14 under the Chairman's proposal would be taxed at his own rates up to $5,000.00. And then it would be taxed at the parents' rate regardless of whether the property generating the unearned income came from the parents or came from the grandparents or from some other transfer.

Under the Administration's proposal, it would only apply with respect to amounts transferred by the parents themselves. Then, as I say, it would be taxed at first dollar.

Senator Chafee. Mr. Chairman, I must say I see a lot of revenue here so this is the tempting factor here. Outside of that, it seems like a strange proposal.

Senator Moynihan. Would my colleague yield for just a general comment?

The Chairman. Senator Moynihan.

Senator Moynihan. Is that all right, Senator Chafee?

Senator Chafee. Yes, sure.

Senator Moynihan. I just want to make the point that at the beginning of this -- I don't want to make every time, but, Mr. Chairman, you know, you and I have been on this Committee 10 years, friends, allies and so on, and here came along a situation which I asked about why aren't we using the President's proposal. And the staff of the Joint Committee made the general proposition about, well, one proposal is like this and the other proposal is like that. I would say illuminating but not very specific.

Only when we press do we learn that the President's proposal affects 1.5 million people and our proposal affects 50,000. Only when we press do we find the House provision has $1.4 billion in revenues and ours point five.

If we have to drag that out --

The Chairman. Senator Moynihan, in fairness, the Joint Committee, I think, is willing to respond to every question. But if they are going to tell us everything they know on every subject whether we want to know it or not, we are going to be here through the rest of the year.

Senator Moynihan. But I was eight years on the Intelligence Committee and so was Senator Chafee, and if there is one thing we learned it was -- and Senator Durenberger, Mr. Chairman -- God help you if you have got a witness in front of you and you don't know what questions to ask him and he only answers the ones that are asked.

We always will want to know how many people are involved and how much money.

The Chairman. Obviously, when you go from zero to $4,000.00, you are going to exempt some people. Neither of us exempt the very rich. The way the bill passed the House, it upset tremendously people -- and made it more complicated -- people that were involved in these kinds of gifts and estates. We more or less kept the rules but changed the rates. And now they don't like that either, although they suggested that would be preferable to the House bill. But I understand why they don't like it and they would just as soon keep the law the way it is.

The question is: Do you want to tax a minor who happens to receive a gift of $25,000.00 or $30,000.00 from a parent and you would very quickly be over a $1,000.00 exemption? Or do you want to say we really mean this for not just parents but parents or grandparents or uncles who make major transfers of income to their children principally for the purpose of lowering their rates of taxation.

Mr. Mentz. Mr. Chairman?

The Chairman. Mr. Secretary.

Mr. Mentz. Thank you, Mr. Chairman. Let me just try to illuminate a little bit more the President's proposal and the philosophy behind it.

First, I would like to say our numbers differ in terms of the number of people affected. Based on 1983 levels of income, we show 265,000 people affected by the President's proposal and between 25,000 and 30,000 affected by the Chairman's proposal. So there is a difference there.

But let me get to the philosophy. The Administration looked at the problem as a matter of money that is within a household that is simply put in the name of a child for the sole purpose of getting a reduced tax rate to apply to it, money that for all practical purposes is household money comingled with or could be comingled with the father and the mother's money. And it was that problem that we were addressing.

We were not trying to deal with the bona fide gift from an uncle or a grandparent or a tort award or income that the child earned. I recognize that the Chairman has taken care of those last two. But it is the philosophy of trying to get at the problem where the money is all basically household money and the only difference is it is being used -- it is being taxed at a lower rate because it is transferred to a child under 14. That is the reason the President went after that particular target, and that is the reason he has thrown a little broader net. It is more people than the Chairman's proposal. And it raises more money.

Senator Chafee. Mr. Chairman?

The Chairman. I might add that last Friday the Joint Committee passed out, at least to the staffs because they were requested to, revenue estimates that cover a fair variety of sections including this and quite a number of others. You have to look through it. It is about a -- oh, I would judge looking at it -- a 15-paged document. But they have the President, House and the Chairman's proposal with comparative revenue estimates, including the one that we are on.

Senator Chafee.

Senator Chafee. Mr. Chairman, as I say, I have trouble with this entire proposal. And if we are going to do it, I have a feeling we ought to do it. And if we are not going to do it, we should not do it. But we seem to be having a compromise here that leads us into all kinds of problems.

For example, what are you going to do in your exception here, Mr. Mentz? You have got the income earned from tort recoveries. Now what happens if one parent dies and leaves life insurance? How is that? Where are we then? Is that a gift?

Mr. Mentz. Are you speaking about the Chairman's proposal or the President's proposal?

Senator Chafee. Well, I guess I am on the Chairman's proposal. Who is responsible for this? Mr. Colvin? Mr. Jenner?

What happens if one parent dies and there is some life insurance that goes to a child? Is that exempted?

Mr. Jenner. Not under our proposal, no.

Senator Chafee. Well, why not? What is the difference -- a tort recovery and the parent leaving some life insurance?

Mr. Jenner. Again, we are assuming that that child is residing with the surviving spouse. And then it is the same concern we would have in any transfer of income from a parent to a minor child; that that income would be available for use by the household. This would be quite consistent, I would think, with the Administration's concerns where it was a transfer to a minor child by a living parent in that the income would be available for use by the parent, in this case, the surviving spouse, as freely as it would be if it were an inter vivos transfer from a living parent to the child.

Mr. Mentz. Although, Senator, I would point out that the

Administration's proposal would exempt transfers of death. So in that particular case, that transfer would not be subject to the President's proposal.

Senator Chafee. You may have said this, again, but let us hear it once again if we could, please. You may have said it previously, Mr. Jenner.

What is the rationale for the exemptions in the Chairman's proposal, the first $4,000.00? Is that just considered de minimis?

Mr. Jenner. It is a concern, Senator, that parents do transfer income to their children for legitimate non-taxable reasons. We were concerned that the Administration and the House threshold of $1,000.00 was much too low, brought in too many children whose parents might have transferred assets to them for non-tax reasons.

We were concerned with the transfers that looked as if they were for tax avoidance reasons. If you look at the exemption level under our proposal, assuming that the assets would be earning a 10 percent rate of return, which, of course, is high in today's world, you would have to have $50,000.00 in an account before you ever reached the threshold under our proposal.

That is a relatively high level, and it picks up only theoretically those people who we are concerned about, those who are shifting significant amounts of assets to their children for tax avoidance reasons; not the parents who are transferring assets to their children for college savings.

Senator Chafee. For who?

Mr. Jenner. College savings, savings for college tuition.

Senator Chafee. Four thousand dollars is not going to get you very far in college.

Mr. Jenner. But that is income, Senator. That is not assets. Assuming a 10 percent rate of return, you would need $40,000.00 in the bank to ever hit the $4,000.00 level. And under our proposal it is $4,000.00 plus one, so you have to have $5,000.00 of unearned income not from -- not generated by earned income or tort recovery in order to reach the threshold.

Senator Chafee. I just want to ask Mr. Mentz one other question.

The Chairman. Go ahead. Then I want to make a comment and move on, hopefully.

Senator Chafee. All right.

Mr. Mentz, take the President's proposals -- what are the administrative problems involved with that?

Mr. Mentz. Well, I would say the principal administrative problem is setting up qualified segregated account. In other words, identifying funds that have come from a source other than the parents. It is -- if that cannot be done, then the child is taxed at the parent's rate. However, it is of course worth doing and presumably not that many people are in that category -- even under the President's proposal, 265,000. It is a matter of some accounting that would be worth doing.

Senator Chafee. Well, Mr. Chairman, just in conclusion let me just say that I would point out to everyone that your proposal loses a billion dollars, $900 million, from the President's. And I think we ought to bear that in mind, if we are going to do it. Well, anyway, you lose it.

The Chairman. In defense of my proposal, I will say I was trying to balance off as with many of these.

Senator Chafee. Pardon?

The Chairman. I was trying to balance off as I was with many of these. Fairness versus making sure that the very wealthy do not escape taxes, whether it be in a minimum tax or tax shifting to their children. And it seemed to me that basically a $4,000.00 plus a $1,000.00 threshold was not an exemption for the very, very rich. We are still going to catch them.

If you want to go down to the President's proposal, you can catch a million and a half children. And you can tax any kind of gifts from middle income people or even lower middle income people, if that is the choice of the Committee.

But in terms of taxing the very rich, we are going to catch them under either the Administration's proposal or my proposal. And, secondly, under mine, you are going to catch those from transfers that come from other -- or I should say in addition to parents.

Senator Danforth.

Senator Danforth. Mr. Chairman, when is the age 14 significant? I mean somebody becomes 14 on April the 8th. Is that prorated?

Mr. Jenner. I believe, Senator, it is the year in which the person turns 14 that they are no longer subject to this rule.

Senator Danforth. Thank you.

The Chairman. All right. Can we move on to the income taxation of trusts and estates? Page 211 in the book. And, again, let me reannounce to the members that have come in that starting tomorrow we are going to have to meet both mornings and afternoons if we hope to finish on a schedule that I hope we can finish on. And that is to get the markup done by early May so that the staff can have time to prepare it and get the Committee report ready so members can look at it after it is done so that those outside the Senate can have a chance to review it. And all of that needs to be done by early May so that we can start on the Floor on this, I would hope, in early June.

And if we slip past that deadline and don't finish this until June and get on the Floor in July with a two and a half week recess coming in July, I would fear for the life of the bill at all.

So we will be going mornings and afternoons. This Friday, we have a hearing. We are going off this subject. We are having a hearing on the Administration's request to start negotiations on the free trade agreement between Canada and the United States.

But short of that, we will be meeting mornings and afternoons Monday through Friday for at least the next two to three weeks. And we will be having votes on some of the topics we have gone through, although I will try to have those votes in the morning when we are less likely to be interrupted by votes than in the afternoon.

Senator Moynihan. Mr. Chairman, as you know, I was alone -- only you and I were here when this first came up, and I was speaking generally for the Committee when I said it seems to be it was a rather early notice that we would be on a five-day schedule. And is it clear that this coming Monday and the following Monday?

The Chairman. It is not an early notice. I announced this prior, and several times prior, to --

Senator Moynihan. Consider the inattentiveness of some Committee members.

The Chairman. Well, they are a very attentive lot by and large, and I think it was also sent out in writing. I indicated that we would be going Monday through Friday prior to the recess.

Senator Moynihan. If that is your wish, sir, we will do. But everybody wants to know this.

The Chairman. Senator Bradley.

Senator Bradley. Mr. Chairman, does that mean we will begin tomorrow and go morning and afternoon, including this Friday?

The Chairman. We will not go this Friday afternoon because we are going to go Friday morning on the proposed Canadian-American free trade. But we will go mornings and afternoons next week.

And I will try, if we have gone through a section -- and the members have been very good, and I appreciate it, about giving me amendments that they think they want to bring up on sections we have covered. It makes it very helpful if you know that there are only going to be two or three amendments and the members have talked to you about them and they look like they are relatively easy to handle. You can take up a section that -- I mean take up a section and vote on it that you have considered. If you have got 30 or 40 amendments, that is another matter.

Senator Bradley. Mr. Chairman, in regard to that, I believe you said that tomorrow we would deal with depreciation. Is that correct?

The Chairman. I would like, if we could, to take up votes tomorrow. We are very close to an agreement, I think, on depreciation. But I would like to take up votes on whatever amendments members may have to the energy and natural resource section. And if we can do also depreciation the same day, I would like to.

Senator Bradley. In regard to depreciation, I should let you know, as I said when we discussed this, that I was waiting for numbers to come back from Joint Tax Committee. I hope to be getting those numbers soon. I cannot formulate my amendment until I get the numbers.

Senator Pryor. Mr. Chairman.

Senator Baucus. Mr. Chairman.

The Chairman. Senator Pryor and then Senator Baucus.

Senator Pryor. Mr. Chairman, now Friday morning on the Canadian free trade agreement, will there be votes on Friday morning?

The Chairman. On the Canadian free trade agreement?

Senator Pryor. On the Canadian free trade.

The Chairman. It is a hearing.

Senator Pryor. It is a hearing.

The Chairman. I know what you are saying. If we are going to vote one way or the other on this, we have a time deadline, but it is a hearing on Friday morning.

Senator Pryor. Now I am sorry I was not here earlier when you and Senator Moynihan, I think, were the only two members for a while. Was it announced this morning when you might hold a hearing on the excise tax provisions? Has that date been set?

The Chairman. I did not announce it. I think it is a week from Monday, isn't it?

Mr. Colvin. That's correct, Mr. Chairman.

The Chairman. On the 21st.

Senator Pryor. On the 21st of April?

The Chairman. Right.

Senator Pryor. Now have the people who will be giving the testimony already -- have they been selected for that, Mr. Chairman, or would we have any input into possible witnesses?

The Chairman. They have not been selected. What I would hope to do, however, is pick representative witnesses for an industry where by and large one or two people can speak for 15 or 20 members of the industry. And I am going to try to conduct the hearings all in one way although I assume they will go morning and afternoon. But as of yet, there have been no witnesses selected.

Senator Pryor. I thank you, Mr. Chairman.

The Chairman. Senator Baucus.

Senator Baucus. Thank you, Mr. Chairman. You announced the votes Mondays and Fridays.

The Chairman. Pardon me?

Senator Baucus. When you announced votes Mondays and Fridays, is that your intention or is that going to be the case? What I am getting at is sometimes there are exceptions. I hear one already on the 21st.

The Chairman. That is correct.

Senator Baucus. That is going to be a hearing.

The Chairman. We are going to have hearings that day on the excise tax.

Senator Baucus. And there also will not be votes on Friday.

The Chairman. That is correct.

Senator Baucus. Now what other days will there not be votes? Mr. Chairman, the reason I am asking you this, as you well know, there are good intentions around here, sometimes on the Floor and sometimes on the Committee. And often, as it turns out for whatever reason, we don't meet, we don't have votes. And if you are this morning announcing that there are going to votes on Mondays and on Fridays, I would like to know whether there will be votes on Mondays and Fridays or will there sometimes be exceptions to that rule.

The Chairman. There will on occasion be exceptions, but I am not sure how far ahead of time -- other than scheduled hearings like on other subjects -- I can announce them.

Because what may happen is we are trying to get through today the section on the trusts and estates and also the section on pensions and employee benefits. And if we get through with those, I would like to go on to some votes tomorrow on energy and depreciation.

But if we don't get through with pensions and employee benefits this afternoon, the schedule may slip now and then. All I can say is that henceforth I would like to be able to have votes. Most of them would take place in the mornings. I understand the problems in the afternoon with both constituent appointments and votes on the Senate Floor that are going to take us away from here. So I would use the afternoons more likely for continued discussion of subjects that we have already started or discussion on subjects we haven't yet covered.

But there is the possibility of votes on Mondays and on Fridays. But not on this Friday and not on the Monday that we have the hearings on the excise tax.

Senator Baucus. Now we are getting some place. Is there a possibility of votes Mondays or Fridays or will there be votes Mondays and Fridays?

The Chairman. Well, I can't tell you. Maybe nobody will offer any amendments and there won't be any votes at all. I don't know. Do you mean am I precluding the possibility of votes on a Friday or a Monday? The answer is no.

Senator Baucus. What I am getting at is do you firmly intend to keep the scheduled votes on Mondays and Fridays or something might come up and we might not meet on some Monday or some Friday for whatever reason and we may not know about it until low and behold we are not meeting Monday or Friday.

The Chairman. It is not my intention. As a matter of practice, it would be unlikely we would have votes on a Friday afternoon. It would be unlikely we would have votes on a Monday morning even if we were meeting. But we would be meeting then to continue on the discussion of sections that we had either covered and that we hadn't yet covered.

Senator Baucus. Mr. Chairman, if we do stick with this tightened scheduled, I think it would be only fair to members of the Committee for you to outline on what dates what subjects, at this point, you think we will consider them.

The Chairman. I announced earlier, and I will try to. I will give to the Committee members an outline date by date of what I would like to accomplish on that day so long as the Committee realizes that it may slip; we just don't finish.

Senator Baucus. When will we get that outline? How far in advance?

The Chairman. Is that ready today?

Mr. Colvin. Yes, Mr. Chairman.

The Chairman. Yes.

Senator Baucus. And I am asking for, if we can have it, is an outline for the rest of the markup. The best that you can determine it.

The Chairman. So long as if you are willing to say is the best I can determine it, realizing there are going to be a slippage of two or three days. If I try to say three weeks from now, three weeks from Monday, which section we will be on, I may miss it by quite a bit.

Senator Baucus. Why don't you give us the order?

The Chairman. I think I can give you the order with some degree of definiteness. And that, at least, the day before we recessed, I announced the order of the first eight or nine topics we would be taking up this week, always leaving the possibility of coming back to a section we had covered for votes. But listed eight or nine topics. But I will get those again to you this afternoon. And probably even beyond that in terms of the order that we will take them up, and some idea as to the days I would like to hit them.

Senator Baucus. All right. Thank you.

The Chairman. Now let us go on to the income taxation of trusts and estates.

Senator Moynihan. Mr. Chairman, how would I record that I would like to offer the President's proposal as an amendment when we come around together on this subject?

The Chairman. You can consider it offered now. It helps if I could have a notice in writing that you want to do it. But that is fine, and I appreciate it. So we are not blind-sided, and so I have a rough idea of how many amendments are coming up because that helps with the scheduling.

Senator Moynihan. So when you get around to this, I will offer that amendment.

Senator Bradley. Mr. Chairman, I should say as well --

The Chairman. Senator Chafee.

Senator Chafee. Senator Moynihan is referring to this subject here we just --

Senator Moynihan. Unearned income of a minor child.

Senator Bradley. Mr. Chairman, just in spirit of letting you know on amendments, I will probably be offering some amendments on the natural resource section as well.

The Chairman. Good. Thank you.

Income taxation of trusts and estates.

Mr. Colvin. Mr. Chairman --

The Chairman. Page 211. John.

Mr. Colvin. Let me open with a general comment about Pages 211, 212 and 213. After the House had passed its tax reform bill, we heard from member offices and from the public complaints about the complexity of the trust provisions. And so the Chairman's proposal includes an alternative approach to trusts. It addresses the same problem, but it does it in a way that is significantly more simple than the House approach.

The problem is income shifting to trusts. And the solution contained in the Chairman's proposal on Page 211 is to tighten the tax brackets that apply to trusts. It leaves in tact trust law as it now stands, but it does take much of the financial advantage out of income shifting to trust.

The Chairman. Basically, I have just compressed the rates.

Mr. Colvin. Yes, sir.

The Chairman. Discussion?

Senator Chafee. For what?

The Chairman. Again, attempting to as much as possible discourage the wealthy from attempting to transfer income to their children and to lower the aggregate family taxation rate in doing so. And by "aggregate family taxation," I, in essence, mean the taxes that the principal earning spouse is probably paying. And by compressing the rates, I was able to do so.

Senator Chafee. Well, I don't quite get the rationale. Are trusts bad?

The Chairman. There are legitimate reasons for trusts, but if we are trying to inject fairness and the concept of fairness in the bill, one of the legitimate reasons is not to use it for the principal reason of escaping or lowering taxation.

If that becomes the principal reason, it is like the criticisms we have had of investments in tax shelters where the investments are made for tax purposes; not economic purposes. The purpose of creating a trust, the principal purpose of creating a trust, should not be for the avoidance of taxation.

Senator Durenberger. Mr. Chairman.

Senator Chafee. Well, let me just continue this. Well, go ahead.

Senator Durenberger. John, this is a related question to clarify it. Let me ask the Chairman because I think he probably understands the President's motivation maybe better than the rest of us. And this is applicability in general to the function of a 35 percent rate or a lower rate. Is there a point at which the marginal rate discourages the utilization of these kinds of tax minimizing measures? And should we even be thinking about that as we go through these relatively small, relatively targeted kinds of provisions?

The Chairman. You mean as the rates get lower, the incentive for creating any of these trusts or making any of these gifts is reduced?

Senator Durenberger. That is right.

The Chairman. It is. And I tried to take that into account. And over and over I have asked people in the past at what rate they would not care any longer about deductions or trusts, and they say, well, at about 25 percent. At that case, the incentive for gifts and trusts and deductions almost disappear. And most people are willing to say, gee, if I have made $100,000.00, I will pay $25,000.00 taxes.

Over the years, I would like to push us down toward that 25 percent rate so that we could once again visit the whole issue of base broadening without the political downsides that we now have. But I tried to consider the fact that at a 35 percent rate there is less incentive for somebody to create a trust than at a 50 percent rate. And that was less than a 70 percent rate.

Senator Durenberger. If John will excuse me again, will that be sort of a philosophy that might guide us in this particular section as we are comparing the Chairman's proposal with the President's proposal and the House proposal where, in effect, it looks like they are minimizing except down under zero bracket in the exemption? They are minimizing the utilization of these household transfers almost entirely; whereas, the Chairman is trying to, I think, target the utilization of these at higher income --

The Chairman. That is correct. You grasp it exactly. For those that I call the very wealthy, although that I suppose is a subjective standard, depending upon where you are in the income scale. But I was trying to say that for the very wealthy I still think at 35 percent there is an incentive to attempt an income shift to their children.

And I tried to set a threshold. And I don't want to use the word "de minimis," because to most Americans $5,000.00 in interest, if we are talking about the previous section, is not de minimis.

But for purposes of income tax shifting, I think relatively few people are going to try to do it at the $5,000.00 level. And that is the reason for the threshold in the previous section.

Senator Durenberger. I thank you.

The Chairman. Senator Armstrong.

Senator Armstrong. Mr. Chairman, I don't think I have any particular problem with the trust section. So far as it applies to new trusts, I think it is going to shut them down. I don't think anybody is going to do it much, but that is your intention, and we understand that purpose.

My question relates to those that are already in existence. As I understand it, you would apply these new and much higher rates to non-grantor trusts that are already in existence, which by definition are trusts where people have made decisions based on present law and have not retained unto themselves any power to change the arrangement. That is, to take back the assets or dissolve the trust. That seems, if

I understand it correctly, to be unjust.

Mr. Jenner. Mr. Chairman, if I may. One of the major criticisms of the House bill, and I would, in fact, say the major criticism, is that it set up two different parallel tracks for existing and new trusts. The new system under the House bill would have applied only to existing trusts. The old system would have applied to old trusts. Practitioners in the field were concerned that they would have to keep track of what was new, what was old. You get into the question of whether new assets added to an old trust are taxed under the new law or under the old law, whether you have some sort of blended mechanism.

It becomes much simpler and well within Congress' power to simply change rates. Bear in mind also that most of these trusts are allowed to distribute income under our proposal to the beneficiary. Once the income is distributed, it is taxed at the beneficiary's rate and not the trust. So the change would never apply to these trusts. It is only to the extent that income is accumulated in the trust that the new rates would apply.

Senator Armstrong. Well, Mr. Chairman, nobody is disputing the power of Congress to do this and nobody is disputing the simplicity of simply making a change like this. My point is quite different.

It seems to me to be unjust. That when people make irrevocable arrangements based upon a principle of taxation that has existed as long as I know, then to precipitously change it seems to me to be unfair; particularly, when the people involved are stuck.

I mean I recognize we could tax all these trusts at 100 percent, and they still couldn't change their arrangements because that is the nature of the trust we are talking about.

Do we have, may I ask, an estimate of the revenue effect of making this prospective rather than retrospective? Could we get that?

Mr. Brockway. We will get it for you.

Senator Armstrong. My concern is not with the money in it at all but simply that it seems unfair, and maybe there is some way we can resolve it. And there may not be any large number of people affected. I would judge that it is not a huge item, but I would like to at least take a look at it. I may offer an amendment on this subject.

The Chairman. Secretary Mentz.

Mr. Mentz. Thank you, Mr. Chairman.

I would like to add the Treasury's support to the Chairman's proposal here. Subchapter J is a very complex area of the tax law, and I think that what Mr. Colvin said at the beginning of his remarks is exactly correct. That making a major change in Subchapter J and setting up a two-track system where new trusts would be under a whole new tax regime and existing trusts would be under the old tax regime would complicate it greatly.

The proposal that you have come up with is one that takes care of the abusive cases. It takes care of the so-called spousal remainder trust where a husband puts money in trust for his child and the income goes to pay his college expenses and then it reverts back to his wife, and that income is taxed at a lower rate. But when really you get finished, it just goes around in a circle and nothing really has happened.

It also takes care of the Clifford Trust, which, again, is basically an income shifting mechanism explicitly sanctioned under present law. And I think that you take into account the lower rates. Remember, we do have a top rate here of 35 percent, and that is for any kind of an accumulating trust, a complex trust. A 35 percent rate is going to mean less taxes, not more, for the typical trust.

Senator Armstrong. Mr. Secretary, take a look at the smaller trusts, the zero to $5,000.00 annual income. That rate is 15 percent in here. And comparing that with the present bracket, that is not such a favorable treatment.

Mr. Mentz. Well, that is true, but there aren't that many trusts set up at that -- I won't say there are none, and I take your point, Senator Armstrong. But there is sort of a de minimis point where it really isn't worth it to set up a trust, the paperwork, the trustee's fees, the administration and so forth. It just isn't productive to do it.

When you get into a trust that is larger than that and it is income of $50,000.00 or $100,000.00, you are benefitting that trust through lower rates even though you have compressed the rate brackets. So I think all things considered, your proposal, Treasury supports it over its own proposal.

Senator Armstrong. Mr. Secretary, I just want to be sure we understand each other because I guess this is not the moment to argue it through to a conclusion. But the $100,000.00 a year income trust would be at the 35 percent bracket anyway. Am I mistaken about that?

Mr. Mentz. Yes, that is right. But what I am saying is if you were under current law, it would be in a bracket higher than 35 percent.

Senator Armstrong. I understand that. But the issue here is whether to justify a separate track of rates, a separate rate schedule, for these trusts rather than putting them on the individual tax rate structure which they have been on at the present time.

And in support of the proposition for a separate schedule of rates, I thought I heard you make the point that the little guys, it wouldn't matter because it is only a few dollars, and the big guys are getting a break on the rates. My point is somebody who has got $50,000.00 or $100,000.00 a year income in such a trust is taxed at the top bracket anyway either on this rate schedule or under the new proposed individual rate.

So it appears to me that precisely the people who will be disadvantaged by this will be relatively speaking the smaller trusts, not the larger trusts. The larger trusts spill over into that bracket anyway.

Mr. Mentz. Yes. There will be a disadvantage to the $100,000.00 trust because going up the rate bracket he will get to 35 earlier than he would if he were under the -- so there is a disadvantage to that case. I take your point, Senator.

All I am saying is that particularly for the really little guys, there aren't that many of them because you don't have trusts set up in those cases.

Senator Armstrong. I think Mr. Brockway has indicated that he can have that information for us if, as and when we need to consider an amendment.

Mr. Brockway. Yes.

Senator Armstrong. How many there are and what the revenue impact would be.

Senator Bradley. Mr. Chairman?

The Chairman. Senator Bradley.

Senator Bradley. Would it be possible for the Joint Tax Committee or Treasury to tell us what income level uses trusts? Are trusts used by middle income taxpayers who are on wage income?

Mr. Brockway. Well, it certainly wouldn't be on wage income generally. We will see what we can get in terms of information. There should be some information on that. Generally, though, I think you could feel safe in saying the upper middle income and above generally simply because there are certain costs. One, of setting up the trust, legal costs, and then under the current rules, it is fairly complicated to just do the tax return, for example, on trusts the way they operate. So if you have got anything other than a simple trust, it probably is upper middle and above.

Mr. Mentz. May I respond?

Senator Bradley. Yes.

Mr. Mentz. I don't have any precise information, quantitative information, for you, Senator, but I can tell you from years of practice that there are non-tax reasons for setting up trusts. And there are a number of them, particularly testimentary trusts, that are set up by a testator whose property -- and it may not be seven figures or anything like it -- that person wants to leave to children or grandchildren in a way that doesn't permit the child to take the money and zoom off to California with a surf board.

So I don't think it is a fair conclusion that trusts are simply a mechanism for the rich to figure out ways to to avoid taxes. There are very clear bona fide non-tax reasons for setting up trusts, as well as tax reasons.

(CONTINUED ON NEXT PAGE)

The Chairman. In your experience, would many people with wages, incomes, below $30.00 a year--and that is their only source of income--set up trusts?

Mr. Mentz. It would depend on what other property they have, Senator. If they don't have any other property, no; there wouldn't be anything to put into the trust.

The Chairman. I am talking about the average Jane or Joe that is working, and they own a house. They may have a recreational vehicle. They might be one of those 9 or 11 percent that have a second house that is a beach cabin or a mountain cabin, although I am not sure.

I listening to the debates on that, I was amazed at how many people I was told fall into the lower income brackets that have second homes.

Mr. Mentz. Maybe they are not counting their munitipal bond interest.

(Laughter)

The Chairman. Which we are going to exempt to the extent of $30,000 and $40,000 from any tax at all, anyway.

So, in essence in your practical experience, middle income taxpayers usually do not set up trusts?

MR. Mentz. Usually do not, but it can happen that someone will have a home that has greatly appreciated and young children or young beneficiaries, and that person doesn't want to provide the money or the funds immeidately for that person to possibly fritter away; and so a testimentary trust is typically created.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. I want to echo what Mr. Mentz said. Clearly, you have in the testimentary area, particularly with life insurance, people with very modest assets leave trusts for their minor children, and the income is accumulated until the children are of the age to go to college.

Now, it is true that under your provision here, it is the undistributed income that is being taxed at these rates; but I think these rates are pretty stiff, and I personally will move at a proper time--and I would like to have some estimates, Mr. Brockway.

What would it cost to decompress these rates? I am not going to ask you for it now, but I will later, to juggle these rates around; not to have the 35 or even the 25 percent start so early.

You must have something on that.

Mr. Brockway. Yes, sir. We would just spend some time after the mark-up and go over what would be some hypos you would like us to run, and we can give you the estimates on it.

Senator Chafee. All right, because in addition to minor children, you have got disabled children. I think we have all seen instances of trusts being set up for a child that is far from a minor but is disabled in some fashion--retarded or whatever it might be.

So, I just don't subscribe to the view that people who set up trusts are rich.

The Chairman. Further discussion on the taxation of trust section before we move on to the taxation of the States?

(No response)

The Chairman. All right. Let's move on to the taxation of the States, which is on page 215. John, go ahead.

Mr. Colvin. Mr. Chairman, under this proposal, the income of an estate beginning the second year after the death of the decedent would be taxed like a trust.

In some respects, it is similar to the provision we have just been talking about.

The Chairman. Comments? No comments?

Senator Bradley. Mr. Chairman, what is the rationale for this change?

Mr. Brockway. Generally, under present law, an estate is taxed in the same way as a trust. Under the Chairman's proposal, generally trusts now will have a collapsed rate bracket, rather than as under present law being taxed at the rate of a married person filing singly--separately.

Now, they will have a more collapsed rate bracket.

What this does is for the first two years after death, treat it at the married person filing separately rate; and then if income and property stays within the State, putting it under the same regime as trusts will be under the propsal, that is, the collapsed rate bracket, so that you don't have the benefit--or it reduces the benefit of keeping income at the State level rather than paying it out.

Senator Bradley. I notice under the President's proposal that he raised $600 million from the estates portion; and this provision raises only $200 million.

Where did the $400 million go?

Mr. Brockway. I don't have a precise breakout on that right now. I think one of the things would be, just in terms of the Administration proposal, it would eliminate the present $600 personal exemption. It would have a cliff.

If you went over $600 at the State level in the Administration proposal, then there would be no personal exemption. There is under present law, and there would be under the proposal.

That might be one item; but we will be able to get a more precise breakout of the difference between the numbers, between the chairman's and the House bill and the --

Senator Bradley. Because, you know, $400 million here and $400 million there, and you are going to be at $1 billion pretty soon.

And I think that when we are looking at revenues, I personally would like to know what happened to the $400 million in order to be able to determine is it the right thing we should do.

I mean, after all what we are talking about, and this is how to get rates down for middle income people; and $400 million in increased taxes on the States generally could help get rates down for middle income people in the whole tax reform effort.

And I would like to know about where the money is.

Mr. Brockway. We will get back to you on the specific rates. There are like five separate different items under the Administration proposal. I don't have a breakout of how much any one of the ones is.

I have a suspicion they were estimated as an aggregate pool, but I will try and see what any one of the specific ones as a modification of the chairman's might raise.

Senator Moynihan. Mr. Chairman?

The Chairman. Senator Moynihan?

Senator Moynihan. We have a good presence here at the committee at the moment. I wonder if I could make a suggestion of procedure.

On the first day we began this process, I remarked that five years ago this committee marked up a revenue neutral tax bill which produced a decade-long protracted fiscal crisis. It wasn't revenue neutral.

We cut back $1 trillion in personal income rates and $1 trillion in business taxes and produced the deficit that has produced the price that we still live with.

And I said it seemed to me that the last thing we should do would be to repeat that experience by passing a nominally revenue neutral tax bill that wasn't neutral.

And this morning we have had several cases--two now-- where we have a proposal before us as a committee mark-up which raises significantly less revenue than the President's proposal; but we only find that out by persisting in asking questions.

And I wonder if it wouldn't be a routine--we have our good friend and much admired Assistant Secretary for Tax Policy, Mr. Mentz, here--if it could not be a routine that when the President's proposal will raise more money than either the House proposal or our proposal, that the routine of our procedure be for the President's representative here to explain that fact or call attention to that fact and explain why, in this nation's view, the President's proposal is preferable, unless on occasion you may have changed your mind, if you think the House came up with or we came up with something better.

Does that not --

The Chairman. Let me again call to the committee's attention the chart that all of you should have had put out by the Joint Committee last Friday on the comparative provisions to the extent they have them, of the President's proposal, the House bill, and the chairman's proposal, so long as you accept the two caviats.

One, the years are different; two, the economic assumptions are different.

The House bill and the President's bill were estimated under last year's economic assumptions. The Senate bill, or the chairman's bill, is estimated under the more current assumptions. So, you are going to be off somewhat just on economic assumptions.

I have no objection to members asking the Treasury why the difference and the merits of why the difference--what have you done?--realizing that so far the committee has taken great glee in indicating where we lose money.

When we come to areas like the minimum tax, we pick up money significantly over the House and significantly over the President's proposal.

Senator Moynihan. Reverse the process then.

Senator Bradley. Mr. Chairman, so that on every provision where we try to make a comparison, we don't have that answer from Treasury or from you or from Joint Tax, which is why we have different assumptions here, could we get the President's proposal and the House bill based on current budget assumptions?

The Chairman. I have asked the Joint Committee to do that; but at the moment, they are going to have to give us a hunch or a guess as to where the differences are because they do not have those, and they cannot run them all that fast.

But I have asked them to prepare the running of them, but in some cases we are going to have to make decisions based upon their estimates--I mean, their top-of-the-head estimates.

Senator Bradley. So, in a couple of weeks maybe, we will be able to have them?

The Chairman. Mr. Brockway?

Mr. Brockway. It is a matter of competition for resources. I mean, it is a question of we could go through and devote all the resources to estimating the House bill; and obviously, when you are in conference, that is going to have to be done in any event.

The Administration bill, I don't think that we would otherwise try and reestimate that. It takes a fair amount of time to go through that process, and the members have a number of specific proposals and modifications to the chairman's proposal that they would like to see looked at.

And I think that those would take priority; but to the extent that we have time, assuming we can complete the work on the various amendments that the members wish to see, we will devote it to the other.

Senator Bradley. But you can, off the top of your head, give rough figures?

Mr. Brockway. I will do my best to do that.

Senator Bradley. If we know that they are rough figures, could he just go through maybe and give us a sheet of rough figures, recognizing that we might have those changed?

The Chairman. I would rather have him give us rough figures orally. You get a sheet of rough figures, and those get circulated; and I think that is unfair to the Joint Committee.

Senator Bradley. All right.

The Chairman. As we go issue by issue, I think he can say I think we are off $200 million; but I am reluctant to have him just go through this whole sheet and say, well, here is my guess as to where I think we are off.

Let's go on to Generation, skipping the Transfer Tax.

Senator Grassley. Mr. Chairman, just at the tail end of this, I want to bring up a farmer's State tax issue. I don't want to get in the middle of any plans that you have.

The Chairman. Let's finish this one; and that is the last of this particular section, so bring it up and mention it before we move onto the issue of Pensions.

Senator Baucus. Mr. Chairman, I have a similar one. I have a farmer's State tax provision as well.

10

The Chairman. Go ahead, John, with the Generation Skipping.

Mr. Colvin. The chairman's proposal retains current law. The House bill had made significant reforms in the Generation Skipping area.

The revenue yield from the three approaches--the Administration, House, and chairman's proposal--according to the Joint Tax figures circulated last Friday is--

Excuse me, there would not be a revenue impact on these changes because you are looking at essentially the intermediate generation dying at some point in the future.

So, all these generation skipping taxes might some time in the distant future have a significant revenue impact, but in the short run, you are not likely to see any. So that is a de minimus revenue change regardless of present law or the other proposals.

The Chairman. Comments on the Generation Skipping section?

(No response)

The Chairman. If not, let's move to the two issues that Senator Baucus and Senator Grassley have. Senator Grassley, and then Senator Baucus?

Senator Grassley. Mr. Chairman and members of the committee, and I will explain to the committee and then staff can listen and then ask if there is any sort of problem the way I look at this.

It deals with a period in time in the State tax legislation under the Special Use provision, when we had a 15-year requirement that land had to be held to qualify for special use provisions.

Then, I think it was in 1981 that we changed that to 10 years. And I don't know why we didn't change it for those who were already covered by it, but we didn't do it.

So, now we have some with a 15-year requirement and some with a 10-year requirement; and I would like to change it so that all would have a 10-year requirement, and the reason for doing that is because, with the falling land prices, there are people that maybe need to sell their land and they won't have an opportunity to do that without losing the benefit of the special use.

It would not be my idea that any of these people could avoid any of the State tax that they would otherwise have to pay in the annual installment that they pay that tax.

The Chairman. Senator Baucus?

Senator Baucus. Mr. Chairman, my amendment is slightly different. Essentially, it would direct IRS to use the rule of reasonableness when the State tax form is filed, to the degree it conforms with provisions reflecting the special use election.

Currently, the IRS is saying that not only must a taxpayer elect at the time that it files the State tax return, but also must at that time file the statement of agreement of errors to the election.

In 1984, we did--this committee and by law--enact a provision that the taxpayer would not have to in the first instance, when he originally files, conform to every provision with every "i" dotted and every "t" crossed.

That is, he could come back when he has not filled in something correctly, and fill it in correctly. However, it looks like the report language that accompanied the bill tightened up and changed our intention here so that there are taxpayers now who file their State tax returns and find them summarily rejected because the taxpayer did not completely fill out every portion of the return.

So, I would suggest an amendment which provides a rule of reasonableness, as is the case with all other returns, so that if the State tax filer elects the special use under, I guess, it is Section 2032(a), he is entitled to the principle of reasonableness just like very other taxpayer.

Senator Grassley. I would like to have any comments that the staff might have on the provision that I just brought up because I would also like to add that I have had brought to my attention in my State the same issue that Senator Baucus has brought up as well.

The Chairman. Comments on these two issues?

Mr. Brockway?

Mr. Brockway. Mr. Chairman, on Senator Grassley's proposal, it was in 1982 as the Senator said that the recapture rule for special use valuation was changed. It was reduced from 15 years to 10 years, if the inheritors of the property took the property out of agricultural use and sold the property.

That was simply done on a prospective basis for transfers after the 1982 change, and we have not done any revenue estimate analysis on that yet; but we will look into that.

Senator Grassley. Yes, that is fine; but maybe you missed the point I was making. I would not propose that there would be any-- In other words, any tax that would be owed by that estate that had a 15-year proposition connected with it for holding it would still be paid.

I am just suggesting that they would only have to hold it 10 years instead of the 15 years. Whatever tax that estate would have to pay, I would want that still to be paid so that the Federal Government would not lose one penny.

Mr. Brockway. Right. I think to the extent that there would be a revenue impact at all, it would be the situation where someone at a pre-1982 transfer found that, for whatever reason, transferred the property between the years 10 and 15 under present law, they would be required to pay tax at the nonspecial use rates, whereas under this amendment, it would treat them in the same way as taxpayers who were decedents after 1982.

I don't know whether the issue itself, of looking at earlier States, was looked at in 1982.

Senator Grassley. Understand that, under my proposition still, everybody would still have to hold their land for at least 10 years.

Mr. Brockway. That is correct.

Senator Grassley. All right.

The Chairman. Further comments?

(No response)

The Chairman. If not, let's move on to Pensions, Deferred Compensation and Employee Benefits and Employee Stock Options. And that starts on page --

Mr. Colvin. Page 124.

The Chairman. Page 124. In the section on Deferred Compensation and Pensions, in drafting the chairman's bill, I very much attempted to move toward the direction of requiring employers to tilt toward wage earning employees; or put it the other way around, I found many, many instances where the Pension and Deferred Compensation Law tilted toward higher income employees.

Whether you would say that would be at the expense of your wage employees or not, I don't know if that is a fair way to phrase this; but you had plans set up in such a way that it was much easier for highly compensated employees to take advantage of them than lower compensated employees.

And so, in this entire area, you will see a consistent thread of attempting to either move toward nondiscrimination or at least financially to make it very difficult to have plans that tilted toward just the highly compensated or principally toward the highly compensated without covering others.

I must confess I stole generously from Senator Heinz and Senator Chafee in this area in the work that they had done, and I think they will see a good many of their nuggets spread throughout the chairman's proposal.

Senator Grassley. It will sound better tomorrow.

The Chairman. Well, I will give them full credit. They did good work, and there is a fair portion, whether it was stolen, borrowed, or begged, of their work in this section.

So, let's start through it. Mr. Weiss? Mr. Colvin?

Mr. Colvin. On page 124, the first issue is Spousal IRAs, and this is a minor provision that corrects a quirk under which spousal IRAs are not available if the spouse earns between $1.00 and $250.00.

On Item B, the issue is an increase in the IRA withdrawal additional income tax from 10 percent to 15 percent, and also the provision of an exception if the withdrawal is for an annuity.

Senator Danforth. Is that it for IRAs, John?

Mr. Colvin. That is it for page 124. The relationship between an IRA and a 401(k) comes up on a later page. On page 125 --

Senator Danforth. May I ask before you move from page 124, on IRAs, a lot of advertising before the April 15th deadline--you see it on billboards even--urging people to borrow in order to put money into IRAs.

I would like to ask Mr. Mentz: Is that consistent with the purpose of IRAs? Is what we are intending to do to encourage people to borrow in order to save?

And if you were advising a client, what advice would a client get from a lawyer on the benefits from borrowing in order to create IRAs?

Mr. Mentz. Well, I guess the advice to a client would be that an IRA is sort of like chicken soup--it can't hurt you. It is a no-lose proposition.

So, you might as well put your $2,000 into an IRA; and if you need to borrow to do it, I would be worried about my client being able to pay my fee if he had to borrow $2,000 to put into an IRA.

But as a practical matter, sure, borrowing under current law, there is nothing wrong with it; and you certainly would advise a client to do it.

The chairman has recognized that there is a kind of --at least in perception and more than that perhaps--a problem in borrowing to fund an IRA. It is hard to see how that really enhances a true saving.

And under the chairman's proposal dealing with interest --interest incurred on a loan to fund an IRA--is not deductible. Treasury would support that position.

The Chairman. One of the things that was in the back of my mind, Senator Danforth, in crafting these proposals was the demographics that we faced.

And anything that would encourage, and especially employers, to provide pensions for lower and middle income employees where they are now not doing it or where they are offsetting them with Social Security or where they were relatively minimal, the proposal tilts toward encouraging those kinds of retirement plans.

It tilts toward making it a little bit more difficult, or at least a little bit more penalized, to withdraw for purposes other than for retirement where it was initially set up for retirement, although there that parallels, at least in philosophy, the Administration's idea also.

Senator Danforth. Can I ask a question about the borrowing? Now, under present law, you deduct your interest and you also deduct what you put into your IRA; and there is no increase in savings, and it is a total wash.

But even if interest that is paid on loans in order to fund IRAs is not deductible, still that doesn't get at the underlying problem. I mean, what we have done is to provide a deduction of up to $2,250 for somebody who, in essence, doesn't do anything at all--just shifts money from borrowing to savings.

The whole point of an IRA, as I understand it, is to increase savings, not to have a wash.

Am I correct on that, Mr. Mentz? Is it sort of just a gimmick?

Mr. Mentz. Well, I wouldn't call it a gimmick, Senator. I think that, while in a given case it may be that an IRA represents a transfer from one account to another, I think that in many cases an IRA provides an incentive for an individual to save, to put away that $2,000; and instead of spending it, particularly at this time of year when they are getting ready to file their tax returns, and you can still put it away before April 15th, I think people are doing it.

Senator Danforth. Sure, it does, and that is the intention of it; but what I am saying is if somebody borrows in order to fund an IRA, that doesn't accomplish the objective of the Congress in creating such a thing, does it?

Mr. Mentz. You might have a short-term borrowing when it is paid off next month out of next month's salary and you effectuate the intent; but I think your point is basically right.

And I think the chairman meets it with his treatment of interest on funds borrowed to --

Senator Danforth. I don't understand how he meets it. I mean, he meets it by preventing a double form of deduction. He meets it by preventing a deduction of interest and a deduction of what was put into the IRA.

But still, you get to deduct what you put into the IRA even though you really haven't saved any money at all.

The Chairman. Are you questioning the original concept of the IRAs at all?

Senator Danforth. No, not at all. I think that we should actively encourage savings, and I am all for it; but what I am saying is that is it a bizarre situation if we are offering a deduction to people who don't increase their net savings. They simply borrow in order to --

The Chairman. Well, that has been a point that has been raised all along on the IRAs and other savings devices, including the fabled All Savers Certificates.

We were going to encourage people to save money that somehow they weren't otherwise saving; and in many of our experiences, it has been that they are shifting their savings from one form of savings to another.

You certainly can't look at the savings in the United

States, after all of the incentives we have put in in the last few years, and say, gee, they have gone up. They have gone down unfortunately.

I think that is a separate issue, however, from the particular IRA issue here. Whether or not we adopt my proposal or the House's or the President's, I don't think it faces the issue of whether or not this incentive discourages, encourages, or is neutral about total net savings.

That may be an issue in this bill, if we want to bring it up, or for another bill; but I don't think any of the proposals address themselves to that subject --

Senator Danforth. I guess what I am saying is that there could be something that could be put in this bill that would get to the, what I would suggest, is an abuse.

I mean, if this is a tax reform bill, is there something that we can put into the bill which would say--maybe it is just impossible to draft such a thing--but which would say that what we don't want people to do is to just shift money from borrowing to savings, where there is no net change.

Senator Chafee. Mr. Chairman, we raised this with you, and I thought we had the specific provision covered; that you would be against the law to borrow --

The Chairman. To borrow. That is correct.

Senator Chafee. For an IRA. And it is my understanding that that is covered.

The Chairman. I think, though, that Jack may be driving for even more than that. I am not sure.

Senator Chafee. I thought it was similar to the limitation on borrowing for speculating.

The Chairman. It is. But I am curious if this is what Jack is getting at.

You earn money. Prior to the IRA, you might have put it in your savings account. You didn't borrow it; you might have put it in your savings account, upon which you would then pay taxes on the interest you received.

Now, instead of putting it in your savings account, you may put it in an IRA; and you don't pay taxes on the interest while it mounts up. And you get to deduct it.

And I am not sure if Senator Danforth is saying that somehow that ought to be prohibited because, in essence, it is a shift of savings, and it is the same $2,000.

I don't know if that is what you are driving at.

Senator Danforth. No, here is what I am saying.

Coming in to National Airport this past weekend, I walked by a little area--you know, a shelter--where people stand out of the rain. And there was a poster up in the shelter, and the poster was advertising a bank, and it said: Borrow in order to invest in your IRA.

In other words, what the bank was doing was advertising a program which would ask people to come into the bank, borrow money from the bank, and then take that borrowed money and put it in the IRA in order to get the deduction for putting it in the IRA.

And if all we do is to say, well, that the interest on the borrowed money is not deductible, you really haven't solved the problem because, in effect, what you are doing is saying to somebody: We are going to give you a $2,250 deduction from your Federal income taxes for doing nothing at all.

You are just going to the bank and you are saying: Please lend me some money so I can put it into a certain kind of savings account and get a deduction.

The Chairman. We are saying that when you borrow the money, you at least cannot take the payment on that as a deduction in addition to the IRA deduction.

Senator Danforth. I know, but that doesn't solve the problem. That is to say, that instead of getting a total deduction of maybe $2,500, maybe all you get is a deduction of $2,250.

The Chairman. Senator Pryor?

Senator Pryor. Mr. Chairman, I think about 60 or 70 percent of all the mail that I am getting right now on tax reform relates to this area that we are just about to get into.

I would like to, first, ask this question: Is the reason for changing the pension area of the 401(k) and IRAs to get more revenues or to straighten out a problem or an abuse?

The Chairman. David, let me answer that if I can. As far as I am concerned, in the way that I drafted it, it does produce revenue. But I was more concerned with fairness.

Take the 401(k)'s for example. $30,000 current limitation. You go around and ask a company that has got a fair number of employees--a broad section of employees--what percent of their employees' contributions fall above the $7,000 limit. And if you get any employer that has got 200 employees or more with fairly broad participation, if you get an answer of more than one or two percent, I will be surprised.

If what we are trying to do is to encourage savings for the broad mass of middle income Jane's and Joe's in this world, you don't need a $30,000 limitation; and the $30,000 limitation was being taken advantage of by small, closely held corporations allowing partners or shareholders of some degree of wealth to set aside a large sheltered income.

And I don't think that is fair, nor is it needed, with this one exception; and I don't know how you come out on this one. A number of employers who, when they would be frank and honest with me, say, well, we have got it in our company; it is very popular. We could never get rid of it; 95, 96, 97, or 98 percent of our employees fall below the $7,000, but had we not been able to have the $30,000 deduction, we never would have set it up because we really set it up for ourselves, and we had to extend it to the rest.

Senator Pryor. What are we talking about, Mr. Chairman, if I might ask the officials about the revenues that we are going to gain by making this change? I know it is too early to get to 403(b), and that will come probably later; but I would like to know.

Maybe they could give just the 401(k) versus the IRA changes. What revenue changes are we talking about?

The Chairman. What page is that on in your charts? I am looking for it now.

Mr. Colvin. Page 10 on the revenue chart.

The Chairman. Thank you.

Mr. Colvin. Senator Pryor, this may be a partial answer to your question. The House bill raised $4.7 billion from Section 401(k) plans, and the chairman's proposal loses $.4 billion.

The Chairman. And the specific reason it loses the bulk of it is that we backloaded, rather than frontloaded, the IRAs; and that is 90 percent of the difference in the revenue.

Otherwise, if you frontloaded it, you would put money into an IRA and you couldn't have any 401(k) at all, and I didn't see that that was doing much for the middle income employee.

Senator Matsunaga. Mr. Chairman?

The Chairman. Senator Matsunaga?

Senator Matsunaga. This may be the appropriate time since Senator Pryor raised an issue, but at the appropriate time as we have been advised by the chairman to let him know, I will offer an amendment to the Pension section of this bill which, in large measure, will retain present law, which will retain present rules relative to basic pension laws.

And I have distributed a one-page description of my amendment, and I am doing this, Mr. Chairman, because I just returned from Hawaii and I have been talking to businessmen who have been providing retirement plans on a voluntary basis.

And because we have been changing the laws so often--we changed TEFRA in 1982, and then we changed it twice in 1984 under what we call DEFRA and RAR--and since 1982, one law firm alone advising employers told me that more than 450 of his clients have terminated plans because they say they can't stand the uncertainty of the law.

Every time they lay out a plan, pay attorneys' fees to lay it out, then they have to change it. They have to pay attorneys' fees again, lay out new plans.

So, rather than paying the attorneys' fees and going through all that expense and going through periods of uncertainty, they said, well, let's terminate the employee pension plans, which means that the employees are suffering because of the termination of plans to which employers make contributions.

And so, I will not go into detail of what my proposal will be, but in general, I have submitted a one-page description.

Senator Pryor. If I might ask, Senator Matsunaga, does it also relate to the 403(d) changes that we are looking at?

Senator Matsunaga. If we change the present law.

Senator Pryor. All right. I may want to address that--

The Chairman. Let me interrupt just a second while we have a quorum.

Senator Heinz?

Senator Heinz. Mr. Chairman, I anticipate that today you will discuss a little more of the Pensions and Deferred Compensation sections than we have discussed thus far.

Senator Matsunaga has indicated that he will have an amendment that in large part--and I reviewed his outline of it--will return us in many instances to current law.

I want to commend the chairman for having borrowed or stolen, or whatever he did, what John Chafee and/or I have done over the last several years.

And in general, I think your proposal has much to recommend it. There are some areas where I would like to seek some modification of some of the things in your proposal, Mr. Chairman, and will be at the appropriate time offering either one amendment or a series of amendments to make those modifications.

But without going into those in detail--and I will be sending around shortly a list of what those are--I want to just say to all my colleagues that there is a real issue. Senator Matsunaga, in fact, has put his finger on a very important one which is employer uncertainty about what happens in this pension and deferred benefits area generally.

And one of the reasons there is uncertainty is that every time Congress convenes, we do something that gives them great reason to be uncertain about the future because we, the Finance Committee and the Ways and Means Committee, change the laws.

And so, their uncertainty is based on certainty, that is, that we are always doing something to them.

What I think the chairman's goals are, and certainly mine in the legislation that I have introduced, is to try and introduce a number of elements of certainty so that the Congress doesn't keep coming back, again and again, trying to raise a little revenue by fiddling with some of the limits that affect the defined benefit or the defined contribution plans or other changes that add a few dollars to pay for some new form of tax reform or increase some revenues, as we did in 1984 and 1982.

It seems to me that, in addition to setting forth a kind of a framework for pension policy where we indicate clearly that it is our national policy to encourage savings for retirement income purposes as a first priority; and if it were up to me, to encourage savings for other purposes as a secondary and important priority.

Then, the next thing we might logically seek to do, having made those distinctions, is to structure our pension laws in a way that safeguards them from attack.

One of the problems that Senator Packwood mentioned a moment ago is that plans can have top-heavy benefits. Also, our pension system as a whole is nothing to write home and be proud about.

Of all the people working--the 100 million people working today--only about half of them worked for an employer that has any pension plan at all. And of that half, only one-half or about 25 percent of all the workers, therefore, now working can expect to receive a benefit from that pension plan.

Typically, and now I am talking about the 50 percent that aren't in jobs where there are no pension plans; what that means is that this very significant tax expenditure--it added up to about $44 billion in tax expenditures last year--isn't performing quite as broadly and well as I think we would all like it to.

I think we would all like to see more people benefit from the pension plan system that we have over the years evolved. And yet, statistically, we know that unless we make some changes in it, the benefits that it provides are going to be rather narrowly targetted to a minority of the work force, and secondly, that there is the risk that a substantial amount of the $44 billion today in tax expenditures--I guess, 1984--could in fact go to relatively well-off people.

Now, there is nothing inherently wrong with pension plans doing better for more upper income people than somewhat lower income people because Social Security does somewhat better for lower income people than upper income people.

And if the goal of our pension policy is to give everybody a pretty decent replacement rate of their pre-retirement income, then pension plans are necessarily going to do better by upper income people as opposed to low income people.

But I would hope, Mr. Chairman, as we go through the pension plan section, that we understand that we have an opportunity--indeed, I think we have an obligation--to try and make sure that in whatever we do we do what we can to improve coverage for people. Coverage is low. That we minimize the kinds of integration out of any benefits at all that occur in some pension plans; that we give incentives for retention of savings nominally set aside for retirement income purposes to, in fact, have strong incentives to be set aside for retirement income purposes and not some other more immediately attractive purpose.

And that we do all of this in a way where, having set forth a national policy that makes some sense, that has some rationale to it, the Congress will therefore keep its hands off of this area because we have done something logical and rational and far-sighted and comprehensive and that Congress will go away and leave pensions alone for the next 10 or 15 or 20 years.

That is probably asking for too much, but that would be my goal, if we could possibly achieve it. I think it will be related to how rational and good and thoughtful and comprehensive a job we do here.

If we stick with current law or something like it, there is no doubt in my mind that we will be back at pensions again and again and again. And the very goal of the Senator from Hawaii, which I strongly support, which is predictability, will in fact be the one we don't achieve, even though he and I both seek to achieve it.

Senator Matsunaga. If the Senator will yield; I appreciate the Senator's support --

Senator Heinz. I didn't say I was going to support his amendment.

Senator Matsunaga. Oh. At least the support in principle and perhaps the goal --

Senator Heinz. Is agreed upon.

Senator Matsunaga. Actually, in the last five years, as the Senator may know, terminations of plans have increased by 300 percent, and the principal reason given by employers for such terminations is that they have got inadequate time and attention to consider the full ramifications of the changes that have been made, some of which of course surface in the chairman's proposal; and the expense of the plan amendment, legal expense.

And this is particularly burdensome for small businesses. And of course, Hawaii is primarily small businesses, and they have come to me in droves saying that they are being forced to terminate their plans if we insist on changes.

Now, the House bill, Mr. Chairman, under coverage, which Senator Heinz pointed out, should be further studied. The House bill provides for further study, whereas in your proposal, Mr. Chairman, you imposed stricter rules than perhaps --

The Chairman. Well, in one section only.

Senator Matsunaga. In coverage.

The Chairman. Yes. In fairness, and I do appreciate the fact that several days ago you gave the staff the amendments that you were talking about --

Senator Matsunaga. Right.

The Chairman. But I think there is a difference in philosophy. You would like to keep current law in most areas. I find the current law unfair to middle income employees and to lower income employees.

Senator Matsunaga. To retain present law, Mr. Chairman, primarily for the purpose of letting business adjust. If we are going to make any changes, we ought to project into the future 5 to 10 years so that they can lay out their plans in accordance with what the chairman deems to be a fairer or an improvement in the law.

The Chairman. Senator Moynihan?

Senator Moynihan. Mr. Chairman, I certainly have heard the same kinds of propositions as Senator Matsunaga and Senator Heinz have put forth. I think we all have. I am pleased to learn that in Hawaii there are more employers than there are lawyers.

But can I ask my routine question this morning? As I look at page 10 under Title XIV, the President's proposal would raise $16 billion, and the House proposal would raise $5 billion, and we lose $400 million, a pattern we have seen all morning.

And I wonder if Mr. Mentz can tell us what is the case for raising the revenue as the President proposed it and what he thinks about our proposal to lose revenue.

Mr. Mentz. Senator, I would be glad to. It was a question that I did anticipate.

Treasury II, as written in May of 1985, provided an $8,000 limit for 401(k). When Treasury II was estimated by the Joint Committee in July, it came up $25 billion short of revenue neutrality.

As a result, Treasury had pledged to the chairman of the Ways and Means Committee that we would amend our plan to have it start out revenue neutral.

The two significant amendments that brought it down to revenue neutrality were (1) complete elimination of 401(k) and (2) a change in index FIFO inventories.

Now, the reason 401(k) was eliminated in part some of the points that have been mentioned already this morning, 401(k), since it is voluntary with each individual, you would tend naturally to get a discriminatory pattern. You will tend naturally to have the higher income people be in a position to defer, whereas the lower income people not be in a position to do so; and also 401(k) may be regarded as less of a method for retirement saving than a normal defined benefit pension plan where amounts are put away, and it is only at retirement age--55 or 60 or 65-- that an annuity is provided.

The Chairman. May I interrupt to ask a question?

Mr. Mentz. Sure.

The Chairman. The answer to Senator Moynihan's question is that you principally got rid of the 401(k)'s and that is where the big savings in revenue came in?

Mr. Mentz. Yes. We got rid of the 401(k)'s in order to make up a good piece of that revenue.

Now, I think what the chairman has done is taken the $7,000 401(k) limit and has basically met the tax policy objection to existing 401(k), that is, as you explained, it tends to benefit very much the higher income people, but he has not completely repealed 401(k).

And frankly, I think that there really is very little if any sentiment for complete repeal. I think the explanation of the President's proposal is more in the historical context that I --

Senator Moynihan. Was it revenue driven?

Mr. Mentz. Totally.

Senator Moynihan. Then, how come we end up losing?

The Chairman. Again, the difference between the House and my provision is that we backloaded the IRA, whereas the House frontloaded it. And in essence, you could not have had an IRA and a 401(k), and that costs about $3.5 billion to allow you to have a combination of $7,000 IRA and 401(k) total.

Mr. Colvin. Senator Moynihan, one additional area where the chairman's proposal loses revenue compared to the House bill is it extends 401(k) plans to State and local governments.

That was terminated under the House bill.

Senator Moynihan. Thank you.

Senator Bradley. Mr. Chairman?

The Chairman. Senator Bradley?

Senator Bradley. If I could go back to the IRAs where you have minus 3.6. Just for the record, what did IRAs cost last year without the additional benefit?

Mr. Mentz. I think, Senator, that minus 3.6 would have extended the spousal contribution.

Senator Bradley. Yes, I understand. I just want to know what does the current IRA provision cost the Government?

Mr. Brockway. In fiscal year 1987, our estimate was that the IRA provision resulted in a revenue loss of $15.9 billion.

Senator Bradley. $15.9 billion. Now, when we passed the IRA in 1981, what was the estimate? Do we know?

Mr. Brockway. It was significantly less than that.

Senator Bradley. But, I mean, by a wide margin, wasn't it? I mean, wasn't it about--wasn't the estimate about $3 to $4 billion, it was going to be?

Mr. Brockway. I don't recall the exact figures, but I think you are right.

Senator Bradley. We were off in our ability to estimate how much IRAs would cost by about $12 billion. So, now in this proposal, we are suggesting essentially, and the President has suggested as well, to double the IRA. Is that not correct? Give a spousal IRA?

The Chairman. That may or may not double it. It presumes that everybody who can afford a $2,000 IRA would buy another $2,000 IRA for a nonworking spouse. And I guess that would double it, if everybody did it.

Senator Bradley. I am not suggesting that we have $30 billion in IRAs now, by this change, but I am suggesting that it might be a little higher than $3.6 billion.

In other words, how did you arrive at $3.6 billion?

Mr. Brockway. We essentially used data on the number of one-earner couples that benefit from this provision. I think it is worth pointing out that many couples--two-earner couples essentially--would not be affected by this provision.

This is just one-earner couples, and it is only those where the full $2,250 that is allowed under present law is already being utilized.

Senator Bradley. Right.

Mr. Brockway. So, we tabulated data on that and tried to make an estimate.

Senator Bradley. Do you also have what income level that falls in?

Mr. Brockway. We don't have a specific estimate of the income level that this particular provision would be used by.

Senator Bradley. Because it is my guess that the income level that would be able to use the spousal IRA would be an upper middle to higher income level person, consistent with what Mr. Mentz has said about IRAs generally.

And I think that we might want to consider that fact as well as the revenue loss which might be considerably different. And I just wanted to raise that for the chairman's attention and suggest that maybe, when we come back to this issue, that might be something that I would want to talk about.

The Chairman. Senator Boren?

Senator Boren. Mr. Chairman, I wondered on the 401(k) about the ceiling question, the $30,000 and the $7,000. What is the revenue gain that occurs by lowering that cap?

Mr. Brockway. We think that about $1.7 billion is raised by taking the $30,000 down to the $7,000 level.

Senator Boren. Is that roughly calibrated? In other words, if you went to $17,000 or whatever, would that still raise about half the revenue?

Mr. Brockway. No. What happens is that there are only a few people, a relatively few people, affected by even a $7,000 cap; and once you raise it even $1,000 or $2,000, virtually all the effect of the proposal goes away because there are just not that many people who are making more than $7,000 or $8,000 or $9,000.

Senator Boren. Have you done any kind of study on-- I am told that so many of the new companies, the start-up companies, are considering whether or not to start these plans--the entrepreneur involved or the executive involved. Many of them might just decide not to have plans for the rest of their employees if they didn't have a personal incentive to create them themselves.

The Chairman. I talked about that earlier. I can give you some personal experience on that because I have asked 15 or 20 companies who have 401(k)'s with a rather broad participation, first, what was their average contribution. 98 percent are less than $7,000.

Senator Boren. Right.

The Chairman. Randy Weiss is right about how many are contributing above that; but several of the employers, very frankly, said they never would have put it in but for the $30,000, and they were putting it in for themselves.

And if, by chance, their employees took advantage of it, why so much the better for the employees; but you know, that is like saying: Why should we have any taxation on people who make over $500,000 a year? There aren't enough of them to make any difference in terms of income.

So, at some stage, I don't think the retirement policy of the Federal Government ought to be to disproportionately encourage the very privileged to set aside money for retirement in the hopes that some of the middle income taxpayers might get covered.

Senator Boren. Well, the only thing I would say about that is that we have to be somewhat cautious because especially when you have newer and smaller--probably the smaller the operation, the more important it is in terms of the attitude--but if indeed 98 percent of the people benefitting from 401(k)'s fall below the ceiling, there is some significant benefit to the creation of it for lots and lots of people.

I think to sort of turn the argument around a little bit, I think we have to consider that point --

Senator Durenberger. Before you leave that point, would you yield for just a short question on the point you are raising and that the chairman responded to?

In addition to the more well-paid executives, it has been my experience--and maybe somebody can confirm or deny this--that there is another group of employees who utilize 401(k)'s above $6,000 or $7,000 or $8,000; and that is people who work very hard, say, the first 20 years of their existence to raise a family, educate their kids, they are getting their kids through college, and so forth.

They have now reached about 50 years of age. Their salary or their income is about as high as it is going to get, with some incremental increases; but their costs are starting to go down again.

So, at that point, it becomes possible for them to do what they weren't able to do when all of their income was going into current expenses--household expenses--and that is to start saving via 401(k).

Now, what does experience tell us about that kind of a reality?

Senator Moynihan. Mr. Chairman, may I offer the thought that experience tell us that they never leave home.

(Laughter)

(Continued on the next page)

3: 4-8-86

Senator Durenberger. Well, that has to do with the refrigerator.

(Laughter)

Senator Durenberger. But is there an answer to that? The Chairman is characterizing the 7000 and over as being the wealthier employees, and I am suggesting that there is a whole other group of employees that the size of their income has nothing to do with it, it is the size of their expense relative to their age.

Mr. Colvin. Senator Durenberger, we have seen information that savings rates increase with age, as you point out; but I believe that a majority of people even in those higher savings rates would not reach the 7000 limit.

The Chairman. I wonder if we might march through this section, because we have about 50 pages to go in the entire section.

David?

Senator Boren. I just wanted to mention the two elements that I may offer an amendment on later. They deal with the material on pages 143 and 152, with early withdrawal and also company withdrawal from qualified pension plans.

I am very concerned.

The Chairman. Was your latter one the reversions? Did you say company withdrawal from pensions?

Senator Boren. The company withdrawal, and also the early-out before age 59 and a half.

Like everone else, I want to make sure that we preserve the security of these funds, that we don't have them endangered. But where we have over-funding of plans -- we have some situations that have resulted from the great stress that our economy is going through in our region right now.

One of our largest corporate citizens, for example, had no choice but to sell. He's going to have to do some of this while still keeping its plan well above the minimums required by law and by prudence. And there are also some people that are getting retired that don't want to retire; they are being forced to terminate early before age 59 and a half. We have had massive layoffs in the energy industries and in corporations in that area that are totally non-voluntary, and many of these people are now unemployed and are going to have a tough time finding other jobs.

So I want us to at least think about not penalizing some of those people that are now being forced by economic developments.

The Chairman. If you could, I would appreciate it, and most of the members have been very good so far about letting me know in writing some of the things they are thinking of. The reason for that is going back to the question Max Baucus asked earlier about the schedules, now that we are going to be going morning and afternoon, and when are we going to be doing such and such a thing. That depends upon how many amendments there are, and it depends upon how many are going to be adopted.

I have a rough idea, as I see them ahead of time. You can get a pretty good sense as to which ones are going to take time and which ones aren't. But we will be, with the exception of the day set aside for the Canadian-American pre-trade negotiations, and one day for hearings on the excises, going Monday through Friday, mornings and afternoons, with the possibility of votes on issues on all occasions with the rule-of-thumb exception of maybe Friday afternoons and Monday mornings.

Senator Boren. Well, I will probably have amendments to those two sections, Mr. Chairman.

The Chairman. Senator Danforth, then Senator Baucus, then Senator Matsunaga.

Senator Danforth. Mr. Chairman, I may have an amendment disallowing deductions for IRAs in the case of funding IRAs from borrowed money.

The Chairman. I thought that was in the bill.

Senator Danforth. No.

Mr. Brockway; Mr. Chairman, your proposal has a provision to disallow the interest deduction on borrwed funds.

The Chairman. Oh, you are going to disallow the borrowing altogether?

Senator Danforth. Disallow the IRA deduction in the case of just shifting money from borrowing to savings.

The Chairman. All right.

Senator Baucus?

Senator Baucus. Mr. Chairman, I would like to pass notice that I have some amendments, too. One is going to be to change the Social Security maximum wage base -- as used, the Social Security maximum wage base -- a percent of that with a limit, the upper limit, for the 401(k)s. It seems to me it makes good sense if we are going to index the maximum Social Security wage base for Social Security, we should also do the same thing for 401(k)s, just have some concommity in policy here.

My thought is that that upper limit, therefore, would be either 25 percent of the base, or 20 percent of the base. If it is 25 percent, I think it comes out to about, instead of $7000, I guess $10,000.

But anyway, I want to set the principle of concomity and parallelism between the two. So, I will be offering that.

The Chairman. Again is a request: If you could just have your staff give it to our staff, even in its idea form -- it doesn't have to be technically drafted -- so we have a rough idea of what you are aiming at.

Senator Baucus. And in addition, I would allow an employee to buy an ESOP, $2500, above and in addition to the wage limit for 401(k)s, so long as the stock is held for a requisite period of time, in my case at least three years.

What I am trying to do is encourage more employee participation in companies. That's why I think the ESOP limit, the contribution, should be at a reasonable level, say $2500, and in addition to the 401(k) limit.

Also, slightly changing the non-discrimination rules, basically, Mr. Chairman, adopting your approach, but liberalizing it just slightly from your approach. It seems to me that there is not discrimination against the middle-income employees -- that is, it seems to me that those middle-income employees, those middle-income wage earners, have an opportunity to join or not join many plans depending on how they marshall their assets. But it further seems to me that those non-discrimination rules should not be tightened up quite as tight as they would be under your approach.

Finally, if I might add, I want to help the availability of 401(k) programs to smaller business; that is, 401(k) master or prototype plan I think should be more readily available to smaller concerns.

As it is now, it is very, very difficult and it is very expensive for a company to file a 401(k) plan, with high attorneys' fees, and I am trying to get rid of those attorneys' fees, frankly, in the filing requirements so that smaller-sized businesses can more readily --

The Chairman. I have no philosophical objection to the last, although some of the biggest abuses I have seen of this are in small firms of highly-compensated people that take full advantage of the $30,000 deduction each. And I don't think that is what we intended for the small businesses.

Senator Baucus. Mr. Chairman, that is true, but I think the non-discrimination rules could take care of that. I just don't think that smaller firms should be impeded of filing a plan just because of the complexity of the legal requirements.

The Chairman. Let me announce, if I can, for those who are now here, what I hope we will be able to do the rest of the week in terms of both going through the bill and taking some action on amendments.

Tomorrow I would like to make some final decisions on both energy and ACRS, if we can. Tomorrow afternoon, back to pensions again, going through this, although we will continue to go through it for another 45 minutes or an hour today.

On Thursday morning, I would like to be able to make some decisions on the accounting provisions that we have already gone over. And on Thursday afternoon go to the foreign tax provisions, for preliminary discussion, and the same next Monday morning, preliminary discussions. I have said Friday will be the Canadian free-trade hearing.

Senator Moynihan. Mr. Chairman, the discussions also on Monday morning?

The Chairman. Yes.

And then, if we move along that fast, going on to bonds, preliminary discussion, on Monday afternoon. And preliminary discussion on individual and insuarance taxation on Tuesday.

Senator Bradley. So, no votes on Monday?

The Chairman. I don't plan any votes on Monday right now.

Senator Danforth. Mr. Chairman?

The Chairman. Yes?

Senator Danforth. If members present to you their suggestions or present to the staff their suggestions for amendments, would it be possible for those suggestions to be circulated in advance to the members, so that we could get some idea of what we are going to be voting on in advance?

The Chairman. What I would hope is -- we will try to. I would hope all the members would circulate their own amendments to the other members. And I would think that any member who wants his amendments adopted might circultate them beyond just me and get them to the other members.

Senator Danforth. It would also be helpful if there is some judgment as to what the revenue effects would be.

The Chairman. Our Joint Committee will try on it. I can't guarantee that they will always have it all the time, but they will try on them.

But it is up to the member to at least go and ask what the revenue estimates are, just don't throw them out to the wind and assume that some of them fall on the Joint Committee, and that they will pick them up off the street, make estimates on them, and throw them back up in the wind and hope that they arrive someplace else.

Senator Matsunaga. Mr. Chairman, in that regard may I ask unanimous consent that the Chairman request of the Joint Committee the revenue estimates on my amendment?

The Chairman. They will do the best they can.

Senator Matsunaga. The Chairman will so request?

The Chairman. I will request it. I cannot by unanimous consent guarantee they can produce it.

Senator Matsunaga. But a request will be made. Thank you.

The Chairman. Now let us continue on through the section. Out of 50 pages in the last hour we have gotten through a quarter of a page.

Mr. Colvin. Mr. Chairman, on page 125, the 401(k) elecgive deferrals are limited to $7000, and the last dollar offset is used instead of the first dollar offset in the House bill.

On page 126, that should also be read with page 127. That relates to the non-discrimination requirements for 401(k) plans and the change made by the Chairman's proposal, on page 127, where the average deferral percentage ratios are tightened somewhat from the current law.

However, as I said, that should be read in connection with the previous page, where the tighter, higher-compensated employees definition is not used, and so the effect of the Chairman's proposal is to be significantly more relaxed than the rules that would be in the House bill.

Page 128, a number of other issues relating to 401(k) plans. A couple of the major ones: the extension of 401(k) plans to state and local employees; another is the limit of hardship withdrawals to elective deferrals. Those are the major points on that page.

Senator Heinz. Mr. Chairman, can I just go back one page here? In terms of the non-discrimination requirements on CODAs?

John, how would you describe the main differences between the House bill and the Chairman's proposal, with respect to that?

Mr. Colvin. The Chairman's proposal does not change the "highly-compensated" definition. It retains the one-third/ two-thirds from current law.

Senator Heinz. And what are the effects, as you see it? Or what policy goals are achieved by doing one and not the other? One set or the other?

Mr. Colvin. The effect of the Chairman's proposal compared to current law is to tighten discrimination rules for 401(k) plans. It does not go as far as the House bill did.

Senator Heinz. And how different do you see the Chairman's proposal being from current law?

Mr. Colvin. The impact would vary by the company's payroll situation. But I could give an example:

Let's say that today the non-prohibited group -- that is, the bottom two-thirds paid of the work force -- were deferring 3 percent into a 401(k) plan. Under current law, the top one-third could elect to defer 6 percent of their income into the 401(k) plan. So, it's 3 percent versus 6 percent.

Under the Chairman's proposal, it would be 5 percent. So, under the Chairman's proposal if the bottom-paid two-thirds were electing to defer 3 percent, the top-paid one-third could elect to defer 5 percent. That is somewhat tighter than current law but doesn't go as far as the House bill did, because they tightened the definition of "highly compensated."

Senator Heinz. All right. Thank you. Very helpful.

The Chairman. Do you want to go on to employee matching contributions, page 129?

Mr. Colvin. These provisions are somewhat similar to the average deferral percentage ratios that we just talked about for 401(k) plans.

On page 129 and 130, the Chairman'a proposal imposes the same kind of average deferral test on employer matching contributions.

The Chairman. And these are similar to the President's proposals, and the revenue estimates are about the same on all of them, right?

Mr. Colvin. The revenue estimates are not stated separately on page 10, but that is probably correct.

The Chairman. You interrupt, Mr. Secretary, as we are going, if you have additional comments.

Mr. Mentz. I will.

The Chairman. Go ahead, John.

Mr. Colvin. On page 131, the subject there are the deferred compensation plans of state and local governments. These are sometimes called "section 457 plans."

The principal change made by the Chairman's proposal is to require distributions over the retirement years of the participants. That prevents the possibility of continuing tax sheltering into the retirement years for a state and local employee.

On page 132, the top there is the continuation of the item I just mentioned. At the bottom of page 132, it would tax the investment earnings of an annuity policy owned by a corporation or trust -- that is item A. And item B would impose a 15 percent additional income tax on withdrawals from annuities prior to age 59 and a half.

Senator Heinz. Mr. Chairman?

The Chairman. Senator Heinz?

Senator Heinz. Mr. Chairman, let me ask staff on that. Now, as I understand a deferred annuity contract, aren't those contracts purchased with after-tax money, as opposed to before-tax money, like a CODA? I see heads nodding up and down. Is that correct?

Mr. Strella. Yes.

Senator Heinz. Given the fact that these are in fact, in a sense, not purchased with what we would count as tax expenditures -- these being purchased with after-tax money -- why would we want to subject them to as high a penalty withdrawal tax as we would in the case of 401(k)s and IRAs?

Mr. Colvin. The earnings on these annuities accumulate income tax free. So, while there is not a tax incentive going in, there is an element of untaxed income during the period the annuity is held.

Senator Heinz. Oh, I understand that. But if you just do the math, clearly somebody who is putting in pre-tax money, and getting the benefit of the inside buildup, is getting the inside buildup not only on the part that would have been taxed but the part -- both parts: the part that would have been taxed and the part that would never be taxed. Whereas, with a deferred annuity contract, the base is lower in a sense, because after-tax money is going in, and you are not getting any inside buildup on contributions that weren't previously taxed, as you do under a CODA.

Therefore, it seems logical to me that, since there is less benefit, there should be less of a penalty for early withdrawal.

Mr. Brockway. Senator Heinz, the early withdrawal tax would apply only to the earnings in the case of a deferred annuity. So, the penalty would be much less.

Senator Heinz. It would only be on the inside buildup, you are saying?

Mr. Brockway. Right. It would not apply to the contribution, because, precisely as you stated, it is out of after-tax dollars.

Senator Heinz. That is all well and good, but it still does not answer my question about the difference and the source of the buildup.

Now, the source of the buildup in this case comes from after-tax money. In the case of the CODA it comes from deferred compensation that is pre-taxed. And it seems to me there is still a legitimate distinction.

I hear what you are saying, that it is only on the inside buildup, but, you know, the person who is in the CODA is being subjected to a 15 percent tax on the inside buildup of funds that were pre-taxed funds and not after-tax funds. And it seems to me that you could make a very good case that you shouldn't tax both of those the same. And I am arguing the case as to why you should tax this as highly as you tax the former.

Mr. Mentz. Senator, if I may reply, you are quite right that they are not the same. You have identified one aspect of it, but the other is that moneys coming out of a CODA or indeed out of any qualified plan come out of a plan where by law there is a discrimination test and a whole set of statutory rules that are designed to provide at least some benefit for the middle class. That is the basis of the tax subsidy, as you indicated before.

A deferred annuity is simply an individual investment. Typically, a deferred annuity would be purchased not by your middle-income fellow but by a higher-income person who wants the deferral, and if he bought a bond or any other kind of an investment he would most likely be forced to take income into account every year.

So, I think your point is exactly right, these are not the same as moneys coming out of 401(k) or any other kind of a qualified plan.

The reason for the same 15 percent tax is kind of rough justice -- it is not the same in one respect, it is not as good; and in the other respect it is not as bad. But that is really the rationale.

Senator Heinz. These people, it seems to me, fit into Dave Durenberger's category that he was talking about a moment ago: they are in a sense people whose employment periods could be average. But, because they are making these arrangements at age 50 -- people at age 50 have averagely higher incomes than people at age 40 or 30 or 20 -- and you are talking about people who have gotten a lot of their expenses, putting their kids through college and so forth, behind them but have not had the opportunity to save, and in effect are attempting to save some retirement income on an after-tax basis from their relatively higher income. I am concerned that we are being a little tough on them.

Mr. Ment§. Well, I think that is right; I think they will first put their money into an IRA, a 401(k), any kind of a qualified vehicle that they can find, even an employee contribution that is not matched to a qualified plan, so that the income can accumulate tax free. And then they will go to the deferred annuity.

Senator Heinz. Thank you, Mr. Chairman.

The Chairman. Go ahead, John.

Mr. Colvin. The next issue is on page 133, and it concerns tax-sheltered annuities. The principal parts of the Chairman's proposal in this area are the limit of elective deferrals to $7000, which corresponds to the limit of 401(k)s. As compared to the House bill, the Chairman's proposal uses a last-dollar offset instead of a first-dollar offset, relating to IRA contributions. And finally, the Chairman's proposal includes the special catch-up provisions which primarily benefit the situation Senator Durenberger was mentioning earlier with respect to people whose savings increase in their later years.

Senator Heinz. Mr. Chairman, on those tax shelter annuities, the 403(d)s, and on the 401(k)s, I would hope that, irrespective of whether we set the limit at $7000, or irrespectively if we modify that or not, tha we would index whatever limit we set to the Social Security wage base, as you have done in other parts of your proposal with respect to the defined benefit or the defined contribution plan limit.

It seems to me one way of building instability to whatever changes we make is to build in changes that will automatically take into account, in the limitations, the kind of changes in inflation and the value of those contributions that could be eroded over time, were we not to index them to the Social Security wage base.

I will probably have an amendment as part of my package to do that.

Mr. Colvin. The next issue on page 134 is the simplified employee pension provision, taken from the legislation introduced by Senators Heinz and Chafee.

It is a provision not contained in either the President's proposal or the House bill, and it has a revenue loss of about $200 million over the period.

This is a simplified form of employee pension plan which is much like an Individual Retirement Account, coupled with a non-discrimination rule provided in current law, and it would contain the liberalizations described on pages 134 and 135. And as I said, that is taken from the RIPA pension bill introduced by Senators Heinz and Chafee.

Senator Heinz. Mr. Chairman, on that, I will have probably four minor changes -- not to change the intent but just some perfecting amendments. So that bill, RIPA was written about a year ago. We have gotten a lot of good comments, but we think we could make it even simpler and more workable.

The Chairman. Thank you.

Mr. Colvin. The next issue is on page 135, and it relates to coverage requirements for pension plans. Under current law, speaking generally, an employer must cover 56 percent of the workforce or a fair cross-section of employees, and this proposal raises the 56 percent to 80 percent. That is a variation of the proposal in the Heinz-Chafee legislation.

Senator Heinz. Let me know before you leave this, because I have a couple of questions I want to ask here.

The Chairman. Go ahead, John.

Senator Heinz. The goal of the provisions in RIPA under the non-discrimination rules is basically to try and extend coverage to employees who are currently excluded from coverage altogether.

I am not interested in forcing uniformity in benefits. As I mentioned earlier, uniformity in benefits, when it comes to pension benefits, doesn't make sense, because of the way Social Security benefits are structured. They are much more generous to the lower-income people, and then tail off, as measured by replacement rates, as you get upscale to the Social Security wage base. And then, of course, they tend to disappear at that point for people with higher incomes.

There are some differences in what you have drafted here compared to RIPA, and I just want to be clear on whether the intent of the Chairman's draft is to prevent reasonable disparities between a salaried and hourly plant, or merely to prevent the extreme disparities that were permitted under Revenue Ruling 83-58.

Mr. Colvin. It is to prevent only the extreme disparities, and that is why the revenue ruling is specifically identified as being reversed. And that revenue ruling is described on page 136 on the spreadsheet.

Senator Heinz. I have received some comment that there is some uncertainty about what our goals were, the staff's goals were here, and I think we are going to have to do some clarification, because there has been some misinterpretation of that intent. The intent you described is one I fully support. I think we are going to have to find some ways to make it clear that that, in fact, is the intent, because there is some concern that the language as written doesn't do justice to what you have just described, John.

Mr. Colvin. The next separate issue is on page 137, which relates to non-discrimination rules for section 403(b) annuities, tax-sheltered annuities.

The Chairman's proposal does not impose non-discrimination rules in that area. The House bill had done so, but they had acknowledged the difficulty of applying them due to the special circumstances faced by the groups involved. And the Chairman's proposal does not apply the non-discrimination rules.

Senator Grassley. Mr. Chairman, we are on 403(b)?

The Chairman. That is correct.

Senator Grassley. As it relates to some church organizations, there has been a great concern expressed over some of the provisions that are in here.

It is my understanding, although it seems to have worked out, maybe changes in this area are not looked upon badly by staff or by you. We haven't really gotten down to great detail in this effort, but I would hope that we could maybe work something out in this area, because it seems to me, at least with the church groups, dealing with -- even today. I mean; sure, over the last two or three decades -- with a group of people who early in their professions, particularly if they have had family responsibilities and haven't been able to save a lot of money, and then maybe in the out-years after the kids are away from home they have been able to save a larger amount of money for retirement, in later years, that is just one facet of it.

The other one is that basically a whole pay to begin. And I would hope that we could make some changes in this area so that it is not detrimental to that cause.

The Chairman. In this area, we were all subject to significant lobbying by churches, Boy and Girl Scouts, YMCAs, a different type of organization from the normal employer that manufactures something.

So in my draft I did not apply the normal non-discrimination rules, because some of those organizations have had a historical concept of professional and clerical, for lack of a better term, and they covered their professionals in an entirely different way.

I think, prospectively, I would like to change it; but I am not going to argue that battle now. But they simply overwhelmed us, and they are all organizations that we have all learned to love, like, and adore.

In terms of whether they should be given a special exception -- because I pulled down the limits to the 401(k) limits -- whether they should get a different exception than the employees that Senator Durenberger referred to, or the others, who have worked until they are 45 or 50 and their children have left, and they are now in a position, and are making slightly more money, to put in more money, I am not sure whether that case can honestly be made as between somebody who has worked all of his or her life for the Episcopalian Church and somebody who has worked all of his or her life for 3M.

Senator Danforth can make that distinction, he says.

Senator Grassley. I guess I want to ask the committee to consider that point of view. Or, if that is trying to carve out too special an exemption for a group that I don't even really think we would consider "a special interest," if there is some other way to do it, I would be happy to look at those ways. But I think we have to deal with it, because generally I look with sympathy upon these people who go beyond and above the call of duty, not limited to a 40-hour work, to serve society.

The Chairman. Go ahead, John.

Mr. Colvin. The next issue is on page 138, Social Security integration. This proposal is significantly --

The Chairman. This is almost directly from Heinz-Chafee, isn't it?

Mr. Colvin. That is correct, Mr. Chairman.

Senator Heinz. Mr. Chairman, I probably will have an amendment that somewhat modifies this, that would permit employers to limit combined Social Security and employer-provided pension benefits to 100 percent of an employee's final pay.

The whole purpose of the integration section is simply to prevent employers from integrating, as one or two or a very few do, out people who thought that they were going to get a pension plan.

The Chairman. Then they have an offset, and they have nothing secured.

Senator Heinz. Then there is an offset, and some little 65-year-old lady finds that, even after contributing for 10 years, she has absolutely no pension whatsoever. That is the goal of this section; it is not to try to impose some arbitrary definition of "fairness." It is to get at what I really perceive to be very serious abuses.

The Chairman. I thought the point you wanted in terms of the integration was well taken, and I think the point you raise now is a good point.

Mr. Colvin. The next major issue is on page 140, item F, the limitation in the -- limits the amount of includable compensation in a pension plan that can be taken into account, to $200,000.

On page 141 are provisions relating to vesting. These are taken from the Heinz-Chafee legislation, and they provide five-year vesting for pension plans.

The next issue is on page 143, withdrawal of the benefits.

The Chairman. Here we might ask for the Secretary's opinion, because I know this was an area that the Administration had strong feelings in, on the 15-percent tax on the pension withdrawals before age 59 and a half.

Mr. Mentz. I wasn't sure what you were referring to, Mr. Chairman, but we support the Chairman's bill in this regard; the 15 percent tax we think makes sense. It is basically a tax on early distributions.

We have had, and I am sure you have had as well, folks come in to tell you that 59 and a half is too late, that it should be earlier, it should be upon retirement at any age, and so forth. And perhaps there are nuances there.

But basically I would just like to say that the Administration and the Treasury Department supports your position here.

Senator Boren. Mr. Chairman, what is the effective date on that provision, under your draft? Would that be January 1, 1987?

Mr. Colvin. Generally.

Senator Boren. So, it would not take effect if there were withdrawals prior to that period? It would not take effect? Because, as I say, we are confronting a situation where we have had some massive layoffs and forced early retirements, and these people are not really able to get other employment at this point in time.

How many people do you think would be affected if there were some kind of an exception made, where you have involuntary early retirement situations?

Mr. Colvin. If they took the money from the pension plan to use it to buy an annuity, in effect they would be exempted under this proposal. If they were to use the money currently, they would be --

Senator Boren. The problem you have -- take a company in the energy industry. We have had some companies that have had to shrink their workforce by as much as one-fourth. And so they have had massive forced early retirements at say age 55. Many of these people, given the climate in that industry, are simply not able to get other jobs, so they are going to have to draw that out in order to live on it.

And it seems a bit harsh, if there is a situation where they are a part of a forced contraction of the workforce at a company, and they are forced out of employment and are not re-employed. It seems like a rather harsh effect on them at this point in time, when they are already going to have to be -- their expectations were to work past 59 and a half, and to have a higher retirement when they did retire. But now they are being forced into early retirement.

Mr. Mentz. And presumably they need the cash.

Senator Boren. They need the cash, yes.

Mr. Mentz. You can always roll it into an IRA, but they can't afford to do that.

Senator Boren. They are going to have to live on it.

Mr. Mentz. Yes. Well, as I mentioned before, you do get into nuances as to whether 59 and a half is the right age, or whether that indeed is the right rule.

If someone is 35 and gets a distribution, I think it is a pretty clear case.

Senator Boren. Oh, surely. In fact, I don't even object to the 59 and a half at all, if we are dealing with a voluntary situation. But if we are, say, dealing with above age 50 and it is an involuntary situation, where it is a matter of company policy that these people are subject to involuntary layoffs, I think we might want to work on some sort of an exception for that kind of a situation.

Mr. Mentz. Well, let us work with you on that. It may be easier to have just an age cutoff rather than to get into whether it was voluntary or involuntary. You get into provisions that the IRS will have trouble administering. But let us get with you on that, Senator Boren.

Senator Boren. The prospective effective date helps us as to those that are already having to go through it, and there are 2500 more in one community in Oklahoma that are going to be forced into it in the next two months. So, that helps, the prospective effective date. But I would like to at least think with you about that.

The Chairman. Senator Heinz, and then Senator Grassley.

Senator Heinz. Mr. Chairman, what we are discussing, of course, also relates back to page 128 and your provisions on withdrawals.

As I understand the Chairman's proposal, you don't have a definition of "hardship," and don't permit, therefore, hardship withdrawals. Is that right, John?

Mr. Colvin. For 401(k) plans, hardship withdrawals are allowed for the electric deferrals, but not for pension plans.

Senator Heinz. But not for pension plans.

The idea, as I understand it, and I address this either to you or Mr. Mentz, of the 15 percent excise tax here is that the 15 percent tax fully recaptures the tax benefits from retirement money that is used prior to retirement for other purposes. That is the reason we have the 15 percent, is it not?

Mr. Mentz. That is the theory, although it is of course rough.

Senator Heinz. Yes.

Mr. Mentz. Now, you are recapturing benefits from, in effect, not the intended use of the tax benefit.

Senator Heinz. But the idea is to discourage the use of this money unnecessarily?

Mr. Mentz. Correct.

Senator Heinz. Now, under the Chairman's prosposal, could somebody still, nonetheless, if they had a hardship, withdraw their money?

Mr. Mentz. They could from a 401(k). And if you are talking about a regular pension or a profit-sharing plan, ordinarily not, I believe.

That's right, not from a pension plan, because a pension plan is designed to provide a pension. But if it is a profit-sharing plan, yes.

Senator Heinz. Oh. Under profit-sharing plans, some of which are 401? Profit-sharing plans typically are 401(k) plans, are they not?

Mr. Mentz. That is true, but a profit-sharing plan is a much broader group than just 401(k).

Senator Heinz. I agree.

But now, if our goal is simply to discourage unnecessary withdrawals, and somebody has a genuine hardship -- they have huge medical bills; they have a terrible casualty loss: their house or their farm burns down; maybe, in Dave Boren's example, someone becomes laid off from their steel mill in

Alliquippa, or their town in Oklahoma, as the case may be, at age 55, and the unemployment rate is 50 percent in that area, we might decide that could be a hardship, and obviously I have some concerns that it is -- people could take their money from a 401(k) or a profit-sharing plan under the committee print, and they would be subjected to a 15 percent tax, would they not?

Mr. Mentz. That's right.

Senator Heinz. Well, Mr. Chairman, my concern is that, if we can arrive at a definition of a genuine hardship, that we shouldn't tax people on a hardship situation if it is genuine, because that overshoots what I think we want to do. We just don't want this to be a kind of convenient tax-favored way for savings for niceties that one wants to have at some future time.

So, Mr. Chairman, I hope to be able to draw up an amendment that will achieve the purpose of not unduly taxing genuine hardship withdrawals.

The Chairman. Senator Grassley?

Senator Grassley. Mr. Chairman, someone is going to have to sell me on the theory behind this 15-percent tax on some plan other than just, what I understand the reason is, the uniformity between those plans and Keoghs and Iras, unless I am wrong, because it seems to me like Congress has evolved a policy where certain plans could have early withdrawal, at some age before 59 and a half. And then we evolved Keogh plans and IRAs that had the 59 and a half year in them for another reason, because they served a different purpose.

Now we are trying to say that because we have it for Keoghs and IRAs at 59 and a half, then it ought to be for all of them; whereas, it seems to me like if that rationale would be good today, then when we evolved the 59 and a half for IRAs and Keoghs we should have applied all of these retirement programs, the same principle.

In other words, there had to be some reason at the time Congress adopted these original plans, made them permissable under tax law, that we didn't have the 59 and a half years in there.

The Chairman. I am not sure we thought about it that much at the time we started those plans -- or, to put it the other way around, at the time those plans were started. We didn't really start them.

But philosophically, we are asking people to put money aside for retirement -- whether it was the Keoghs or the 401s, or pre-those days. And they get a tax benefit for putting it aside. Then, we ought to be very wary about letting it be withdrawn for other than retirement purposes, because we weren't allowing the tax deductions for other than retirement purposes.

Senator Grassley. So, in other words, if you retired at 55 or 56, then there is no 15-percent tax applicable?

The Chairman. That is if they roll it over, as I recall, into an annuity. Then there is not a tax.

Mr. Mentz. Yes, or take an annuity.

Senator Grassley. But what is wrong if they just draw it out? If they actually retire at age 55, why shouldn't they be able to draw it out and not pay the 15-percent tax, if it was the philosophy at the time the Congress adopted it that it was all right? Now, why penalize, just because we have established an arbitrary policy for Keoghs and other plans for 59 and a half?

Mr. Colvin. Senator Grassley, the theory behind the proposal is that retirement tax incentives should result in benefiting the retirement years, and not benefit later working years, let's say. So, the penalty would apply if the money is used before age 59 and a half, unless it is put into an annuity. But if a person does retire in their fifties, let's say, and puts the money into an annuity, the penalty would not apply.

So, in short, the theory is to target the pension and retirement and savings incentives to retirement years.

Senator Grassley. Let me ask you. Maybe I don't understand how it works. But what is the gimmick about rolling over into an annuity? Can't you draw out? If I retire at age 55, and I have a system there that I have for retirement, can't I just draw it out on a monthly basis and not pay the 15-percent tax?

Mr. Colvin. If you receive the annuity computed based on your remaining life, you avoid the penalty tax.

Senator Grassley. Under this plan?

Mr. Colvin. Yes, sir. And so, that encourages you to use your pension incentive for the retirement years.

Senator Grassley. If you actually the retirement at age 55, say between 55 and 59 and a half, you don't have to pay the 15-percent tax?

Mr. Colvin. No, sir. It is only the lump-sum withdrawals before 59 and a half that this would catch.

Senator Bradley. May I ask Treasury a question?

In the sheet that we were given, withdrawals before age 59 and a half, the President's proposal raises 1.9 and our bill raises 2.1 billion. My question: Current law has a 10-percent early withdrawal penalty; the President had a 20-percent early withdrawal penalty; Senator Packwood has a 15-percent early withdrawal penalty. How can a drop from 20 to 15 produce more revenue?

Mr. Mentz. It was 20, but it would have dropped to 10 under certain circumstances. And I believe in the House they concluded that, rather than have a different standard as to which penalty applied, it would be just easier to make it one rate, 15 percent. I think we subscribed to that. It is an improvement.

The Chairman. Go ahead, John.

Mr. Colvin. On page 144 there are a cojple of special issues in this area for tax-sheltered annuities. The proposal broadens withdrawal restrictions which now apply to some 403(b) annuities to all withdrawals, and it limits hardship withdrawals to elective deferrals.

On page 145, item B is the change from ten-year averaging to five-year averaging for lump-sum distributions from pension plans.

On page 146 there are several issues. The one that has received the most attention is the three-year basis-recovery rule, which is repealed by the President's proposal and the House bill and the Chairman's proposal.

The Chairman. Except we have a prospective effective date; the House's is last January -- is it January or July? I can't remember.

Mr. Colvin. The House bill would have been effective July 1, 1986.

The Chairman. And ours is half-effective next January and fully-effective the January after that.

Mr. Colvin. That is correct.

Senator Chafee. I will have an amendment on that, Mr. Chairman.

The Chairman. Go ahead, John. Let's see if we can get through the last four or five pages until we get onto employee benefits. I am not sure there is any point in starting the entire employee benefit package today, because it is a long package.

Mr. Colvin. Page 147 are the provisions relating to loans from qualified plans.

The Chairman's proposal includes a provision also from the House bill and the President's bill which has the effect of preventing rollovers of loans year after year, thus effectively bypassing the limits on loans enacted by Congress, I believe in 1982.

On page 148 is the issue of the limits on contributions and benefits under pension plans.

The Chairman's proposal retains the $30,000 limit on defined-contribution plans.

The Chairman. There again you are very simliar to Heinz-Chafee on that.

Mr. Colvin. That is correct, and the Chairman's proposal allows the $90,000 limit on defined-benefit plans to be indexed until it reaches $120,000. And then, when it achieves a ratio of 4:1 with the defined-contribution limit, both would be indexed. And the basis of the indexing is the Social Security wage base. And several of those concepts are in the Heinz-Chafee legislation.

On page 149 are some special provisions relating to employee groups that have unique characteristics, primarily that they have early retirement years, and so the limit on benefits is calculated in a special way for those groups.

On page 150 is the question of treatment of pension benefits greater than $112,500. Under the Chairman's proposal and the House bill there would be a 15-percent excise tax imposed on pension income greater than that amount.

Senator Heinz. Mr. Chairman, I will have an amendment on that.

The Chairman. On the $112,500?

Senator Heinz. Yes.

Mr. Colvin. On page 151 are some provisions that the House bill had included. The Chairman's proposal does not include them because of the Social Security integration provisions in the Senate bill. These provisions would be redundant with those provisions.

On page 152, the 25 percent limit on aggregate compensation available for pension plans would be applied to a few additional categories of pension plan, and the purpose is to prevent abuse in connection with attempts to bypass those limits.

On the bottom of page 152 is the issue of asset-reversion under qualified plans. This would impose a recapture tax on plan reversions coming back to the employer.

Mr. Mentz. Mr. Chairman, on that point, I would just like to note that the effective date is very important, and it is reversions after 12-31-85. If you slip that effective date, you provide an incentive for plan terminations to escape the tax. That is what happened at the end of last year.

So, that is one effective date, one of the very few effective dates, that should stay at 12-31-85.

Mr. Colvin. On page 153 is a provision providing for a general prospective effective date for most of the major provisions of this Title, so that they would not require plan amendments until after December 31, 1988.

And on page 154 is a provision from the House bill that collective bargaining agreements must be bona fide to be eligible for the collective bargaining rules in the provisions.

And that completes the pension portion of the spreadsheets.

The Chairman. Why don't we stop there, and we will move to trying to finalize the bulk of energy and ACRS tomorrow, if we can. And then tomorrow afternoon, go through, starting with the employee-benefits section.

(Whereupon, at 12:28 p.m., the meeting was recessed, to reconvene Wednesday morning, April 8, 1986, at 9:30 a.m.)

C E R T I F I C A T E

This is to certify that the foregoing proceedings of an Executive Committee meeting of the Senate Finance Committee, held on April 8, 1986, were as herein appears, and that this is the original transcript thereof.

William J. Moffitt

WILLIAM J. MOFFITT
Official Court Reporter

My Commission expires April 14, 1989.

April 8, 1986

MATSUNAGA AMENDMENT TO PROPOSAL ON BASIC PENSION RULES

ELIMINATE UNNECESSARY BURDENS AND NEED FOR PLAN AMENDMENTS

-- Retain current law rules regarding minimum coverage requirements.

-- Eliminate proposal to apply new minimum participation requirements to qualified plans.

-- Delete proposal to apply a new limitation on the amount of compensation that can be taken into account in determining benefits under a qualified plan.

-- Retain current law with respect to minimum vesting requirements.

-- Retain current law with respect to minimum distribution requirements.

-- Retain current law with respect to deduction limit carryforwards.

-- Retain current law permitting an offset of benefits under a defined benefit plan by an employee's elective deferrals.

-- Retain current law with respect to the special nondiscrimination test for 401(k) plans.

-- Retain current law rules governing permissible integration with social security.

-- Retain current law rules governing overall limits on contributions and benefits, except retain proposed exceptions for (i) police, firefighters and pilots (and also corrections officers); (ii) cost-of living arrangements; and (iii) certain health and welfare agencies.

-- Delete proposal to impose special non-discrimination requirements on employer matching contributions.

-- Provide that plan amendments, if any, required by changes resulting from tax reform need not be made until the the date after January 1, 1989 on which the plan is next amended; provided (i) that the plan complies in operation with the changes as of any seperately stated effective date; and (ii) the amendment applies retroactively to any such effective date.

ELIMINATE BURDENSOME RESTRICTIONS ON DISTRIBUTIONS TO EMPLOYEES

-- Delete proposals which would increase the additional income tax on withdrawals prior to age 59 1/2 from 10% to 15% for IRAs, from 5% to 15% for non-qualified deferred annuity contracts and from 0% to 15% for qualified retirement plans and qualified annuities.

-- Delete proposal to apply a 15% excise tax on annual distributions from tax-favored retirement arrangements in excess of $112,500.

-- Retain current law regarding hardship withdrawals from 401(k) plans and 403(b) annuities.

MR. GRASSLEY
4/9/86

(1) Solvent Farmer Income Forgiveness

Discharge of indebtedness income arising from an agreement between a solvent individual engaged in the trade or business of farming and an unrelated financial institution to write-down qualified agricultural indebtedness would be treated as income realized by an insolvent individual under Code section 108.

Individuals would be treated as engaged in the trade or business of farming if at least 50 percent of their average annual gross receipts during the three taxable years preceding the year of the debt write-down was derived from the trade or business of farming. Additionally, only those individuals having a debt-equity ratio of at least 70-30 immediately before the write-down would be eligible for this treatment.

Qualified agricultural indebtedness would be defined as debt incurred to finance the production of agricultural products or livestock in the United States, or debt secured by farmland or farm machinery and equipment.

The ordering rules of section 108 would be applied by offsetting basis in farmland last.

Joint Committee on Taxation
April 4, 1986
JCX-3-86

Estimated Revenue Effects of Tax Reform Provisions Contained in the President's Proposal, the House Bill (H.R. 3838), and the Finance Committee Chairman's Proposal for Fiscal Years 1986-1991*

[Billions of Dollars]

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
I.—INDIVIDUAL INCOME TAX PROVISIONS			
A. Basic Rate Structure:			
Tax rate schedules (includes capital gains)	-224.6	-134.2	-131.4
Zero bracket amount (standard deduction)	-17.9	-32.6	-51.9
Personal exemption and repeal of additional exemption for the elderly and blind	-163.5	-147.5	-156.3
Floor under itemized deductions	P/L	40.9	P/L
Limitation on tax-liability reduction for highest-bracket individuals attributable to personal exemptions and certain itemized deductions	P/L	P/L	21.1
Two-earner deduction	24.8	27.0	27.1
Earned income credit	-7.6	-11.8	-12.6
Income averaging	4.0	6.3	7.9

P/L Present Law
— No revenue effect

***NOTES:** Estimates for the President's proposal and House Bill were based on earlier economic forecasts and were estimated for fiscal years 1986-90 only. Therefore, figures are not being provided as current revenue estimates, but for "order of magnitude" comparisons only.

Estimates reflect changes in income taxes, excise taxes, and employment taxes. Outlay effects as well as revenue changes are included.

Estimates assume the enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985 (H.R. 3128); thus, provisions in H.R. 3128 that were listed in the comparative spreadsheet prepared for the Finance Committee tax reform markup (JCS-8-86) have been deleted from these estimates.

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
B. Tax Treatment of the Elderly and Disabled:			
Credit for the elderly	-4.3	P/L	P/L
Unemployment compensation	2.3	2.3	3.2
Worker's compensation and black lung disability	4.6	P/L	P/L
C. Scholarships and Fellowships	0.6	0.6	0.6
D. Deductions for Personal Expenditures:			
Itemized deduction for certain State and local taxes	111.8	P/L	19.8
Charitable deduction for nonitemizers	2.5	-2.5	-6.9
Adoption expenses	(1)	(1)	P/L
Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel	P/L	(2)	(2)
E. Expenses for Business or Investment:			
Travel and entertainment expenses	6.1	11.4	12.1
Employee business expenses, investment expenses and other miscellaneous itemized deductions	7.1	13.2	14.7
F. Political Contributions Tax Credit	1.1	0.5	P/L
G. Presidential Campaign Checkoff	—	P/L	P/L
Subtotal: Individual Income Tax Provisions			-252.7
II.—ACCELERATED COST RECOVERY SYSTEM AND INVESTMENT TAX CREDIT			
A. Depreciation:			
Accelerated (incentive) depreciation system	32.0	41.1	24.8
Indexing	-11.7	—	-4.3
Gain on disposition	0.6	(1)	0.3
Expensing	1.4	-1.3	-22.9
Transition rules	—	-13.4	-2.2
Subtotal: Depreciation			-4.3
B. Windfall Recapture of Excess Accelerated Depreciation	47.6	P/L	P/L
C. Regular Investment Tax Credit:			
Allowable credit	130.3	130.3	171.3
Transition rules	—	-10.0	-24.1

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
D. Mandatory Refund of Unused ITC Carryovers	P/L	P/L	-0.6
E. Finance Leases	P/L	0.9	1.4
F. Multi-Family Residential Rental Housing Provisions	---	-0.8	(3)
Subtotal: ACRS and ITC			143.9
III.—ACCOUNTING			
A. Simplified Dollar Value LIFO Method for Certain Small Businesses	P/L	-2.5	-2.7
B. Limitations on the Use of the Cash Method of Accounting	4.0	2.7	3.4
C. Installment Sales	2.6	5.7	6.3
D. Capitalization of Inventory, Construction, and Development Costs:			
Inventory	11.5	14.0	18.4
Self-constructed property and noninventory property produced for sale	4.4	4.7	4.8
Long-term contracts	5.6	14.7	5.5
Interest	10.3	11.0	11.1
E. Special Treatment of Certain Items:			
Reserves for bad debts	4.4	7.2	7.2
Returns of magazine, paperbacks, and records	0.1	P/L	P/L
Qualified discount coupons	0.1	P/L	0.1
Subtotal: Accounting			54.2
IV.—CAPITAL GAINS			
A. Individual Capital Gains	(4)	(4)	(4)
B. Corporate Capital Gains	P/L	(4)	P/L
C. Incentive Stock Options	P/L	P/L	(5)
D. Small Business Participating Debentures	P/L	P/L	-1.4

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
E. Straddles	P/L	P/L	0.4
Subtotal: Capital Gains			-1.0
V.—COMPLIANCE AND TAX ADMINISTRATION			
A. Increased Penalties:			
Penalties relating to information returns	(1)	(1)	(1)
Penalty for failure to pay taxes	1.8	1.5	1.5
Negligence and fraud penalties	P/L	(1)	(1)
B. Interest Provisions:			
Interest rate	P/L	1.4	1.7
Underpayments of accumulated earnings tax	P/L	(1)	(1)
Interest on tax refunds	P/L	P/L	-0.2
C. Information Reporting Provisions:			
Reporting on real estate transactions	P/L	1.0	1.0
Reporting on persons receiving Federal contracts	P/L	0.1	0.1
Reporting of State and local income and property taxes paid by individuals	P/L	0.2	(1)
Tax-exempt interest required to be shown on tax returns	P/L	(1)	P/L
D. Suspend Statute of Limitations During Prolonged Dispute with Third Parties	P/L	P/L	(1)
E. Tax Shelters:			
Tax shelter user's fee	P/L	P/L	0.8
Tax shelter registration	P/L	P/L	(5)
Penalty for failure to register a tax shelter	P/L	P/L	(1)
Penalty for failure to report the tax shelter identification number	P/L	P/L	(1)
Penalty for failure to maintain lists of investors	P/L	P/L	(1)
Tax shelter interest	P/L	P/L	0.4
F. Estimated Tax Payments by Individuals	P/L	1.8	1.8
G. Tax Litigation and Tax Court:			
Awards of attorneys fees in tax cases	P/L	(2)	(2)

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
Exhaustion of administrative remedies	P/L	(1)	P/L
Tax Court provisions	P/L	P/L	(2)
H. Tax Administration Provisions:			
Authority to rescind statutory notice of deficiency	P/L	---	---
Authority to abate interest due to errors or delays by the IRS	P/L	(2)	(2)
Suspension of compounding where interest on deficiency is suspended	P/L	(2)	(2)
Exemption for levy for service-connected disability payments	P/L	(2)	(2)
Modification of administrative rules applicable to forfeiture	P/L	(1)	P/L
Certain recordkeeping requirements	P/L	(1)	P/L
I. Modification of Employee Withholding Allowance Forms	P/L	(1)	(1)
J. Report on Return-Free Tax System	---	---	---
K. Decrease Period of Tax Deferral for Trusts	P/L	P/L	1.7
L. Payment of Income Taxes of Estates	P/L	P/L	0.9
Subtotal: Compliance and Tax Administration			9.7
VI.—CORPORATE AND GENERAL BUSINESS TAXATION			
A. In General:			
Corporate tax rates (includes capital gains)	-91.7	-87.8	-108.7
Corporate dividends paid deduction	-16.3	-2.4	P/L
Corporate dividends received deduction	P/L	1.2	1.1
Dividend exclusion for individuals	2.2	2.6	2.9
Stock redemption payments	P/L	---	---
Limitations on net operating loss (NOL) carryovers	P/L	0.4	0.2
Recognition of gain or loss on liquidating sales and distributions	P/L	2.2	2.6
Modification of merger and acquisition rules	P/L	P/L	(2)
Miscellaneous subchapter C changes	P/L	P/L	(1)
Extraordinary dividends received by corporate shareholders	P/L	P/L	0.2
Ordinary income treatment on sales between related entities	P/L	P/L	(2)
Holding period requirement for dividends received deduction	P/L	P/L	(1)
Amortizable bond premium	P/L	P/L	(1)

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
B. Rapid Amortization Provisions:			
5-year amortization of trademark and tradename expenditures...............	0.1	0.1	0.1
5-year amortization of pollution control facilities......................	(1)	(1)	(1)
50-year amortization of qualified railroad grading and tunnel bores.......	(1)	(1)	(1)
Deduction for loss in value of bus-operating authorities..................	P/L	P/L	(2)
C. Deductibility of Federal Excise Taxes and Tariffs..........................	P/L	P/L	62.6
D. Other Capital-Related Costs:			
Marine Capital Construction Fund..	0.4	(1)	(1)
Limitation on business tax credits..	P/L	1.3	0.1
Contributions in aid of construction......................................	P/L	0.5	0.6
Subtotal: Corporate and General Business Taxation..			-38.1
VII.—ENERGY, AGRICULTURE, TIMBER, AND NATURAL RESOURCES			
A. Agricultural Provisions:			
Special expensing provisions..	0.4	0.3	0.2
Farming and ranching costs..	0.9	0.5	P/L
Treatment of certain plant variety protection certificates as patents.....	P/L	(2)	P/L
Dispositions of converted wet lands and highly erodible croplands.........	P/L	(1)	(1)
Prepayments...	P/L	P/L	0.1
B. Timber and Ornamental Trees:			
Reforestation expenses..	(1)	(1)	P/L
Expenses of growing timber and ornamental trees...........................	2.2	3.7	P/L
C. Capital Gains for Coal, Iron Ore, and Timber:			
Capital gain treatment for coal and domestic iron ore royalties...........	0.4	0.3	P/L
Capital gain rules applicable to timber...................................	0.9	0.9	P/L
D. Hard Minerals:			
Exploration and development costs...	P/L	0.2	(1)
Depletion of hard minerals..	1.7	1.4	P/L
Mining and solid waste reclamation costs..................................	0.2	P/L	P/L
Gain on disposition of interest in mining property........................	(1)	(1)	P/L

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
E. Oil and Gas:			
Intangible drilling costs	P/L	1.2	(1)
Depletion for oil and gas	2.0	3.0	P/L
Gain on disposition of interest in oil, gas, or geothermal property	(1)	(1)	P/L
F. Energy-Related Tax Credits and Other Incentives:			
Residential energy tax credits	P/L	-0.4	-0.6
Business energy tax credits	P/L	-0.1	-0.7
Credit for fuels from nonconventional sources	(1)	(1)	(1)
Alcohol fuels credit and tax exemptions; import duty	(1)	(2)	(2)
G. Gift & Estate Tax Deductions for Certain Conservation Easement Donations	P/L	P/L	(2)
Subtotal: Energy, Agriculture, Timber, and Natural Resources			**-1.0**
VIII.—EXCISE AND EMPLOYMENT TAXES			
A. Excise Taxes:			
Increase in wine excise tax rates to beer tax equivalent rate	P/L	P/L	1.5
Adjust alcohol, tobacco, and fuel excise tax rates to reflect increases in price	P/L	P/L	11.2
Collection of diesel fuel tax	P/L	(1)	P/L
Taxicab fuels tax exemption	P/L	(2)	P/L
Windfall profit tax exemption for exchanges of crude oil	P/L	(5)	P/L
B. Employment Taxes:			
FUTA tax (for agricultural wages)	P/L	P/L	-0.1
Subtotal: Excise and Employment Taxes			**12.5**
IX.—FINANCIAL INSTITUTIONS			
A. Reserve for Bad Debts:			
Commercial banks	2.1	2.5	3.5
Thrift institutions	2.0	0.8	0.9
B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations	0.4	0.3	1.3

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
C. Reorganizations of Financially-Troubled Thrift Institutions.................	---	1.4	0.4
D. Credit Unions..	1.3	P/L	P/L
E. Special Rules for Net Operating Loss Carryovers of Depository Institutions..	(1)	(1)	-1.4
F. Treatment of Losses on Deposits in Insolvent Financial Institutions.........	P/L	(2)	P/L
Subtotal: Financial Institutions...			4.7
X.—FOREIGN TAX PROVISIONS			
A. Foreign Tax Credit:			
Foreign tax credit limitation..	9.3	2.1	1.9
Credit for taxes in lieu of income taxes...............................	P/L	2.1	1.8
Effect of losses on foreign tax credit.................................	(6)	0.1	0.1
Deemed-paid credit..	(6)	0.3	0.3
B. Source Rules:			
Income derived from purchase and sales of inventory-type property.........	3.5	0.3	(1)
Income from manufacture and sale of inventory-type property...............	(6)	1.4	(1)
Income from the sale of intangible property.............................	(6)	(1)	(1)
Income derived form sale of other personal property......................	(6)	(1)	(1)
Transportation income..	(6)	0.6	0.6
Other offshore income and income earned in space.........................	(6)	(1)	(1)
Dividend and interest income...	(6)	0.1	(1)
Allocation of interest and other expenses................................	(6)	3.3	1.4
C. U.S. Taxation of Income Earned Through Foreign Corporations:			
Tax haven income subject to current tax..................................	P/L	1.5	0.5
Application of accumulated earnings tax and personal holding company tax to foreign corporations..	P/L	(1)	(1)
D. Special Tax Provisions:			
Possession tax credit...	0.1	0.3	0.2
Other rules with respect to U.S. possessions.............................	(1)	(1)	(1)
Taxation of U.S. employees of Panama Canal Commission....................	P/L	(1)	(1)
Foreign Sales Corporations (FSCs)..	P/L	0.6	P/L

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
Private sector earnings of Americans abroad	P/L	0.2	P/L
Transfers of intangibles to related parties outside of the U.S.	P/L	0.3	P/L
Compliance provisions applicable to U.S. persons resident abroad	P/L	P/L	(1)
Foreign investment companies	P/L	0.1	0.1
E. Foreign Taxpayers:			
Branch-level tax	(1)	0.1	0.2
Retain character of effectively connected income	P/L	(1)	(1)
Tax-free exchanges by expatriates	P/L	(1)	(1)
Excise tax on insurance premiums paid to foreign insurers	P/L	0.2	P/L
Foreign investment in U.S. business assets	P/L	P/L	0.4
Withholding tax on interest paid to foreign persons	P/L	P/L	0.3
Reporting by foreign-controlled U.S. corporations	P/L	P/L	(1)
Foreign investors in U.S. partnerships	P/L	P/L	(1)
Income of foreign governments	P/L	P/L	(1)
Transfer prices for imports (sec. 482)	P/L	P/L	0.2
Dual resident companies	P/L	P/L	(1)
Interest paid to related tax-exempt parties	P/L	P/L	0.2
F. Foreign Currency Exchange Gain or Loss	(1)	0.1	(1)
Subtotal: Foreign Tax Provisions			8.2
XI.—INSURANCE PRODUCTS AND COMPANIES			
A. Insurance Products:			
Life insurance products	0.2	—	—
Other policyholder issues	(1)	(1)	(1)
B. Life Insurance Companies:			
Reserves	2.0	P/L	P/L
Special deductions	3.5	3.5	3.6
Tax-exempt entities engaged in insurance activities	P/L	1.8	P/L
Operations loss deduction of insolvent companies	P/L	(2)	(2)
C. Property and Casualty Insurance Companies:			
Reserve deductions	4.8	4.8	5.9
Policyholder dividend deduction for mutual companies	(1)	—	P/L

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
Protection against loss account for mutual companies	0.4	0.4	0.4
Special exemptions, rates, and deductions of small mutual companies	(1)	-0.2	-0.1
Subtotal: Insurance Products and Companies			**9.9**
XII.—INTEREST EXPENSE			
A. Nonbusiness Interest Limits:			
Interest subject to limitation	2.4	0.4	10.4
B. Deduction for Interest on Loans to Make IRA Contributions	P/L	P/L	(1)
Subtotal: Interest Expense			**10.4**
XIII.—MINIMUM TAX			
A. Individual Minimum Tax	1.6	19.1	24.9 (7)
B. Corporate Minimum Tax	10.4	5.8	20.9 (7)
Subtotal: Minimum Tax			**45.9**
XIV.—PENSIONS AND DEFERRED COMPENSATION; EMPLOYEE BENEFITS; ESOPs			
A. Treatment of Tax-Favored Savings:			
Individual retirement accounts (IRAs)	-3.6	(2)	(2)
Qualified cash or deferred arrangements (sec. 401(k) plans)	15.9	4.7	-0.4
Employer matching contributions and employee contributions	(6)	(6)	(6)
Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers	(1)	(1)	(1)
Deferred annuity contracts	1.2	0.2	0.2
Elective contributions under tax-sheltered annuities	P/L	0.3	0.2
Special rules for simplified employee plans	P/L	P/L	-0.2
B. Minimum Standards for Qualified Plans:			
Nondiscrimination rules	(2)	(2)	(2)
Benefit forfeitures	(2)	(2)	(2)
Vesting	P/L	P/L	(2)

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
C. Withdrawal of Benefits:			
Uniform minimum distribution rules	(1)	(1)	(1)
Withdrawals before age 59-1/2	1.9	2.1	2.1
Uniform tax treatment of distributions	10.6	8.1	8.0
Loans under qualified plans	(1)	(1)	(1)
D. Tax Deferral Under Qualified Plans:			
Overall limits on contributions and benefits	-0.9	1.8	0.1
Deductions for contributions to qualified plans	0.2	0.2	0.2
Asset reversions under qualified plans	0.1	0.1	0.1
E. Miscellaneous Pension and Deferred Compensation Provisions:			
Plan amendments not required until January 1, 1988	P/L	—	—
Discretionary contribution plans	P/L	(2)	(2)
Requirement that collective bargaining agreement be bona fide	P/L	(1)	(1)
Penalty for overstatement of pension liabilities	P/L	(1)	P/L
F. Employee Benefits:			
Statutory employee benefit exclusions:			
Employee benefits	12.4	-0.5	-2.2
Health insurance for self-employed individuals	P/L	P/L	-3.2
Nondiscrimination requirements for employee benefit plans	0.5	0.6	0.6
Benefits provided under a cafeteria plan	(1)	(1)	(5)
Prizes and awards	(1)	(1)	(1)
Accrued vacation pay	P/L	0.2	0.2
Faculty housing	P/L	P/L	(2)
Health benefits for retirees	P/L	P/L	-0.1
G. Employee Stock Ownership Plans (ESOPs):			
ESOPs as employee benefit plans	(1)	(1)	P/L
Incentives for ESOP financing	0.1	5.8	P/L
Subtotal: Pensions and Deferred Compensation; Employee Benefits; ESOPs			5.9
XV.—RESEARCH AND DEVELOPMENT			
A. Expensing of R&E Expenditures; Incremental Research Tax Credit:			
Expensing	P/L	P/L	P/L
Incremental tax credit	-4.6	-3.7	-9.3
Donations of scientific equipment	P/L	(2)	P/L

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
B. Allocation of Research Expenses to Foreign Source Income	P/L	-0.5	-0.7
C. Personal Holding Companies	P/L	-0.1	(2)
D. University Basic Research Credit	P/L	-0.3	-0.5
Subtotal: Research and Development			-10.5
XVI.—REAL ESTATE PROVISIONS			
A. At-Risk Rules	0.1	(1)	(1)
B. Tax Credit for Rehabilitation Expenditures	7.2	4.0	4.3
C. Low-Income Housing:			
5-year amortization of expenditures to rehabilitate low-income housing	(1)	(2)	P/L
Credit for low-income rental housing	P/L	P/L	-1.1
D. Real Estate Investment Trusts	P/L	P/L	-0.1
Subtotal: Real Estate Provisions			3.2
XVII.—TAX-EXEMPT BONDS			
A. General Restrictions on Tax-Exemption	(8)	(8)	(8)
B. Tax-Exempt Bonds for Certain Nongovernmental Activities:			
Industrial development bonds	(8)	(8)	(8)
Student loan bonds	(8)	(8)	(8)
Mortgage revenue bonds	(8)	(8)	(8)
Tax-exempt bonds for section 501(c)(3) organizations	(8)	(8)	(8)
Qualified redevelopment bonds	(8)	(8)	(8)
Miscellaneous restrictions on tax-exempt bonds	(8)	(8)	(8)
C. Volume Limitations on Nongovernmental Bonds	14.3	4.0	-3.6
D. Arbitrage Restrictions:			
Profit limitations and determination of bond yield	0.1	0.1	0.1

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
Prohibition of advance refundings	0.6	0.2	(1)
Restriction on early issuance of bonds	0.1	0.1	P/L
E. Information Reporting Requirement for All Tax-Exempt Bonds	---	---	---
F. Special Transitional Exceptions	P/L	-1.3	P/L
G. General Stock Ownership Corporations (GSOCs)	---	---	---
Subtotal: Tax-Exempt Bonds			-3.5
XVIII.—TRUSTS AND ESTATES; GENERATION-SKIPPING TRANSFERS			
A. Unearned income of a minor child	1.2	1.4	0.5
B. Income Taxation of Trusts and Estates:			
Trusts other than grantor trusts	1.1	0.6	1.0
Taxation of trusts after the death of the grantor	(1)	(1)	P/L
Taxation of distributions to beneficiaries	(1)	(1)	P/L
Taxation of previously accumulated income	(1)	(1)	P/L
Grantor trusts	(1)	(1)	P/L
Estates	0.1	0.1	0.1
	0.6	0.2	0.2
C. Generation-Skipping Transfer Tax:			
Taxable transfers	(1)	(2)	P/L
Exemption from tax	(2)	(2)	P/L
Tax rate	(2)	(2)	P/L
Credit for State taxes	(2)	(2)	P/L
Subtotal: Trusts and Estates; Generation-Skipping Transfers			1.7
XIX.—MISCELLANEOUS PROVISIONS			
A. Expiring Provisions:			
Tax credit for orphan drug clinical testing	P/L	(2)	P/L
Expensing of costs of removing architectural barriers to the handicapped and elderly	P/L	(2)	-0.1
Rules for spouses of Vietnam MIAs	P/L	(2)	(2)
Targeted jobs tax credit	P/L	-0.9	-1.1

Provision	President's Proposal 1986-1990	House Bill 1986-1990	Chairman's Proposal 1986-1991
B. Olympic Trust Fund and Excise Tax	P/L	(1)	(1)
C. Exempt Organizations:			
Exchanges and rentals of membership lists of certain tax-exempt organizations	P/L	(2)	-0.1
Distribution of low-cost articles by charities	P/L	(6)	(6)
Tax exemption for certain title-holding companies	P/L	P/L	(2)
D. Allocation of Housing Cooperative Interest and Taxes	P/L	(2)	(2)
E. Foster Care Payments	P/L	(2)	(2)
Subtotal: Miscellaneous Provisions			-1.2
GRAND TOTAL			2.1

Joint Committee on Taxation
April 4, 1986

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(1) Gain of less than $50 million.
(2) Loss of less than $50 million.
(3) The impact of this provision is included in the estimate for item XVI. C. (Credit for low-income rental housing).
(4) The effects of changes relating to capital gains are included with individual and corporate rate changes (Parts I. A. and VI. A.).
(5) Negligible.
(6) Estimate for this provision is included in the preceding item.
(7) The preference for tax-exempt interest is assumed not to apply with respect to bonds issued before January 1, 1987.
(8) The impact of this provision is reflected in item C. XVII. (Volume Limitations on Nongovernmental Bonds).