EXECUTIVE COMMITTEE MEETING ON PROPOSED TAX REFORM ACT OF 1986

TUESDAY, APRIL 15, 1986

Committee on Finance

Washington, D.C.

The committee met, pursuant to recess, at 9:35 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Wallop, Durenberger, Armstrong, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Baucus, Boren, Bradley, Mitchell, and Pryor.

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

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; John Colvin, Chief Counsel; Bill Wilkins, Minority Chief Counsel; Mary Frances Pearson, Tax Counsel, Majority; Lindy Paull, Tax Counsel, Majority; Greg Jenner, Tax Counsel, Majority; Barbara Groves, Tax Counsel, Minority; and Susan Taylor, Executive Assistant.

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

We will start first this morning on the trust and estates and the generation-skipping transfers.

Mr. Jenner, you have got Lindy Paull's nameplate in front of you. I don't know if it makes any difference or not.

Mr. Jenner. Only to my mother, Senator.

(Laughter)

The Chairman. Why don't we start right down A. I know, again, members are coming, and they have got some amendments. But let us start down A on the unearned income of minor children.

In a nutshell, this is a provision where the Treasury -- and I am going to ask the Secretary to speak to this -- would tax all income over $1,000.00. Am I right, Mr. Secretary? But only if derived from assets provided by the parents.

Mr. Mentz. That is right.

The Chairman. We would tax it over $5,000.00 no matter where the assets were derived from. You would cover about a million and a half people. Ours would cover about 50,000.

Mr. Mentz. Our analysis is that we would cover about 265,000.

The Chairman. Wait a minute. I thought we had a million and a half, John.

Mr. Colvin. Those were Joint Tax estimates.

The Chairman. Oh. Those are always absolutely accurate.

Mr. Mentz. It is always somewhere in between, Mr. Chairman.

The Chairman. All right. Let me ask you what your reason is for limiting your coverage to those assets derived from a parent only.

Mr. Mentz. Did you say what's the rationale?

The Chairman. Yes. The argument. Why won't a parent give it to their parent, the grandparents of the child and the grandparents then give it to the grandchild, and you have avoided what you are trying to stop?

Mr. Mentz. Well, if that were the transaction, if it were parent to grandparent to child, I think we would have an anti-avoidance rule that would catch that.

But putting the avoidance-type transaction aside, the philosophy of the President's proposal -- and I must say one that the Secretary feels very strongly about -- is that where you have sort of co-mingled monies that are household or family funds that the father and the mother make a transfer to the child, and it is all sort of within the household, but the effect of the transfer is solely to get the lower tax rates available to the child.

That is the type of situation that the President's proposal is aimed at.

It is not aimed at and an exemption is explicitly provided for any inheritance that a child may receive from a grandparent or an old maid aunt or if he happens to be a rock star and makes a million dollars and has income on that.

The Chairman. Let me interrupt just a minute.

Senator Chafee, we are on the very first part on trusts and estates, the income of minor children. I know you have one interest in that, and the Administration has a different one.

Mr. Mentz. The interest, just to sort of summarize, is not to change the law in the area except with respect to the sort of inter-household transfers. And that is the basic rationale.

And I must say that the Secretary of the Treasury feels very strongly that if you go beyond that you are kind of encroaching into sort of the freedom of people to bequeath or give assets in accordance with their wishes.

The Chairman. Comments?

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee.

Senator Chafee. Mr. Chairman, are we talking now about the compressed rates on the --

The Chairman. No. Here we are talking about the kiddie tax. I know you have got an interest in the compressed rates also, but this is whether or not the assets, in the Administration's case, given by a parent to a child will be taxed at the child's rate -- and they have if it exceeds $1,000.00, they would tax at the parent's rate. I had $5,000.00. But from whatever source derived, whether it is grandparents, aunts, uncles, parents or otherwise.

Senator Chafee. You tax at the grantor's rate, but solely parents? I am sorry. I missed a beat there, Mr. Chairman.

The Chairman. Go ahead, Mr. Secretary.

Mr. Mentz. Yes.

Senator Chafee. You are not talking trust now?

Mr. Mentz. Not yet.

Senator Chafee. Oh, I'm sorry. I thought you were on the trust. Go ahead.

The Chairman. My mistake.

All right, comments about the kiddie tax? A thousand versus $5,000.00 and all sources versus parents?

Senator Danforth. What is the issue, Mr. Chairman?

The Chairman. The issue is income avoidance, income transfer by giving assets to your child or in my case to your grandchild or your niece or your grandniece and the assets are taxed under current law at the child's rate of income rather than the parent's so it becomes a member of tax avoidance. That is the basic issue.

Senator Danforth. In other words, you set up a trust for your kids and you put the money --

The Chairman. No. This is not a trust. This is just where they give the assets. The child has the assets. You are a parent, you give your child $200,000.00 worth of assets. And you are, if the bill were to pass the way I have drafted it, you are in the 35 percent tax bracket; the child, assuming a 10 percent return on $200,000.00 would have $20,000.00 in income; they would be taxed at whatever the tax level is for $20,000.00.

Senator Chafee. Up to the age of 14?

Mr. Mentz. That is right.

Senator Chafee. And then after 14 it becomes taxable at the child's rate.

Mr. Mentz. That is correct.

Mr. Brockway. Regardless of the source. It could be a transfer in a trust or it could be transferred directly to the child. The Administration's proposal essentially would give you $2,000.00 under an income of the child at the child's rate because the Administration allows the personal exemption, the full personal exemption, under an income. The Chairman's proposal would allow $5,000.00 to be accumulated on unearned income a year of income at the child's rate. Any excess over $5,000.00 would be taxed at the parent's rate rather than the child.

Senator Danforth. One issue is how much, what is the floor. And the other issue is --

The Chairman. Source derived.

Senator Danforth. Well, I can see a parent trying to shift income producing assets to their kids as a tax avoidance scheme. It would seem to be less of a tax avoidance scheme to me if somebody for whatever reason were to just give money or --

Mr. Brockway. Yes. I think probably, Senator Danforth, that there is sort of a variation depending on the situation. I think there are a lot of situations where parents will transfer property to the children not for tax avoidance purposes, but many of them will be -- I think also in the case of a grandparent that clearly the tax benefits are obvious to someone. I think that was the case that Senator Moynihan started out with. Where the grandparent transferred the property to the grandchild so the grandchild would earn the unearned income.

An unrelated third party perhaps might be less motivated by the benefit you get from having the income go up through -- a separate run-up through the rate brackets.

But I don't think that each one of these situations there is a tax avoidance purpose. It is just very difficult to draw a rule that turns on that rather than saying that under the Administration's --

Senator Danforth. It is more likely to be just purely generosity, dispassionate.

Mr. Brockway. It may well be, but if you transfer it to the parent, then there are some state tax consequences that might be -- the grandparent transfer to the parent, it might be more beneficial to transfer to the grandchild rather than to the parent.

Plus, from an income tax standpoint, if you transfer the money to the parent to take care of the child or what have you, that it will be taxed at the parent's rate of 35 percent, hypothetical. And if you transfer it to the grandchild directly, it would be taxed at 15 percent.

Mr. Mentz. Where you started, Senator Danforth, is exactly where the President was, and that is the rationale for his position.

I might note that the difference in revenue is significant. It is 1.2 under the President's proposal, and .5 under the Chairman's proposal.

Mr. Brockway. I think that is attributable to the different floors --

Mr. Mentz. That's right.

Mr. Brockway. -- in a way that is unrelated --

Senator Danforth. That would also --

Mr. Brockway. In either one of these proposals -- I think they are sort of separate issues. You can decide whether or not you want to have a $5,000.00 floor, as the Chairman in effect has, on unearned income or a $2,000.00

floor, as the Administration in effect has. And then independently -- and that is largely the revenue difference. Independently, you can decide whether to limit this rule solely to funds that come directly from the parents or you can say it also applies to unearned income derived from sources other than the parent, grandparents in particular, but third parties as well.

I think that is a less significant portion of the revenue.

Senator Danforth. My preference would be, Mr. Chairman, to limit it to parents. I mean I would think that if -- and let us suppose there was some -- supposing there was an elderly widow in a community who has an awful lot of money and doesn't spend it all and just wants to make a gift to some young kid in the neighborhood who doesn't have any money. His purpose of doing that is purely largesse, it would seem to me.

The Chairman. Further comments?

Senator Long.

Senator Long. I want to get this straight to see what -- all I want to do is get straight the difference between present law and the Chairman's proposal.

Now, Mr. Brockway, suppose you explain to me -- under existing law, what is the situation? If I wanted to give $200,000.00 to my grandchild or one of my children and then someone manages that for them, and let us say they are four or five or six years old, how is that taxed and how would it be taxed under the Chairman's proposal? I just want to compare present law with the Chairman's proposal.

Mr. Brockway. Under present law, there is no distinction between earned and unearned income of a child. So if you transferred to either your child or your grandchild and there was actually a legally effective gift to the child, then all the earnings that that child earned, all the income on that property, would be taxable to the child. That would mean that the child would have a personal exemption, which under present law is $1,040.00. It would not, to the extent it was from unearned income, get any zero bracket amount or standard deduction. You are not allowed that against unearned income.

So the first $1,040.00 would not be subject to tax. And then you would go up through the rate bracket. You would have a separate run up through the rate bracket for the child.

Senator Long. Fifteen percent for how much of it now?

Mr. Brockway. Well, the current rates, I think, start at 11, and we have, I think, 15 brackets. So you just run up through the rate brackets to a possible 50 percent.

Senator Long. How much money could they make before they reach the 50 percent bracket? How much would that be now? I am just trying to recall that. I should know it, but I am so vague in my memory.

Mr. Brockway. Under the Chairman's proposal, the rule would work that --

Senator Long. Let us just get this straight now. Somebody ought to know. You have got a table somewhere.

Mr. Brockway. At about $85,000.00 and a single taxpayer, which the child would be, you would hit the 50 percent rate bracket.

Senator Long. So that if I set this -- put $200,000.00 of assets aside for a child or grandchild and the parent administered it on their behalf -- that is how they do it, isn't it? Apparently they use the money for the benefit of the child.

Mr. Brockway. Presumably.

Senator Long. So they would get a favored tax treatment on $85,000.00 compared to how that money would be taxed if it were left in my account --

Mr. Brockway. That is correct.

Senator Long. -- and taxed to me.

All right. Now how would the Chairman change that?

Mr. Brockway. Under the Chairman's proposal, you -- the child would be allowed $1,000.00 of personal exemption and then the child would be allowed up to $4,000.00 additional under unearned income; that the child would be taxed at the child's own rate bracket.

Senator Long. Four thousand is the low bracket?

Mr. Brockway. Correct. So you would have $1,000.00 qualifying for the personal exemption, no tax. The next $4,000.00 would be subject to tax at 15 percent.

And then in this hypothetical, the income above that would be taxed at a 35 percent rate bracket. So that at some point you will get a crossover where there is this change of the Chairman's would increase the tax on this amount of money compared to present law.

But at above a certain point -- I don't know what the number might be -- of something like $100,000.00 in the aggregate you are going to be better off in any event simply because of the rate cuts in the bill.

Senator Long. Now would this bring more money to the Treasury? Would the Chairman's proposal bring more money to the Treasury than the President's proposal or vice versa?

Mr. Brockway. No. The President's proposal would -- the President's proposal is 1.2. The Chairman's proposal is .5. That is largely a function of this $4,000.00 floor that the Chairman has in his proposal that is not in the Administration's.

If you reduce that floor to $1,500.00 so that you would have a $1,000.00 personal exemption, plus an additional $1,500.00 floor, you would have the same revenue pick up as the Administration.

So it is largely a function of where you set that floor of what your revenue estimate would be.

Senator Long. Thank you.

The Chairman. Further discussions?

Senator Chafee. Let's see if I understand this correctly.

Under the Administration's proposal, it is -- there is no floor; there is no exemption. I am talking about the President's proposal.

Mr. Brockway. That is correct.

Senator Chafee. There is no exemption.

Mr. Brockway. That is correct.

Senator Chafee. But it is only money from the parent.

Mr. Brockway. It is only money from the parent.

Senator Chafee. Grandparents can give and so forth?

Mr. Brockway. Plus the Administration increases the personal exemption to $2,000.00, and all that amount can be used against unearned income. So there is effectively a $2,000.00 floor.

Senator Chafee. All right. The $2,000.00 floor.

And that raises a lot of money.

Under the Chairman's proposal, the floor goes up, but it is money from any source.

Mr. Brockway. That is correct. Any unearned income.

Senator Chafee. Yes.

But I mean the gift from any source.

Mr. Brockway. Correct.

Senator Chafee. In the Administration's proposal, it is only a gift from the parent.

Mr. Brockway. Correct.

Senator Chafee. Under the Chairman's proposal, it is only a gift -- it is a gift from anybody.

Mr. Brockway. Correct.

Senator Chafee. Now take Senator Danforth's proposal of the wealthy man who to a young child in the neighborhood just gives him a generous contribution, gives him a generous sum of money. In that instance, under the Chairman's proposal, that money would be taxed at that child's parent's rate if it was over the floor.

Mr. Brockway. Assuming it was over the floor, the income over the floor would be.

Senator Chafee. And if we assume, as Senator Danforth said in his example, that the parent is poor, then the rate is very modest.

Mr. Brockway. If the parent is poor in that situation, there would be no increase. Obviously, I mean you have a situation where --

Senator Chafee. But the yield of revenue in the Chairman's proposal is drastically lower.

Mr. Brockway. It is lower because of the floor. As I say, you could lower the floor and get -- if you had no floor in the Chairman's proposal, the Chairman's proposal --

Senator Chafee. Would get even more than the Administration's.

Mr. Brockway. Yes.

The Chairman. Tell me if anybody knows: How much of the problem is parental transfer of assets and how much beyond parental? I will take a guess off the top of my head that 90 percent of it is parental.

Mr. Brockway. We assume that or indirectly through a route that is through the parent, through the grandparent.

The Chairman. I think Senator Chafee has even persuaded me as to the difference in the money in this area. I would be willing to concede that I think as I drafted it it was wrong, and I would be willing to accept the President's proposal.

Any objection?

Senator Long. Explain the difference in the President's proposal. What is the difference between the President's -- the Chairman's proposal and the President's proposal now?

The Chairman. Let me try to explain it. The difference is that in the President's proposal they, in essence, say if a parent transfers assets to a child -- and this is not a trust; this is an out and out transfer -- under 14 years of age, that apart from a $2,000.00 floor exemption, unearned income above the $2,000.00 is taxed at the parent's rate.

My proposal, in essence, said a gift from any source -- parent, grandparent, aunt, uncle, the dowager down the street -- to a child under 14 will be taxed at the parent's rate, although there is a $1,000.00 exemption in the first $4,000.00 of unearned income that would be taxed at the child's rate. Above that, it would be taxed at the parent's rate.

And considering that the overwhelming bulk of the problem is parental transfer and the difference of roughly $700 million to $900 million, I would be inclined to accede to the Administration's proposal.

Senator Chafee. Well, do I understand what you are saying, Mr. Chairman, when you accede to the President's proposal -- and please don't label this as mine. I must say I am not sure what we are doing here, what the ramifications of all this, I'll confess.

But what you are saying is not take -- drop your proposal, go to the President's proposal which only deals with money given by the parent.

The Chairman. That is correct.

Senator Chafee. Thank you. I am not sure what we are doing here, to tell you the truth.

The Chairman. Mr. Secretary, do you want to speak once more as to what we are doing?

Senator Chafee. I know what the proposal is. I can see that.

The Chairman. What the President wanted to do, what he hoped to do, was to eliminate sheltering of taxes by the wealthy parents simply giving it to the minor child and having it taxed at the child's rate. And the theory being that 14 is probably a fair break point. I suppose you could have picked 18, if you wanted. But the child under 14, almost all of their expenses that they have are probably really expenses that the parents ought to be paying for. And you should not be allowed to avoid some of the taxes by giving the money to the child; paying for those expenses out of the child's unearned income that has come from the parent's assets and have it taxed at a much lower rate.

Senator Chafee. But if you are fortunate enough to have a wealthy grandparent, it is okay.

The Chairman. Well, the Administration thinks that you can avoid, on terms of tax avoidance, the parent giving the grandparent giving to grandchild. But if you happen to have a wealthy grandparent that says I want to take care of Little Timmy and Little Susie and Little Timmy and Susie are five years, yes, under the Administration's proposal, they would be taxed at Timmy and Susie's rate, right?

Mr. Mentz. That is right. And in the case where the parents happen to divorce, I think that is a sympathetic case where the grandparent doesn't want to give -- wants to make the gift directly to the grandchild, we think that that ought not -- if appropriate records are kept so that that money can be identified, we think it is appropriate that that not be taxed at the parent's rate.

Senator Long. Mr. Chairman, I find a lot of sympathy for the President's position and the Chairman's position for reasons that don't quite meet the eye. These young people who come into possession of this money while they are still teenagers often times are the most spoiled brats on God's green earth, and they set a horrible example for other children. Drive around in expensive automobiles and get involved in all kinds of trouble because they can afford all that. People tend to admire them because they have a lot of money from grandpap or grandma or somebody.

And it seems to me the less we encourage that kind of thing probably the better off they are and the country is. So I am going to vote --

The Chairman. I am not adverse, very frankly, to adopting the President's proposal and applying it to both parents and grandparents.

Senator Chafee. Pardon? You would include grandparents?

The Chairman. I am not adverse to it, and it picks up another, how much, $400 million?

Mr. Brockway. I think if you did that it would be more in the neighbor of 100 to 200, if you did that. The remainder is in the difference in personal exemptions.

The Chairman. All right.

Senator Chafee. I heard Senator Long's point, but if he is worried about these young people having too fast, expensive cars, I suppose the theory would be to raise the age higher. But I have a feeling, Mr. Chairman -- I am not opposed to your proposal. I have a feeling I am wading into an area that I just don't know what the ramifications are going to be.

I must say that the dollar signs there are tempting.

The Chairman. Senator Bentsen.

Senator Bentsen. I would just like to ask a technical question. My understanding is that if you have a foster child that that foster child then has the election of choosing between two sets of parents as to the rate charged. And I am not sure that a one year old child has that capacity or capability. How do you handle that?

The Chairman. I will move to --

Senator Bentsen. I am trying to get an answer.

The Chairman. Oh, I'm sorry. I thought you were done.

Senator Bentsen. The question is: You have got a foster child; I am told the foster child has the election of choosing between two sets of parents as to which rate of tax he is going to pay.

Mr. Mentz. I don't think that question -- is not resolved in the President's proposal, Senator Bentsen. I think it is one that obviously needs to be resolved. Frankly, we had not thought of it. I hadn't thought of it.

Senator Bentsen. But it has to be resolved.

Mr. Mentz. Yes.

Senator Bentsen. You know, capability of a one year old or two year old child deciding which tax rate he or she is going to pay seems a little unusual to me.

The Chairman. Senator Moynihan.

Senator Moynihan. Mr. Chairman, as we said when we first took this up -- this is one of the first items we discussed -- I indicated then that there was a great difference between the President's proposal and the one we had here in the Committee. And I am very much disposed in the President's direction.

The Chairman. The Secretary has convinced me of the merits of that, and I have suggested we go to the President's position and add grandparents to the list of restricted donors in addition to parents.

Senator Moynihan. Let's see. We have hopes of being grandparents one day. Is that a good or bad --

(Laughter)

The Chairman. I hate to make reference to a grandfather clause at some stage.

Senator Danforth. Mr. Chairman, I don't think it is a big deal one way or another, but it seems to me to be the most sensible to restrict it to parents, if what we are interested in is a tax avoidacne plan. Because I really think there is a difference between a family that is under one roof and one that isn't under one roof. And, generally speaking, I mean sometimes parents or the grandparents are in the home, but by and large the family unit is the parent of the children, and the transfer of income within that family unit. It seems to me is logically different from any outsider whether it is a grandparent or a great uncle.

The Chairman. Well, let me make a motion, then. I will just go to the President's proposal as the President proposed it which is parents only.

Senator Chafee. Let me ask one question, if I might. What are the ramifications of this in saying somebody setting up a college scholarship -- not a scholarship but a college fund for their child? Somebody who is not really extremely wealthy -- and after all, you don't have to be very wealthy to get into the top brackets here.

What happens now if a parent is setting aside some money for a child's education? Mr. Mentz, how could he do it?

Senator Wallop. Would you include in that request what happens if a parent is setting aside some money for a handicapped child?

Senator Chafee. Yes. All right. Well, take either case. How can he do it?

Mr. Mentz. Well, the way it would work under the --

Senator Chafee. Under the President's proposal, how would it work?

Mr. Mentz. Under the President's proposal, which seems to be the proposal on the table right now, before the age of 14, if a gift is made to a child, there would be $2,000.00 of income. In other words, if you gave, let's say, $20,000.00 or $30,000.00 and invested it in interest yielding investments, the first $2,000.00 would be effectively exempt from tax because of the personal exemption.

Beyond that, whatever the income would be, it would be subject to tax at the parent's rate rather than at the child's rate. So if the child would be at a 15 percent bracket but the parent would be at a 25 percent bracket, there would be an additional 10 percent tax on that income.

And that would be true until the child reached age 14. Once a child reached age 14 -- and I would say most or many college funding programs set up by parents -- well, I guess the ones who are really thinking far ahead start them when their kids are two or three. But somehow the immediacy of college tends to hit you more when your child becomes a teenager.

At that point, age 14, the child keeps his own rate brackets, his or her own rate brackets, and current law, basically, is in effect. So it is a modification for income over $2,000.00, unearned income, for a child under age 14.

Senator Chafee. Thank you.

The Chairman. My amendment is to adopt the Administration's proposal. Comments?

Senator Chafee. Well, you have backed off from the grand-parents?

The Chairman. Back off from the grandparents.

Senator Chafee. Well, I don't quite see the difference. It seems to me that if we are going to go, if we are going to go this route, I don't know why the source of the income should make any difference.

The Chairman. Well, I think Senator Danforth's argument is a good point, the under-the-same-roof theory. And granted there is a possibility of some abuses. But I am not sure that they are enough to justify adding the grandparents.

Senator Armstrong. Mr. Chairman?

The Chairman. Senator Armstrong.

Senator Armstrong. I don't want to interrupt if Senator Chafee is not through.

The Chairman. Senator Armstrong.

Senator Armstrong. It appears to me that if you are going to move on that amendment that the predicate for that should be to decide whether or not they are going to apply prospectively or retrospectively. I have reflected somewhat on my conversation with Secretary Mentz last week, and have thought about it, and I just can't see the justification for going back and saying to these trusts where they have no -- oh, I beg your pardon.

The Chairman. These are out and out gifts, transfer of title. We are going to get to the trusts next, though.

Senator Armstrong. I am sorry. I am ahead of myself, and I shall return at the proper moment.

The Chairman. Further discussion on my motion to adopt the President's proposal?

(No response)

The Chairman. All those in favor, say aye.

(Chorus of ayes)

The Chairman. Opposed?

Senator Chafee. No.

The Chairman. The ayes appear to have it. Ayes have it.

Let us move one. John, are you explaining or Greg or who?

Mr. Jenner. Senator, in the case of trusts, irrevocable trust --

The Chairman. What page?

Mr. Jenner. Page 211.

The Chairman. All right.

Mr. Jenner. You proposed that a new rate schedule would apply to irrevocable trusts which are not grantor trusts. And that new rate schedule --

The Chairman. What do you mean by "not a grantor trust?"

Mr. Jenner. Under the current law, certain trusts in which the grantor, the person who places the assets in trust, has certain administrative control or if the trust doesn't last a certain length of time, all the income from that trust is taxed to the grantor. We are not talking about those particular trusts.

We are talking about --

The Chairman. Where the effective control of the trusts have been given away?

Mr. Jenner. That is correct.

You have proposed that the rate schedule for those trusts would be 15 percent for income from zero to $5,000.00; 25 percent for income from $5,000.00 to $10,000.00; and 35 percent for income exceeding $10,000.00.

The Chairman. Mr. Secretary.

Mr. Mentz. Mr. Chairman, could I just make a very technical point for the record before we get into the discussion of this?

The two types of trusts that you are treating as grantor trusts are the Clifford Trust and the so-called Spousal Remainder Trust. Spousal Remainder Trust is where a parent puts funds in trust. The beneficiary is his child.

The reversion is his wife. So that after three or four years, the trust terminates; the money reverts to his wife, and it all sort of goes around in a circle.

Your proposal has an effective date of -- whatever it is -- 1/1/87, I suppose. I want to make it clear that the Treasury does not endorse and approve of all Spousal Remainder Trusts under current law. There are instances where you get into a back-to-back loan situation where it is possible that a so-called Spousal Remainder Trust will not be effective under current law.

So I don't want anyone to have the impression that up until 1/1/87 all Spousal Remainder Trusts are blessed because they are not.

Mr. Jenner. This is your proposal, Mr. Chairman, on Page 214.

Mr. Mentz. This is really just an aside. It is a comment on current law.

The Chairman. Go ahead, Greg.

Mr. Jenner. The section that Secretary Mentz was commenting on will come up in a minute. We are -- that deals with changes in the law relating to what constitutes a grantor trust.

In the case of your proposed new rate bracket, that applies only to trusts that are not considered to be grantor trusts.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee.

Senator Chafee. Sticking to Page 211, which is the compression of the brackets, I think there is an argument to be made here that the brackets you have come up with, the compression is too tight. And at the proper time, I have an amendment. And if this is a proper time, I would present it to stretch out those -- that compression.

The Chairman. Does your amendment pick up or lose money?

Senator Chafee. Oh, I suspect any time you decompress the rates, you would probably lose a little money, don't you think?

The Chairman. But losing money is a big issue.

Senator Chafee. Well, it hasn't seemed to have slowed anybody else down.

(Laughter)

Senator Chafee. And I am about at the point: If you can't fight them, join them.

(Laughter)

Senator Chafee. And, as a matter of fact, it is a big crowd to join.

The Chairman. We are at that point now. Mr. Secretary, do you want to address yourself to the rates?

Mr. Mentz. Well, I think this is the point that Senator Armstrong and I debated the other day. And I understand it is a very strong feeling that Senator Armstrong has. And I must say that there is certainly a legitimacy to his point.

One suggestion I would make to try to resolve this is how about if we had a proposal that if a trust created before the effective date of the legislation could simply elect to stay on the old rate structure. That way you are certainly not prejudicing them.

The Chairman. That sounds very much, Bill, like the proposal you were suggesting on the tax alternative.

Senator Armstrong. Mr. Chairman, that is certainly preferable, but I gather what Secretary Mentz is saying that if we lower the top brackets on every taxpayer in the country from 50 to 35 percent, the only exception to that would be these people who would stay on the present tax brackets. Is that what you are suggesting?

Mr. Mentz. Yes.

Senator Armstrong. I don't know how many people would be affected by that. But that doesn't seem to me to be quite fair. The essence of my concern is really not the money, and it is actually not any knowledge of who is affected.

As far as I know, nobody has contacted me about this. I don't think that the trusts that are affected perhaps are even aware such a proposal is in the law.

And, Mr. Chairman, I am sensitive to the dollar impact of this, but I am simply not persuaded that the place to start in writing this bill is to determine what the revenue implications are. And we do that a lot. There are a lot of cases where we say, well, we have got to come up with some legislative formulation by which this industry or that industry or this group of people or that group of people ponies up $4 billion or $6 billion or $12 billion. I don't think that is good tax policy.

It appears to me we have done it particularly in the insurance business. And I find that quite offensive to the notion of tax law based on some principle. I mean just sitting around the table and cutting up a pie is not a matter of principle.

The Chairman. No. But it is akin to where we may be in about two weeks when we have -- if we have voted to keep rates at 35 percent for corporate and individual and we have voted to keep capital gains, and we are anyplace from $60 to $75 billion short of money to make the bill revenue neutral.

I am not saying at that stage you say, all right, seven percent from the insurance industry, 14 percent from so on. But you then have to make some decisions as to where you get the money.

Senator Armstrong. Well, clearly, that is true. And I share your enthusiasm for a bill that is revenue neutral. But I don't know that that necessarily justifies the process by which we say, look, everybody has got to suffer and so we are going to pick out the tire industry and the insurance industry and the oil industry and have them pony up X number of dollars and simply back into a formulation that produces that amount of money.

I would be hopeful that we can resort to a more broadly based principle of tax policy. Now the principle that I think underlies this -- and it is not a big dollar item -- but the principle is should we go back and change in a drastic and unforeseen way the tax treatment of these trusts which are beyond the ability of anybody to change them.

I don't care much what you do towards the future. Tax them out of existence. Make it unattractive to create such a trust in the future if that is the desire of the Committee. That really doesn't bother me one way or another.

But when you get somebody who has created a trust acting in good faith in the past, and it is the kind of trust over which, as the Chairman points out, the grantor has surrendered all of his legal rights, he can't go back and change those arrangements. The kind of a punitive tax schedule that is suggested here really is most unfair.

And so I would be against it even if it were only slightly different than the proposed new rates. But as it appears in the bill now, it is not slightly different. It is drastically different. This gets to a 35 percent rate at

$10,000.00. It gets to a 25 percent rate at $5,000.00.

And so, Mr. Chairman, I would just like to move that with respect to this group of non-grantor trusts enacted or put into place before the effective date of the law, that the present ground rules apply. That is, that the trusts each separately calculate their tax liability as a separate taxable entity, and that they be taxed at the rate applicable to a married person filing separately. In other words, at the present law.

The Chairman. Mr. Secretary?

Mr. Mentz. Well, I would like to explain a little bit the basis for the suggestion that I made because I think it is a good suggestion, and I think it meets squarely Senator Armstrong's point.

There are some trusts that have been set up in reliance on current law, with the current law rate structure, and, of course, anytime any taxpayer does something relying on current law, you know it can possibly be changed. So the reliance argument isn't 100 percent.

But to the extent that you have a trust that is in this sort of middle level; it has got $40,000.00 or $50,000.00 of undistributed net income; and it is relying on the present rate structure, let that trust have the option of keeping present law, present law as to the rate structure.

Seems to me in that way you are not frustrating any expectations that that grantor had when he created the trust. Most trusts, I would submit to you, most trusts which are larger and have larger amounts of undistributed net income, will not make that election because they will be up in the higher brackets, and they will be benefitting significantly from the rate reduction in the Chairman's package.

But it does seem to me that that option pretty well meets the reliance point that Senator Armstrong has articulated, and I think articulated quite fairly.

The Chairman. You are suggesting we go to the Chairman's proposal for new trusts; give the old trusts an option?

Mr. Mentz. Give them an option. That is right. As to rates.

Senator Wallop. But, Mr. Chairman, the option is to stay with present law.

The Chairman. What?

Senator Wallop. The option is to stay with present law. You still end out with a set of income production that is treated drastically different than all the rest of income production in the country.

Senator Armstrong. Mr. Chairman, does that mean they stay at present law only for rates or for all purposes? For investment tax credits, oil depletion allowance, depreciation schedules? I mean fair is fair.

The Chairman. We were on rates right now. There is a debate as to whether or not you even want to go to the rates I have suggested.

Senator Armstrong. But the reason I asked the question I think is obvious. That present rates contemplate certain kinds of other arrangements. And our whole task here is to lower rates and to change the other parts of it.

And maybe you have got a trust which enjoys certain kinds of income predicated on existing tax shelters or existing tax treatments on depreciation or oil depletion or ITCs or XYZs or whatever they are. And to simply say, well, we are going to hold them harmless by leaving them on the present rate structure but not in other respects, doesn't quite get it.

And if somebody were to say, well, fine, let us let them opt to continue on the present basis for all purposes, that would have a sort of ring of justice about it, but also the sound of such complexity that it is the antithesis of tax reform.

It seems to me -- I don't want to be too insistent about this, but I guess I am obligated to be if I am faithful to what I think the justice of this is. It seems to me that the right place for us to come down is to do what we think is wise for future created trusts, but to simply treat existing non-grantor trusts as they have been in the past.

And I stress the justice of that arises from the fact that this was done in good faith and reliance of the tax law.

And while as the Secretary points out we can change the law, that does not in my opinion justify doing so. So I would say and my motion is to simply tax them as they have been before on the basis of married taxpayers filing separately at whatever rates and other conditions the Committee establishes for that class of taxpayers.

The Chairman. What would that cost?

Mr. Brockway. That would lose from the package $1.3 billion.

The Chairman. Senator Long.

Mr. Brockway. I gather you are applying to both estates and trusts. They have the same compressed rate bracket. The assumption is that this applies to both the estate and trusts. That would be $1.3 billion.

Senator Armstrong. My intention, Mr. Brockway, is to apply this standard only to those entities which have made irrevocable arrangements. I am referring to non-grantor trusts, and if it needs to apply to estates or other entities, I will be glad to broaden my motion.

But I am not trying to protect anybody who still retains the legal power to change their structure. If somebody has got that right, then they are on their own, as far as I am concerned.

The Chairman. Senator Long.

Senator Long. Well, Mr. Chairman, I don't find any appeal to that. Now, first, let us look at the complexity. If that motion is agreed to, that sets -- here we will be in this area where taxpayers, I understand, would have the option. Either he is being treated by the old law or he is going by the law that we passed. And that just adds a lot of needless complexity to the law, especially if we assume that we are trying to do justice in the first instance, which I think we are.

Now in the second place, a trust is a taxpayer. And I have been in this situation where may times we try to close a loophole and find we don't have the votes to do it. And then we say, all right, we will give a grandfather clause. We will let those who are getting away with those old thing go ahead and continue it. But for the future now other people will be taxed on a different basis.

I know we have done that many times. But in view of the fact that a lot of these trusts were set up with tax avoidance in mind, I don't know why we ought to treat these trusts differently than we are supposed to treat the others.

I would hope that by the time we are through, we will look as this trust just as you look at a taxpayer and say, well, now here, they are going to pay a much lesser rate, as Mr. Mentz mentioned, and since they are paying at a lesser rate, let them go ahead and pay.

But I would hope that we don't abandon the idea of tax uniformity in this area; that is, to treat everybody alike, until we find out if it really creates any insurmountable problem. I would hope that we don't treat them any differently.

And as we see how much we want the trusts to pay, then tax them that way. Now it is not all that complicated for you to break it down where you can put it on an old-fashioned blackboard and take a look at what you are trying to do.

So I would hope we don't do that.

Mr. Mentz. I agree with you, Senator Long. I think that is very clearly the preferable way to go.

Senator Long. Now that is what I propose we do. Let us try to treat them all fairly, but not make any distinction between the fellow who went into this thing early and the guy who went into it late.

The Chairman. Further discussion?

Senator Wallop. Mr. Chairman?

The Chairman. Senator Wallop.

Senator Wallop. I might one other observation. If we were to travel down the path that Secretary Mentz has suggested, in this day and age you open up the trustees for liability law suits of monumental proportions in some instances. Everytime you give them a choice, you open it up to a second guess. They chose the wrong way to go given the obligation of -- or undertaking of duties of a trustee. I don't think we want to do that in this society. I think I would agree with Senator Long that these are income producing things and ought to be treated as income in whatever way income is treated.

Mr. Mentz. Well, I think that is a fair point, too, Senator Wallop.

I was merely trying to make a suggestion that I thought would meet Senator Armstrong's point. But I think maybe the better way to is agree with you and Senator Long and oppose the motion that is on the table.

Senator Armstrong. Well, Mr. Secretary, you may misunderstand the burden of the Senator's point. I hope you do.

Senator Wallop. Yes, he does.

You misunderstand it entirely.

Mr. Mentz. I don't think I misunderstood Senator Long's point.

Senator Long. By the time we arrive at our rate, if what we do here is not going to create any substantially heavy burden on these trusts, then I don't know why not do it.

Now if we do create a significant burden, but we find that where it is creating the burden was an area of very substantial tax avoidance, well, I don't think we ought to turn those people loose unless we knowingly decide that we don't want to tax them even though that is an area of tax avoidance and they have been getting away with it for a long time.

And failing to show that, I just think that we ought to treat them all the same. And try to treat them fairly, but treat them the same.

Senator Armstrong. Senator Long, would you yield to me for a moment?

Senator Long. Yes, sir.

Senator Armstrong. I just want to -- I am not sure how you are going to vote on my motion, but I want to be sure that we have a meeting of minds about the effect of my motion.

My motion says that in the future whatever the Committee decides today will apply. But with respect to trusts established before the effective date of this act, that they will be taxed on the same basis that they have always been. That is, at the rates of a married taxpayer filing separately.

And the difference is this: That you get to the 35 percent bracket under the Chairman's mark, which I seek to amend, at $10,000.00. Now that is really vastly different from where you get -- Mr. Brockway, where does a married taxpayer filing separately get to 35 percent bracket under the Chairman's proposal?

The Chairman. Well, Bill, do I understand that you want the old trusts to have the benefit of the new rates, but the old substantial laws applied to them?

Senator Armstrong. No. Only that they be treated just like any other married taxpayer filing separately. I am not suggesting that they continue to have the benefit of old depreciation guidelines or old oil depletion guidelines or old this, that or the other.

I am just saying that we made a policy decision sometime that this particular class of irrevocable non-grantor trusts would be treated as married taxpayers filing separately. Now I am just saying that we shouldn't change that since they can't change their tax arrangements.

If we wish to change it in the future for future trusts, I have got no problem. But if we make other changes in the law other than rates, I have got no problem.

But let me just pin that down. Mr. Brockway, when does a married taxpayer filing separately under the Chairman's mark reach the 35 percent bracket?

Mr. Brockway. Under the Chairman's mark, it hits the bracket at twenty-seven five. Under present law, twenty-eight five. Under present law, they would hit it at $22,000.00; and they would hit the 50 percent bracket under present law at $88,000.00.

Senator Armstrong. So as far as the 35 percent bracket is concerned, they hit it at $27,000.00 or $28,000.00 under present law or the Chairman's mark. Under the proposal, they would hit that at the 35 bracket at $10,000.00.

So, Mr. Chairman, I don't want to take more time. I think we have aired the issue. I hope the majority will think that the case is made just on the grounds of justice. There sure is no lobby to this.

The Chairman. Clerk, call the roll on the Armstrong amendment.

The Clerk. Mr. Dole?

The Chairman. No.

The Clerk. Mr. Roth?

(No response)

The Clerk. Mr. Danforth?

Senator Danforth. No.

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

Senator Heinz. No.

The Clerk. Mr. Wallop?

Senator Wallop. Aye.

The Clerk. Mr. Durenberger?

The Chairman. No.

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye.

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. No.

The Clerk. Mr. Bentsen?

Senator Bentsen. No.

The Clerk. Mr. Matsunaga?

(No response)

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Baucus. No.

The Clerk. Mr. Boren?

(No response)

The Clerk. Mr. Bradley?

(No response)

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

(No response)

The Clerk. Mr. Chairman?

The Chairman. No. And Senator Dole no.

Senator Heinz. Mr. Chairman?

The Chairman. Senator Heinz.

Senator Heinz. No.

The Chairman. Senator Heinz no.

The Clerk. Four yeahs, 11 nays.

The Chairman. The amendment is defeated.

Senator Bentsen. Mr. Chairman?

The Chairman. Yes. Senator Bentsen has a point he wants to bring up, and he has to go to the Intelligence Committee for a briefing on an obvious subject.

Senator Bentsen. Mr. Chairman, in looking at these taxes on estates, I am struck by the fact that we indexed the income tax, and the logic seems, in the way of consistency, that we ought to index the rates on estate taxes.

You can run into a situation of hyper-inflation that affects as much on estates as on income tax. Therefore, I would recommend that we apply indexation to estate taxes.

My understanding is that over five years that is a $700 million cost.

The Chairman. Does the Administration have a view on that?

Mr. Mentz. The Administration generally has been supportive of indexing brackets. We supported indexing rate brackets. We supported personal exemption indexing.

And we still, Senator Danforth, support indexing of depreciation.

(Laughter)

The Chairman. Senator Danforth, did you --

Senator Danforth. I have difficulty in persuading the Administration of anything, Mr. Chairman. I am not surprised.

Senator Bentsen. Oh, come on, Senator. You have been eloquent and persuasive in many instances.

Mr. Mentz. Exactly.

Senator Danforth. I am not being modest. I have been no more able than anyone else is able to persuade you.

(Laughter)

The Chairman. He is eloquent and persuasive but that is different than changing the mind of the Administration.

Senator Bentsen. All right, all right.

Mr. Mentz. I guess the only thing that gives me any pause at all is the $700 million. The concern that I have overall is working out a bill here that is revenue neutral and gets us to the rates we are trying to get. And, therefore, it is hard for me to support it directly.

But I certainly can't oppose it, Senator, because it is consistent with the Administration's philosophy on indexation.

Senator Moynihan. Mr. Chairman?

The Chairman. Senator Moynihan.

Senator Moynihan. Could I ask did we contemplate that the 15-25-35 set rates will be indexed also?

The Chairman. No, no. He is talking only about the estate tax.

Senator Moynihan. Do we plan to carry indexation all --

The Chairman. Excuse me, yes. That part of the law, yes.

Senator Bentsen. Otherwise, I wouldn't be proposing this. This is just a matter of following through.

The Chairman. Further discussion on the amendment from the Senator from Texas?

Senator Chafee. Now his proposal is to index the --

The Chairman. Estate tax.

Senator Bentsen. Rates only.

The Chairman. The rates on estate taxes.

Senator Chafee. Well, Mr. Chairman, I just am opposed to indexing, period. I think that we have discussed this many, many times in this Committee. I believe that what indexing does is it insulates one great segment of the economy from the evils of inflation.

And so people get to accept inflation because they are taken care of -- no worry, pull up the ladder, they are aboard. Whereas, some segment of the population is always left out. And so, therefore, I would hope that we would not go for indexing.

What is the price tag, again, Mr. Brockway?

The Chairman. Seven hundred million dollars.

Mr. Brockway. Seven hundred million.

Senator Chafee. Seven hundred million dollars.

Senator Symms. Mr. Chairman.

The Chairman. Senator Symms.

Senator Symms. Mr. Chairman, I support the Senator's from Texas proposal, but I would just like to ask Mr. Brockway or someone to go through what the rates are now and where they kick in and what it is in the Chairman's proposal.

Mr. Brockway. Well, the Chairman's proposal would not affect the estate tax rates. But right now, the estate tax rates are -- they begin at 18 percent --

Senator Symms. Where?

Mr. Brockway. That is for a taxable estate above $10,000.00. And they go up to 50 percent, 55 percent rate, excuse me, that right now the 55 percent cuts in around $3 million. You are fading down to a 50 percent rate under present law, which will hit for estates over $2,500.00.

But you also have a unified -- I'm sorry. Two million five hundred thousand dollars, taxable estate. You are subject to a tax at the 50 percent rate.

But there is also a unified credit against estate tax of $600,000.00 we are phasing into. So the first $600,000.00 of tax, you get a credit against. And then above that, you pay at this rate structure.

Senator Symms. What is your assumption on the rate of inflation?

Mr. Brockway. Roughly four percent a year. And so that all these brackets would be widened by four percent a year under the proposal of Senator Bentsen.

Senator Heinz. Just a clarifying question. Senator Bentsen referred to indexing the rates.

Senator Bentsen. That is all.

Senator Heinz. And you are talking about indexing the brackets.

Mr. Brockway. I think that is the same proposal.

Senator Bentsen. We are talking about the same thing.

Senator Heinz. All right.

Mr. Brockway. The rates would stay the same. They would phase down to 50 percent as under current law, but the brackets would get wider.

Senator Symms. So to go through this again, first, you get a $600,000.00 unified credit?

Mr. Brockway. Correct.

Senator Symms. And then over $600,000.00 -- let's just say if it is a cash estate to make it easy to do. Starting at $600,000.00, it kicks in at 18 percent rate. Up to where?

Mr. Brockway. Once it is fully phased in, it will be over $2,500,000.00, plus the $600,000.00, so that will be $3.1 million.

Senator Symms. But over $3.1 million, it is 55 percent?

Mr. Brockway. Will be 50 percent. And then 55 percent would be maybe another $500,000.00 on top of that.

Senator Symms. I would just like to ask Treasury: What is the logic behind having the top tax rate at 35 percent which the President is supporting, and having the tax rate on an estate at 55 percent?

Mr. Mentz. Well, Senator Symms, the original Treasury 1 proposal would have dealt with estate and gift taxation as well. And the determination was made in developing the President's proposal to leave estate and gift taxation for another day.

And -- so there is more to estate and gift tax than just rates. And really the subject was just kind of just not addressed in Treasury 2 or, to my knowledge, in any of the other proposals.

Senator Symms. How was it in Treasury 1? What did it do?

Mr. Mentz. I don't know.

Senator Symms. Well, I don't to want to delay.

The Chairman. All right.

Senator Chafee. Mr. Chairman?

The Chairman. Yes.

Senator Chafee. Mr. Chairman, what we are dealing with here is an income tax measure. And that is the bill that is before us. And to get into the estate tax matter, whether it is indexing or whatever it was, it doesn't seem to me quite appropriate on this piece of legislation.

Now do I understand the Administration is going to come forward with something on estate and gift taxes? Do you have some kind of a study?

Mr. Mentz. Yes. We are engaged in a study. It is not going to be next week, Senator, but, yes, we are going to come forward with some estate and gift tax proposals.

The Chairman. I would hope, as much as I respect my friend from Texas, I would hope we would turn this down at this time not only for the cost but this is a subject we have not -- We know what the subject is. We didn't particularly have hearings on it at this time in this area, and I would hope we would vote no.

Senator Bentsen. I would say, Mr. Chairman, that the basic premise is the same for the income tax and the estate tax. If the logic is there for the income tax indexation, it is there for the estate tax.

It is a very clear and a very simple issue. And we have dealt with a great many estate problems here. I see no reason not to also have this one. And I would move this.

The Chairman. Those in favor of the --

Senator Long. I want to get one thing straight. Are we still down to the law where we phase into a 50 percent bracket or has the House prevailed on that trying to put a higher tax on?

Mr. Brockway. You are phasing into a 50 percent bracket.

Senator Long. And when does it become 50 percent?

Mr. Brockway. Nineteen eighty-eight.

Senator Long. Nineteen eighty-eight. So it is 55 percent until 1988. And at what figure do we reach the 55 percent?

Mr. Brockway. Fifty-five percent, right now, is at $3 million.

Senator Long. Three million.

Now what Senator Bentsen is seeking to do is to keep it basically -- that it would be the same $3 million adjusting for inflation for future years. Is that how this would work?

Mr. Brockway. In current dollars. It would be $3 million always in current dollars.

Senator Long. Right.

Well, in view of the fact that we have done that on income tax, I don't know why we shouldn't do this -- otherwise, you are going to have the estate tax constantly rising. I am going to vote for this amendment.

The Chairman. Questions on the amendment?

(No response)

The Chairman. Clerk, call the roll?

The Clerk. Mr. Dole?

(No response)

The Clerk. Mr. Roth?

(No response)

The Clerk. Mr. Danforth?

Senator Danforth. No.

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

Senator Heinz. Aye.

The Clerk. Mr. Wallop?

Senator Wallop. Aye.

The Clerk. Mr. Durenberger?

The Chairman. No.

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye.

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. Aye.

The Clerk. Mr. Bentsen?

Senator Bentsen. Aye.

The Clerk. Mr. Matsunaga?

(No response)

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Baucus. Aye.

The Clerk. Mr. Boren?

Senator Bentsen. Aye, by proxy.

The Clerk. Mr. Bradley?

(No response)

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

Senator Pryor. Aye.

The Clerk. Mr. Chairman?

The Chairman. No.

The Clerk. Ten yeahs, six nays.

The Chairman. Adopted.

Are there further amendments in the estate section?

Senator Chafee. Yes, Mr. Chairman. I would like to go back to the trust on Page 211. And it seems to me that what you have done in your bracket decompression is going too far.

And whereas I wouldn't go as far as was proposed by Senator Bentsen, I think the brackets you have proposed and suggested are just too tight.

And I would say this, Mr. Chairman: All trusts aren't set up for tax avoidance reasons. People set up trusts for disabled children. They set up trusts -- they fund them, for example, sometimes with life insurance proceeds. It isn't always the great wealthy person.

And I just don't see that if a parent dies and sets up a trust with his life insurance proceeds that the child should suffer because the trust would be paying taxes at a more compressed rate than a real person.

And I know we are always looking for revenue. You would get some revenue over the present law from the proposal I have, but not as much as the proposal that you have.

So I think we have circulated these rates. And I would be open for some discussion.

The Chairman. Open for a question? The only reason, Senator Chafee, I kidded you on revenues and revenue losses -- we all take great umbrage when some other member offers an amendment that loses revenues and we don't like the merits of the amendment anyway but we argue the revenue loss.

But when it comes to an amendment each of us offers, even if it loses revenue, we find a different reason to justify it.

I thought Bill Armstrong's point was very valid. You ought to look on this in merit. And if by chance it gains revenue or loses revenue, you have got to argue it on the merits.

I know we are going to go down issue by issue, and we are going to say \$600 million, \$700 million, \$1.2 billion. But I think probably we would all be wiser off not to disparage each other with tones of umbrage about it loses $600 million.

Now how much does his amendment lose?

(Laughter)

Senator Chafee. That was a question with no tone of umbrage in it.

(Laughter)

Mr. Brockway. If this is the same amendment that was discussed earlier, it would lose -- well, they are slightly different than the numbers from before, but I gather it would lose about $1.3 billion off the package.

Senator Armstrong. Mr. Chairman, if the Senator would yield, I have two questions.

Senator Chafee. Yes.

Senator Armstrong. First, is it the intent of your amendment, John, that this apply to all trusts or only to those -- well, to all trusts?

Senator Chafee. Yes. Future, retroactive to trusts and estates.

Mr. Brockway. Trusts and estates is my assumption.

Senator Chafee. Yes.

Senator Armstrong. Could you explain to me why we would want to impose on trusts a higher tax rate than we impose on anybody else? I can see why you wouldn't want to give them a lower rate than somebody else, but why would you want to tax them? I believe this would put them at the highest bracket -- higher brackets than any other individuals filing jointly or singly, would it not?

Senator Chafee. Well, what we are working from is -- I suppose the real person to ask that question to is the Chairman whose proposal comes up with the compression.

Senator Armstrong. Well, I am getting to him. But in the meantime --

Senator Chafee. I am mitigating the damage here.

Senator Armstrong. Well, I understand that. But, seriously, why do we want to single out a group of trusts and say let us tax them higher than we tax any other individual taxpayer? And for that matter, higher than corporations? Why do we want to do that?

Mr. Colvin. Senator Armstrong, when the bill came from the House, it included a complete revamping of trust tax rules. And it was met with uniform disapproval by the legislative assistants and by the affected members of the public.

And when we were developing the proposal, we tried to find alternatives. We recognized the theory that had been raised by the House bill and the Administration that tax avoidance through the use of trusts should be decreased. But we wanted to find an approach to it that would be far simpler. And compressing the rate brackets was a way to achieve that.

Senator Armstrong. Well, Mr. Colvin, or Senator Chafee, or Mr. Chairman, or somebody, I hear that, but that same purpose could have been accomplished in a much less drastic way. I mean you could have said, okay, therefore, since we want to discourage this kind of trust, we want to discourage tax avoidance, we just think this is an undesirable social behavior -- and I am not sure I agree with that. But if I felt that way, you could say let's put this group of people, these trusts, at the highest bracket that we put anybody else. But I can't understand why we want to deliberately set out to put them at a higher bracket than anybody.

Are there any other taxpayers in this bill that are higher than they are? Why do we put them higher than corporations, for example?

Mr. Brockway. What Senator Chafee's proposal -- propose rate structure that is 85 percent of what the married person filing separately would be. In other words, slightly higher rate structure than a married person filing separately.

Present law treats them as married persons filing separately. The reason for tightening up on that some more, either it is -- as under Senator Chafee's proposal it would be or under the Chairman's -- is simply that the trust allows you to split income between essentially the same person. Is that I could have part of my income coming in my own return, and part of my income coming through a trust. And as long as the trust accumulates the income, then that income will have a separate run up through the rate brackets.

If the trust distributes the income to the beneficiary or the trust income was never -- it was a grantor trust and it was taxed to the grantor, there is no splitting of the income up, and there is no separate run up through the rate brackets.

Senator Armstrong. Well, Mr. Brockway, I understand that, but let me just be sure that I do clearly understand the implications here.

If we have, as Senator Wallop said, a person who passes away and leaves to his minor children funds in trust -- life insurance proceeds, property, whatever it is -- if he had simply given that property to the minor child or children, it would be taxed to them individually at the individual rates, correct?

Mr. Brockway. That is correct.

Senator Armstrong. All right. So that means that under the Chairman's proposal, they would reach the 35 percent bracket at 35,000.00. They would reach the 25 percent bracket at 11,250. Same identical set of circumstances but the taxpayer, as a matter of family planning or prudence or whatever, says I don't think maybe my 15 year old son or daughter ought to have control of this property yet; it ought to go in trust and be supervised for their benefit. Instead of getting to the 35 percent bracket at 35,000, it gets to the 35 percent bracket at 24,225.

And, again, I just can't see the tax policy considerations that justify that. And, John, I would hope you would be disposed to go one more step and say at least they ought to be taxed at the individual rate or one of these other rates.

I can't see the justice in establishing a punitive rate for this group of people.

Senator Chafee. Well, I would say to the Senator, obviously, if he wishes to propose that.

Senator Armstrong. All right, I will move it. Do you want me to move it as an amendment or a substitute or do you want me to wait and see what happens to yours? I am not trying to confuse the parliamentary situation. That is why I addressed it to you.

Senator Chafee. Well, why don't we wait and see what happens to mine.

Senator Armstrong. Well, the only trouble is if we vote on yours, I am personally disposed to vote for yours if we can't get something better even though I think it improves the practical outcome even though I don't think it really lands four square in a logical position.

Senator Chafee. Well, let me just go back to, if I could, Mr. Chairman, to the rationale for my measure. It in many instances -- I think the Senator from Colorado is correct. Are trusts bad? I don't think trusts are bad per se. And there are restrictions on them, and they are set up in order to cover particular situations. As I say, it could well be a handicapped child.

And under the proposal that you have, Mr. Chairman, we want to make clear that we are talking about the undistributed income. In other words, you are taxing the undistributed income which might be retained for future reasons, for education, for whatever it might be, at a very high rate.

Now it seems to me that if my amendment does not prevail or something similar thereto, what we are doing is encouraging trustees to distribute. Maybe unwisely.

But the way you avoid the tax is to distribute the income. And I don't think that is the kind of decision we want to take away from the trustees for a very good reason. They may wish to withhold the income for the very best interest of the beneficiary of the trust. So that is --

Now as for the reason I didn't come with even a greater decompression or going as far as the Senator from Colorado suggested is because I think I can see the way the winds are blowing in the Committee, and this, to me, seems to be a fair compromise. Everything is a compromise around here.

Senator Danforth. Well, Mr. Chairman, despite your earlier comment, it seemed to me that the strongest argument against Senator Chafee's amendment was the revenue loss. But I think that Senator Armstrong has raised an interesting point. And I would like to clarify this with Mr. Brockway or Mr. Mentz as to my understanding of the law.

If we have a higher tax rate, higher tax rates, for trusts than for individuals, does that not mean that the trustee would, where he can, distribute income in order to take advantage of the lower rates?

Mr. Mentz. Well, that will depend on usually external factors, such as whether there is a reason to distribute, what the situation is of the beneficiary. But putting all non-tax factors aside, there would be an incentive.

And I point out that there is an incentive under current law. Because, remember, current law has a differential. You are paying tax in a trust as a married filing separately which is, itself, a more compressed rate bracket than the likelihood of the individual who would be receiving the income would be in.

So we already have that bias. And it is, I believe, for the reason that Mr. Brockway stated. That when a trust is created and is a separate taxpayer and has undistributed net income, that is the creation of another potential run up the rate brackets.

And that is the reason for it in current law, and I think that is the basis for the Chairman's proposal.

Mr. Brockway. Also both under current law and under the proposal it is not always that you will have an incentive to pay out just for tax reasons. It really depends upon what the marginal rate bracket is of the beneficiary. If the beneficiary is already in a high rate bracket, you want to accumulate some income at the trust, get the --

Senator Danforth. To the extent that we compress the rates, we are creating incentives for the distribution of income.

Mr. Brockway. You are minimizing the situations where the trust would have a lower rate bracket, marginal rate bracket, than the beneficiary. There will still be situations where the trust will have a lower rate bracket, in which event would want to retain --

Senator Danforth. We are basically saying that if we are going to change the waiting, we are going to change it in favor of distributing income rather than retaining income.

Mr. Brockway. Insofar as you are looking soley at the tax incentives of whether to retain or distribute the income.

Mr. Mentz. For a medium sized trust. For a large trust, you are going to be way over these rate brackets anyway.

Senator Danforth. Yes.

Mr. Mentz. It is not going to matter.

Senator Danforth. Right. This is displaying my loss of memory since 25 years ago when I last was in law school, but is the taxable event -- is what creates the tax the actual distribution of trust income or is it -- is the individual taxed on something whether he receives the distribution or whether the income is distributable to him?

Mr. Brockway. As a general matter, I would say that the income that is distributed to the beneficiary, he is taxed on that income. The beneficiary also in certain technical situations might be taxed on income not distributed to him if the trust was the type that was required to make that payment and simply did not.

Senator Danforth. What if there is an option on the part of the individual to receive it?

Mr. Brockway. Then the general rule is that the beneficiary will be taxed on income distributed to them, and the trust will get a deduction for that amount.

To the extent it is accumulated to the trust and not distributed, it is taxed at the trust level. If it accumulates for several years and then pays the income out to the beneficiary, at that point the beneficiary is --

Senator Danforth. Can the beneficiary avoid the higher tax if he was given the option under the trust instrument to receive the income or not and he chose not to do so? Would it be taxed to him? Would it then be taxed to him at a lower rate and the money would be retained as trust?

Mr. Brockway. You could certainly structure an arrangement where, in effect, the money was paid out to the beneficiary and then recontributed. I don't know if he would do that.

Senator Danforth. No. What I am saying is that under the terms of the trust, the beneficiary has the election whether to receive the trust income or not.

Mr. Mentz. I don't think so, Senator. I think the way it works is if the trust instrument leaves power with the grantor to make the decision to distribute or not. And if he decides not to distribute, the beneficiary is not taxed.

Senator Danforth. How about if it is in the grantee, the beneficiary?

Mr. Mentz. I think the beneficiary would be taxed in that case, even though he chose not to receive it.

Senator Danforth. All right. So the beneficiary then could take advantage of his lower tax rate by saying I am sorry; I don't want it.

Mr. Mentz. Well, no. I am saying I don't think he could do that. It has to be the -- it has to be the trustee that makes the determination not to distribute. If the beneficiary says, no, don't pay me that money, I don't want it, but the grantor either decides to distribute or the terms of the trust require a distribution, the beneficiary will be taxed.

(CONTINUED ON NEXT PAGE)

Senator Danforth. As I understand it, if the higher rates are the trust rates, then the beneficiary would want the best of all worlds for the beneficiary than if he wanted to save the money. The best approach would be if the trust gave him the option and he said, "No, leave it in the trust." Then he would be taxed as though he had received it; namely, at a lower rate. And the money would be locked in the trust. It would be a loophole, wouldn't it?

Mr. Brockway. It may be, Senator Danforth, under present law -- and then that would carry over into the proposal -- that if the beneficiary has the unfettered right to the income, an election, and doesn't choose to receive it, that income would then be taxed under the constructive receipt notion to the beneficiary at the beneficiary's wish.

Senator Danforth. Which is what the beneficiary would want. He would want it to be taxed to him.

Mr. Brockway. In this hypothetical.

Senator Danforth. Yes. Under all hypotheticals. He would want it to be taxed under him.

Mr. Brockway. Assuming, again, we are in a situation where the rate at the trust level is higher than the marginal rate at the beneficiary's level.

Mr. Mentz. And assuming he has the cash to pay the tax.

Senator Danforth. Right. That's true.

The Chairman. Senator Mitchell, then Senator Wallop.

Senator Mitchell. Mr. Chairman, I just note that I left the federal bench to get away from this kind of discussion.

(Laughter)

Senator Mitchell. I don't think anyone can disagree with your comment earlier, to debate each item on the merits and not, I guess, stress the revenue aspects of it.

But I would merely note in passing that one of the problems with the Tax Code is, of course, that each individual provision was debated on the merits. And if you look at each one individually, almost every one makes sense. What doesn't make sense is the effect of all of the provisions in the aggregate producing unintended and what most of us would agree are unfair results.

So, I know you didn't mean to suggest that revenue is not relevant, because when we get to the end --

The Chairman. Your point is very well taken. As we go along over the years adding amendments, almost all would cost money. We would not do it I think consciously, like we thought, "This amendment has no merit at all; let's pass it anyway."

So all of them that we have passed, we honestly think have merit and never impugn the motives of people who present them. It is not very often that one is presented that picks up revenue that seems to have merit.

Senator Mitchell. And the fact is, when I served as

United States Attorney, I was involved in a lot of tax litigation. And if you go down the Code, there are very few provisions, when viewed in isolation, when considered in the context in which they were offered, debated, and enacted, when you valuate it against the objectives sought, that don't make sense, and in fact do achieve the objective.

It is only when you consider the aggregate effect that you can properly measure each provision. And I hope we don't lose sight of that here, where the overriding objective is to produce some reduction in rates and some greater fairness.

So, I think the revenue is relevant. Indeed, it is more than relevant; it is a controlling factor in that. I asked last week that we keep a running tally. I don't know if it is appropriate to ask the question of where we stand before the vote or after. I would like to know now. Where do we stand?

The Chairman. Who is keeping the tally?

Mr. Brockway. Well, so far today we are even.

The Chairman. I think he means a running tally.

Mr. Brockway. And for the running tally, overall, you started out plus-two and the decisions were somewhat more than 14, so you are down about $12.5 billion right now.

Senator Mitchell. Twelve and a half billion against the Chairman's proposal?

Mr. Brockway. Well, it is about 14.5 against the

Chairman's and about 12.5 against present law. The Chairman's proposal over the five-year period would have picked up about two billion.

Senator Mitchell. All right. So, if I can restate what you have said, the result of the actions we have taken in this markup to date have produced a loss of revenue of 12.5 billion as against current law and 14.5 billion as against the Chairman's proposal?

Mr. Brockway. That is correct.

Senator Mitchell. And as we proceed, obviously, Mr. Chairman, to the extent that we add to those totals, it makes the overall task that much more difficult to achieve.

The Chairman. Well, interestingly, apart from the depreciation issue, this is where we mount them up at $600- and $700-million apiece. This is the old adage. But this is indeed the adage in full fruition.

Senator Wallop has a question first, then Senator Moynihan.

Senator Wallop. Mr. Chairman, thank you.

Mr. Brockway, could you give me the revenue estimate again?

Senator Wallop. On Senator Chafee's proposal, that would be $1.3 billion against the package.

Senator Wallop. Well, I have a very difficult time understanding how it can lose more than the Chairman's proposal raises.

Mr. Brockway. It is because of the way that table is set out. Let me go through it: There is $1 billion from trusts, $.2 billion from estates, plus there is $.4 billion from the effect of this proposal, eliminating from the package, reduces the revenue from a provision in the compliance package that requires trusts to accelerate their payment of taxes. That provision -- if you had less revenue raised from trusts by accelerating the time of payment from the trusts -- would raise less revenue. So that, by changing the rate structure here, it is just a stacking order issue. You not only eliminate the $1.2 billion here -- that is, $1 billion from trusts --

Senator Wallop. But you don't eliminate it. He is not going all the way back.

Mr. Brockway. He is going 85 percent of the way. And so, the total is 1.6. And he is eliminating 1.3 of the total.

To build up to that 1.6, it is $1 billion from the trusts, .2 from the states, and then the impact of deleting that from the proposal on the provisions that require an acceleration of the payment of taxes.

Senator Wallop. But it doesn't take the entire 1 billion from the trusts or the estates.

Mr. Brockway. That is correct. But if you add up those numbers, that was 1.6, of the three pieces. And his proposal loses 1.3 of the 1.6. His rates are close to but not quite the way to what would happen if you had a married person filing separately.

Senator Wallop. Mr. Chairman, I hate to sound skeptical, but I am. This is just precisely what I warned us about when we began this whole process. We have no means of reaching in with our own effort of checking that kind of figuring. It just does not seem, on any basis, logical that by going 85 percent of the way you want it to go, that you lose 104 percent of what you would have achieved. Somehow or another, something is really missing.

The Chairman. The fact that we might have a way of reaching in doesn't necessarily guarantee any better result. We have a way of reaching in with the Congressional Budget Office. And as I have gone through attempting to meet our budget totals, they vary from the Congressional Budget Office from day to day, and week to week. They will be off by billions on identical issues. And these are the ones we are looking at, not Joint Tax.

Senator Wallop. I understand that, Mr. Chairman. But just assuming that we are riding with the same set of assumptions right here today, it defies all logic that by achieving 85 percent of what you wished to achieve, that you lose 106 percent of what you could have gained.

Mr. Brockway. If I could restate it, Senator Wallop, if you adopted the proposal of Senator Armstrong -- that is, a married person filing singly -- that would lose in the package 1.6.

Senator Armstrong. How much if we went to the single taxpayer rates for these trusts?

Mr. Brockway. That would lose something more, because a single rate is a more generous rate than the married person filing separately; it's about 20 percent more generous.

Senator Armstrong. So we would lose less?

Mr. Brockway. No, that would even be a more generous rate than what your proposal would be.

If I understand your proposal, it is the way the trusts are treated right now, which is a married person filing separately.

Senator Armstrong. Yes. But I am saying if, instead of going to that, which the committee did not choose to do, suppose we went to the single taxpayer rates, which are higher rates and lower brackets.

Mr. Brockway. No, no. Single rates, there is a more generous rate structure than married filing separately.

Senator Armstrong. Oh, than married filing separately. Yes.

Mr. Brockway. So, it would lose more.

Senator Armstrong. Thanks. Sure.

Mr. Brockway. But if you adopted your amendment, which

I gather you haven't considered, of totally limiting it, it would be 1.6. Senator Chafee's only goes part of the way, and so that is why it is only 1.3.

As I say, these direct changes plus the effect on the time of payment of tax for trusts -- in the compliance area there is a $1.7 billion pickup from accelerating the time of payment when trusts have to pay tax.

Senator Wallop. But that acceleration isn't affected by Senator Chafee's.

Mr. Brockway. Well, it is, because the amount of tax paid by trusts goes down; so that, by accelerating -- if you adopted Senator Chafee's proposal, the total taxes paid by trusts would go down. And so the amount that you pick up from accelerating the taxation of trusts would also go down.

Senator Wallop. Mr. Chairman, I have a suggestion that is a money-raiser. And that is that we mandate that every minor child in America have a trust sufficient to raise about $24,000 in income. Then we will all be there. I mean, this is an absurd postulation that is being offered to the committee here.

The Chairman. Senator Moynihan?

Senator Moynihan. Mr. Chairman, very briefly but with some feeling, Senator Danforth mentioned trying to remember back to his law school days a quarter of a century ago. I am trying to think back to my days at City College more like half a century ago, or so it seems. And there used to be a term called "demystification" very much in vogue in those days, and it had to do with "what are you really up to here?"

Senator Mitchell spoke about the specifics of the Tax Code as each of them having a case to be made and a reason for them. And yet, overall we are discussing something quite elemental -- I mean truly elemental -- and that is the return to capital and inherited wealth in this country. And the question of who will pay for that return?

We are talking about a stage, the transfer from one generation to another of wealth and power, which is fairly concentrated in this country as it is in most countries. I don't know any country where it is not.

We have been in about our fifth generation of industrial capitalism, and just a lot of money gets transferred from one generation to the other.

To the degree we do this and do it in a public fist, which is not borrowing, you have a case that this is the social arrangement you desired, and they are continuing them. But the situation in the past five years has been one in which great debt has been accumulated. Taxes have not been paid; debt has been incurred.

We have reached the point today where it takes about 44 percent of the revenue of the personal income tax to pay the interest on the debt. Is that not right, Mr. Brockway?

Senator Chafee. More than that, over 50 percent.

Senator Moynihan. Is it over 50?

Mr. Brockway. I simply don't recall, Senator. It is a very substantial amount.

Senator Moynihan. It is in that 50-percent range, though.

Well, think about it this way: If you think of the personal income tax as elementally a tax on labor, and the return to Treasury bonds as elementally a return to capital, you are taking half the tax on labor and transferring it to capital. And every billion dollars we go under in the Chairman's bill is going to increase that return to capital.

It is not given as an absolute that this country is always going to accept the degrees of inequality that exist in it.

Mr. Stockman's new book makes clear -- I am sorry to say -- that the Administration chose to conceal from this committee and other committees the extent of the borrowing that would be necessary. They said they knew they had a triple-digit deficit in 1983, and they said they did not. And they knew it.

And to the degree that we continue this accumulation of debt, we exacerbate a situation which is quite without precedent in our country, that we are imposing enormous taxes on individuals for the sole purpose of transferring wealth to capital.

I don't think we have a right as a committee to spend all morning on generation-skipping trusts, and so forth, and not know we are talking about wealth and the return thereto.

The Chairman. I think the committee is prepared to vote on the Chafee Amendment.

Senator Chafee. Mr. Chairman, I would like to ask one quick question, if I might.

Suppose we had the married people filing separately provision, current law, for trusts under half a million dollars in corpus? And then we phased that out and got up to the benefit of the graduated rates for trusts over a million? Do you have any idea what that would mean revenue-wise? Obviously I am worrying about the revenue factors here, as we try to arrive at something that is fair.

Mr. Brockway. Your number was a corpus of -- ?

Senstor Chafee. Half a million for the present law.

Mr. Brockway. I think that would save some revenue. I don't think it would save that much,because, while a large part of the revenue loss affecting trusts in the overall package from rate cuts comes to very large trusts, that is, trusts with income over $50,000 a year, which would roughly mean, to accumulate more than $50,000 a year would be equivalent to $500,000 of corpus. I think they are relatively few in numbers. So, while there is a substantial amount of revenue there, and you are only talking for those relatively few trusts, how quick their run up through the rate brackets would be, and I don't think they would amount to that much revenue in this context. We would have to look at it closely. I think it would still be close to the 1.3.

The Chairman. Clerk, call the roll on the Chafee Amendment.

Senator Armstrong. Mr. Chairman, before we call the roll, not because of the substance of this but just because it presents the right opportunity to raise the question, could we discuss briefly the proxy rule and the vote after the fact rule, and how that works?

The Chairman. The rule we have followed is that, when the vote is announced -- proxies, of course, can vote prior to that. And we have to have seven people here in order to vote.

Senator Armstrong. Seven?

The Chairman. Yes, seven, in order to adopt an amendment you have to have seven. And after you have established seven under our rules, you can have five. You have to have a quorum, a real quorum, to send a bill out.

Our rule has been in the past that once the gavel is dropped and a vote is announced, you can record yourself later if it does not change the vote.

Senator Armstrong. Mr. Chairman, that is my understanding of how the rule has been operative during this markup, but I would like to suggest that that is really not an optimum arrangement, and here is why:

There is a number of us -- in fact, I think every member of the committee has some other responsibilities. Senator Wallop is off for an Intelligence briefing I guess on the Libyan situation right now. Others of us have other committee meetings that we have to attend, and particularly during the afternoon hours it is difficult, because a lot of us have cleared our schedules in the morning to be here. But in order to do that, we have scheduled things at other times.

So, the opportunity to have our vote recorded on a recorded-if-it-doesn't-matter basis is just not a very attractive option. And it seems to me that a better option would be to say that the votes are recorded, and the votes count. And if they change the outcome, so be it -- with the understanding that any Senator can always go back and reopen an issue at any time, anyway.

But I just would be hopeful that we could reach agreement that the votes of members would count whether recorded at that instant or say later that same day. I think at some point we have followed that rule, I think.

Senator Baucus. Mr. Chairman?

The Chairman. Senator Baucus?

Senator Baucus. Mr. Chairman, I understand the Senator's feeling about it. I, however, strongly feel that the reality, I understand what Max is saying and what you are saying.

But if I think of my own situation last Thusday, for example, I am the Chairman of one committee of the Senate and we were having an important hearing on the Deputy Director of Central Intelligence.

Now, I could have absented because I knew what was going on over here. I could have absented myself from that meeting for a short period of time to come over here and vote if I had notice of the fact that a vote was going to occur at a specific time.

So, I would suggest, as a modification to the position you seem to be taking, that at least we be given some opportunity to know when votes are going to be taken, so that those of us who have those kinds of conflicts don't have to come here and sit for an hour when we can't, at least in the afternoon.

The Chairman. Dave, one of the reasons I have asked for amendments ahead of time -- and I assume that the members circulate their amendments if they want them seriously considered -- is to be able to let the staff come up and say, "Senator Durenberger would like to vote No on this," or, "Senator Danforth wants to vote Aye on this," and by and large your proxy gets voted. Normally, a good staff knows what your views are and knows that you may not want to vote, in recorded votes after the count has been taken, and particularly when the Senator is not here, should not change the result.

I think there are ways the Senators can rearrange their schedules, or this committee can rearrange its hearing schedule, so that a quorum is present when votes are taken. Perhaps votes can be stacked.

But the rule is that we have open voting -- and that is the rule. But the rule should also be that we have conclusive open voting -- that is, absent Senators can vote, but the vote cannot change the result.

The Chairman. I cannot more strongly agree with you, for this reason: You have a 9-to-8 vote, or a 9-to-7 vote, and there are four people missing. And you close the vote. And the four that are missing are suddenly subjected to tremendous pressures, with no benefit of the discussion, and, "Won't you please call up and send in your proxy?"

It is now two or three days later, we have counted up the money we have lost or gained, and suddenly in come four votes that weren't here for the discussion, and whose proxies were not here, and upset what we have done two or three days earlier. We never will conclude anything.

Dave?

Senator Durenberger. Mr. Chairman, briefly, on behalf of Bill Armstrong's argument, though, just trying to deal with some cases, in which case you are not registered.

But if we are going to not just revisit a lot of these decisions at the end -- and I think we are going to, because we are going to be short of revenue -- but if we are going to revisit them every day or every other week, or they are going to change because four or five votes come in that didn't even take the opportunity to keep themselves sufficiently advised, when almost all the votes we're having are in the morning, and when members cannot be there in the afternoon and want to reserve their right -- and there have been some on the accounting section. We will be back to it. I don't have the schedule, but we will be back to it.

To say that the votes can be changed, the votes cast afterwards when they could have been cast by proxy here, I just think is asking too much.

Senator Armstrong. Mr. Chairman, as a practical matter it is not always possible to cast an informed proxy vote. I don't want to be unduly personal, but let me just cite an episode that occurred to me yesterday. And by the way, I am not dissatisfied with anything that happened yesterday, and my proxy was cast, and so on.

But in order to fulfill a longstanding commitment, I was away from Capitol Hill yesterday. There was no way for me to know, as I left Friday morning, what issues would be voted on on Monday.

Now, as I say, I am not complaining of any particular outcome, but I do complain of the process. We are heading into a period where some of us, at least, will be required to be on the floor for extended periods of time if the Leader calls up the budget bill, for example. It is our desire, at least it certainly is mind, to participate fully in the deliberations of this committee, and that means, "By gosh, I want my vote to count, not just to have it chalked up on the wall as sort of an advisory of how I would have voted had I been here."

So, Mr. Chairman, I hope that you would rethink that. I have not looked at what the rules actually provide, and I am very reluctant to suggest that we ought to stick too close to the rules, because part of the spirit of this committee is we all work together.

But one reason why the Senate rules provide that committees may not meet after two hours following the convening is to give members a chance to fulfill all of their responsibilities, not just their responsibilities to one committee or another.

But I really think that is an important issue, Mr. Chairman, and I hope you would reflect on it. I am not going to push it any harder right now, but perhaps later in the day we can discuss it, because we are going to be right in that kind of a time crunch, and we have some tough issues coming up. And I am not eager to delay, by the way.

The Chairman. I will tell you very frankly, if you ever want to give the Chairman an absolute club, that's it. You have a 7-to-6 vote, and the Chairman loses, and all of the members who haven't voted have got lots of things they are asking to be put on the agenda, or favors, and I say, "Well, listen, give me your proxies on that vote we had last Thursday, and we'll consider it." I am not sure that is a good thing from my standpoint, although it gives me infinitely more power. I don't think it is good from the committee's standpoint.

Senator Long. Mr. Chairman, there was a time when we used to leave all of these votes open, unless we had a majority. In other words, 11 would be a majority of this committee. Unless we had a majority voting for something, if it was a controversial matter, we would leave it open until we heard from the absentees.

I know I can recall the times even back before I was Chairman of the committee, myself, when we would get to a close vote on some very important matter and track the guy down. I recall one time they were voting on a trade amendment, a very significant amendment, back when Eisenhower was President. I was out running for office in Louisiana at the time. They tracked me down. I broke the tie by long distance from Louisiana. They called me and said, "It's a tie vote here at this moment." I can't recall if it was a five-year bill or a seven-year bill, or how many years it was going to be, but "How do you want to vote?" And I broke the tie in a long distance call out of Louisiana.

We have done that on occasion. And sometimes I can recall, at an earlier time, when someone would put a call in for a fellow, and one man was explaining it his way, when, "Just a minute" -- someone else wanted to explain it the other way, to explain his point of view. And over long distance the fellow would hear both sides of the argument and then would cast his vote.

Now, on our side ofthe aisle, here we sit with four of us, and I am not complaining at all about what's happened today. But I don't have proxies for these Senators, and I don't know who does. In most instances we are voting on something there there is less than half of the Drmocrats here, at this moment, and the others are not represented by proxies.

So, if it would change the outcome or change the result, we ought to at least be able to reconsider it before the bill is reported.

The Chairman. Mr. Russell, I would just as soon stay with the rules where they are, but as you are well aware, if you want to go to a system where you can go to people or I can go to people and say, "Give me your proxy on such and such," and you call them up, they will be more inclined to give it to you on your side, and they would be more inclined to give it to me on my side.

I think we are just better off to settle these issues, bearing in mind that toward the end of this I think we are going to go back and reconsider a lot of what we have done in order to make this bill come out.

But to literally go back on all the votes we have had and have somebody come in and say, "I've got four votes to change that 8-to-7 vote," and two or three other votes that day may have been dependent on how the 8-to-7 vote came out, I just think it is unwise.

Senator Long. Well, by the time the committee reports a bill, it ought to be a bill where the majority of the committee supports everything in it. You know, not necessarily a majority supporting the whole bill, but where you can get a majority of votes for everything you have in it. And anything less than that is not really expressing the will of the committee.

Now, I don't feel that the proxies should be voted and that it should stay that way if you find out the Senator doesn't feel that way about it at all. If that is not his position, I think that at some point he ought to make known what his position actually is.

Senator Heinz. Mr. Chairman?

The Chairman. Senator Heinz, then Senator Chafee.

Senator Heinz. Mr. Chairman, I just want to agree with your position on this. I think the point you make about how votes that are cast affect other votes, how those results are very important to the orderly working of the committee is the critical point.

I don't like to get into an argument between uou and Senator Long, because you both are extraordinary legislators. But on this one, I think, Mr. Chairman, I feel very strongly and with you.

The Chairman. Well, as there has been no request at the moment to reopen the subject, I would like to vote on the Chafee amendment while we have a fair --

Senator Chafee. Mr. Chairman?

Senator Armstrong. May I ask one more question on this subject?

The Chairman. Yes.

Senator Armstrong. On the procedural issue. Do we have any understanding about votes in the afternoon sessions?

The Chairman. We have, by and large, not been voting in the afternoon. I do have a voting session scheduled tomorrow on the foreign policy section, but the rest of it is discussion today, Thursday, and Friday.

Senator Armstrong. How about pending any further resolution of it? Could we just have an understanding that we won't have votes in the afternoon?

The Chairman. Bill, I don't want to guarantee that. We have already said we won't have votes on Monday mornings and Friday afternoons. I am trying to meet a deadline.

Senator Armstrong. How about this: How about if there is an unusual circumstance where we have to have a vote in the afternoon, that the vote would remain open until the close of that legislative day?

We are heading right into a situation where, for 10 days or so, those of us who are members of the Budget Committee will have some obligation to be over on the floor.

The Chairman. All right, let me consider that last option. What I don't want is, frankly, to have the absent members be put into a position days later by the interest group that doesn't like the way the vote came out.

Senator Armstrong. No, no. I am not suggesting that at all. The longest period I am suggesting a vote remain open is until the close of business. And I think that is the rule we have followed on some occasions.

The Chairman. Senator Chafee?

Senator Chafee. Mr. Chairman, my amendment. I would like to revise it as follows: That this would apply to -- the married filing separately, which is the current law, would apply to trusts under $500,000 in corpus, and then it would phase out at over a million dollars.

Now, I know you don't have a revenue figure, but to me that will have a considerable saving, and it will take care of the situation of the so-called "small trusts" which I am concerned with.

Mr. Brockway. Senator Chafee, just one point of clarification. Are you suggesting the rate structure in your original proposal for the small trusts, or to go to married filing separately. You would lose money if you went to married filing separately rates rather than your slightly compressed rates.

Senator Chafee. All right. I will take my slightly compressed rates, which are some extension of up to $500,000 corpus, and then phase out.

The Chairman. Questions on the Chafee Amendment?

Senator Heinz. Mr. Chairman, let me assure you that I have now no idea what we are going to be talking about.

(Laughter)

The Chairman. Which is a good reason to vote No.

(Laughter)

Senator Chafee. Now, that has never been the custom in this proceedings, Mr. Chairman.

(Laughter)

Senator Heinz. Mr. Chairman?

The Chairman. Yes?

Senator Heinz. Do you mind if I ask just one simple, easy to understand question? It is an irrelevant question, according to what you said, but what is the revenue loss of this amendment?

The Chairman. They don't have a number, I think.

Mr. Brockway. The original proposal would have been a $1.3 billion loss. This would reduce that revenue loss somewhat, but my suspicion is it would not be a substantial amount, but maybe be 1.2 or 1.1.

Senator Chafee. Well, I think it would be a lot less than that. You cannot help but get to a much lower revenue loss when you bring the size of the corpus down like this.

What we are doing, in effect, is protecting the smaller trusts, and then it phases out when you get over a million dollars in corpus.

Mr. Brockway. That is incorrect, but it turns on what percentage of all trusts that accumulate income have over $500,000 of corpus.

Senator Chafee. All of these things are guesses, anyway. You are sticking with the smaller trusts.

The Chairman. Mr. Secretary? And then we will vote.

Mr. Mentz. I would just like to say that if the committee decides to go in this direction, you would probably need a substantially tighter rule on multiple trusts, because a grantor could set up a number of trusts and come in under the favorable-rate bracket, which frankly is a complication that I think you might think about whether that is a good idea from a tax policy standpoint.

Senator Chafee. Well, Mr. Chairman, we have had rules on multiple trusts in the past.

Mr. Mentz. Yes, but you are putting more pressure on it.

Senator Chafee. Okay, we can tighten up on those multiples. But that is in your department. You can do it.

(Laughter)

The Chairman. That is administration.

Clerk, call the roll on the Chafee Amendment.

The Clerk. Mr. Dole?

(No response)

The Clerk. Mr. Roth?

(No response)

The Clerk. Mr. Danforth?

Senator Danforth. No.

The Clerk. Mr. Chafee?

Senator Chafee. Aye.

The Clerk. Mr. Heinz?

Senator Heinz. Aye, I think.

The Clerk. Mr. Wallop?

(No response)

The Clerk. Mr. Durenberger?

Senator Durenberger. No.

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye.

The Clerk. Mr. Symms?

(No response)

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. Aye.

The Clerk. Mr. Bentsen?

Senator Bentsen. No.

The Clerk. Mr. Matsunaga?

Senator Matsunaga. Aye.

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Baucus. Aye.

The Clerk. Mr. Boren?

Senator Boren. No.

The Clerk. Mr. Bradley?

Senator Bradley. No.

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

(No response)

The Clerk. Mr. Chairman?

The Chairman. No. And Senator Dole, No.

Senator Chafee. Mr. Symms, Aye; and Mr. Wallop, Aye.

The Clerk. Nine Yeas, nine Nays.

The Chairman. Nine-9.

Senator Chafee. Anybody can change who is here, if they would like to.

(Laughter)

The Chairman. Nine to 9. The amendment is defeated.

Senator Grassley. Mr. Chairman?

The Chairman. Senator Grassley?

Senator Grassley. Yes. I have an amendment I brought up the other day that I warned the committee about. I think, unlike yesterday, this may even bring in a little bit of money because of bringing money in ahead of time, before it would otherwise be brought in.

This would amend the special-use valuation of the estate tax, and it would change that 15-year period that was in existence for estates settled before 1981, in which you had to hold the land for 15 years to take advantage of special-use valuation.

We changed that to 10 years in 1981. And what I would like to do is change law for those covered by the 15 years, so that they are all covered by 10 years.

Now, this is meant not to cost the Treasury one penny, because taxes that would otherwise be owed would still be owed. So, it would work this way: If a person was covered by

15 years, and let's suppose the estate was settled in 1977; then, to have the full benefit of the special-use valuation, that land would have to be held for 15 years.

So basically what we would be doing is saying that after 10 years, 1987, if that land was going to be sold, it could be sold without losing the special-use valuation; any tax that would still be owed to the Treasury would still have to be paid.

The Chairman. Mr. Secretary, any comments?

Mr. Mentz. I would ask the Joint Committee for confirmation that there is no revenue loss. It seems to me there might be a little bit by shortening that period. But it is probably nominal, Senator.

Senator Grassley. Not only would there not be any revenue loss, but revenue that would be paid in those outyears would have to be paid right away, the minute that they want to take advantage of selling the farmlands.

So, whatever revenue would come in beyond 1987, if a person wanted to settle that issue with the Federal Government, would then have to pay up that tax in order to pass the land on to somebody else.

Senator Bentsen. Would the Senator yield for a question?

The Chairman. Senator Bentsen.

Senator Bentsen. To help me, if I don't understand it, is the current law 10 years?

Senator Grassley. Yes.

Senator Bentsen. I see.

Senator Grassley. It changed in 1981.

Senator Bentsen. So, you are trying to get to the 10 instead of the 15 for those that died prior to '81-'82?

Senator Grassley. Yes.

The Chairman. Further discussion on the Grassley Amendment?

Mr. Brockway?

Mr. Brockway. Just a point of clarification. If I understand the amendment, that is that for pre-1981 trusts or pre-1982 trusts, they have a 10-year recapture period rather than a 15-year period.

Senator Grassley. Yes.

Mr. Brockway. So, the only trusts you are affecting are those that are sold between 10 years and 15.

Senator Grassley. Yes.

Mr. Brockway. So, that would have some revenue loss, but there would not be a substantial one. Because the only affect of the amendment is that, for those prticular transactions where the property is sold between 10 and 15 years, they would not have a recapture tax as they would have under present law. So, the only affect of the amendment is to reduce taxes somewhat.

Senator Grassley. Well, you have to assume that the people are not going to settle that estate and lose all that special valuation. The idea is that you are going to be able to give them the benefit of selling that land before it loses any more value. The Federal Government is not going to lose one dollars of revenue.

So you would have to assume that they were going to sell it anyway and the Federal Government lose money; but that is not going to happen. You couldn't afford to do that today.

Mr. Brockway. You would have to make some assumptions about land prices. You are assuming that there will be a capital gain on the sale of property sold in those situations, and that it really is going to turn on what your land prices are.

In any event, I would say that revenue is not going to be a significant factor.

Senator Grassley. But a person who inherited the land and took advantage of special-use valuation owed the Federal Government x-number of dollars -- that would be they would have to hold it 15 years to pay that x-number of dollars. If it is settled in 10 years, they are still going to owe that x-number of dollars.

The Chairman. Mr. Secretary, you had your hand up.

Mr. Mentz. Well, I never did quite get a chance to state the Treasury position. Treasury does not oppose this amendment.

The Chairman. All those in favor of the amendment will say Aye.

(Chorus of Ayes)

The Chairman. Opposed?

(No response)

The Chairman. Let me make a quick announcement. We are not quitting now, but a quick announcement for this afternoon: If we do not get to bonds this morning -- and it was discussion on bonds, not voting -- we will start this afternoon in formal committee session with bonds on the discussion, and discussion on individual provisions. Discussions, but not rates, the personal exemption, the standard deduction, or the earned income credit. But it will be discussion in both cases, and no votes.

Further amendments on the trust and estate section?

Senator Baucus. Mr. Chairman?

Senator Symms. Mr. Chairman?

The Chairman. Senator Baucus, then Senator Symms.

Senator Baucus. Mr. Chairman, this follows up on the last amendment. It is in section 23(2)(a), special-use rules. Essentially my amendment would make it clear that when an executor attempts to make an election on his return and marks that he wants special-use valuation on the return, I guess it is called Schedule N, and when the executor has substantially provided the information that is required by the return, that the executor would have 90 days after being notified by Treasury to supply any potential missing information.

The whole point here is to try to remedy a problem that presently occurs, where the IRS is rejecting categorically an executor's attempt to file a Schedule N, Special-Use Return, if the executor has failed to supply certain information.

Ordinarily, the executor should have, I think, 90 days to supply the relevant information so that he can proceed to go ahead with the special-use election.

The Chairman. Discussion?

Senator Symms. I support the amendment.

The Chairman. I assume that Treasury and the IRS doesn't like it, but that is because they have had a terrible time, as they think it, with their special valuation rules.

Mr. Secretary?

Mr. Mentz. Well, that is now quite true. Actually, we have sympathy with this amendment. We have had some problems with the forms, switching where the instructions were, so that it is possible that a taxpayer could have gotten fouled up in reporting and making this election.

So, we would be supportive of Senator Baucus's amendment, provided that it be clear that it not apply to a situation where there is no agreement among the beneficiaries to be bound by the recapture rule.

My understanding is that that is what you were intending, Senator Baucus, is that right?

Senator Baucus. I'm sorry. If I understand you correctly, Mr. Mentz, you are asking whether I am in any way changing the rule that the beneficiaries have to file an agreement that they will agree to be subjected to the special-use qualification. My answer is, No, I am not trying to change that. I think the present law should apply.

Mr. Mentz. Right. Very good.

The Chairman. Further discussion on the amendment?

(No response)

The Chairman. Those in favor say Aye.

(Chorus of Ayes)

The Chairman. Opposed?

(No response)

The Chairman. Adopted.

Senator Symms?

Senator Symms. Mr. Chairman, earlier I was asking Mr. Brockway about the rates. You know I backed off of it so we could go ahead and vote on the Bentsen Amendment.

I want to go back to the rates on estate taxes, because you gave me the impression that the tax rate on estate taxes is 18 percent. But that really isn't the case. Isn't it true that you allow a $192,000 credit so that the first dollar -- let's say your estate is $700,000 cash, and you die. How much tax is liable? Isn't it more like 35 percent of the hundred thousand?

Mr. Brockway. Part of it really depends on the credit, the unified credit, which is equivalent to an exemption of $600,000, but whether you have used that credit previously against gifts. If you don't have any credit left --

Senator Baucus. We talked about that, but isn't it true that the taxpayer really doesn't get a $600,000. Once he finally kicks in on the estate tax, it kicks in as though they have taken away the low part of it.

Mr. Brockway. Correct. I think your general point on this is correct. All I am saying is, if you have already used up the credit on the gift, you start in at 18 percent. The way the credit works is, it goes against the lower rate brackets rather than the exemption. So, in effect, if you haven't had any gifts before, taxable gifts, you start in, you use up that credit against all the lower rates, and then you would start in at a 37 percent once you are over that R600,000.

Senator Baucus. So, let's say a taxpayer dies that has a $700,000 estate. The $600,000 is a credit, then the recipient of that estate will owe $37,000?

Mr. Brockway. You are correct.

Senator Baucus. And $37,000 on each $100,000 up until it kicks in at a next rate, and a next rate, and a next rate.

Well, Mr. Chairman, the point that I am getting at is, I absolutely cannot see the logic of this committee reducing the top tax rate to 35 percent on a taxpayer and then turning around and taxing an estate at a rate higher than 35 percent.

I have asked the staff for these numbers. I don't know whether you have them or not, but what would it cost if you taxed the first million dollars of an estate at 15 percent and the second million dollars at 25 percent, and anything over $3 million at a 35-percent rate, and have that be at the top level?

Mr. Brockway. That would be a revenue impact of 2.9 billion over the period.

THe Chairman. Two-point-nine billion over the period to introduce that rate structure.

Senator Baucus: It would be 2.9 billion?

Mr. Brockway. That is correct.

Senator Baucus. I don't know how the other members of the committee, but from my point of view the taxpayer has been taxed all of his or her life, and if they have accumulated an estate, then to have a tax rate of over 35 percnet on it, if we are going to say that the top rate in the economy is 35 percent, just seems inconsistent to me.

Maybe Treasury would want to comment on that.

The Chairman. Mr. Secretary?

Mr. Mentz. Yes. As I mentioned before, Senator, the estate and gift provisions were in Treasury-I but not in

Treasury-II and really haven't been considered since then. The reason that we are trying to get down to 35 percent is because we are seeking to broaden the base and effectuate it in a revenue-neutral way.

Now, I think the way to get there on the estate tax is in a similar process. I don't think you can just cut the rate and sort of leave it without doing more.

I suggest to you that it is worth an examination of the estate tax, and see if we can bring the rates down. But I don't think you can bring them down without doing the base broadening, or you are going to have the non-revenue neutrality that Mr. Brockway indicated.

Senator Symms. Well, Mr. Chairman, I am not going to offer that amendment right at this moment, but I would like to at least have the members of the committee consider that, and maybe I can work with Treasury to work out something.

If there is going to be a reduction in rates, it just seems to me like it is totally inconsistent tax policy to have an estate tax rate at the confiscatory level of 55 percent and then say that the top rate on earned income or unearned income is 35 percent. It just doesn't make sense in terms of fairness, equity, or any other explanation.

The Chairman. You are withdrawing the amendment at the moment?

Senator Symms. I haven't offered the amendment; I just was inquiring about it. I think this is something the committee should consider. It may not be appropriate to offer it today. I would like to reserve the right to still bring that up at a later time.

But I do have an amendment that does not have any cost to it, and it is one that this committee has voted for on two or three occasions, and that is the repeal of the generation-skipping transfers.

I think it would be very prudent for the committee to accept that, to repeal generation-skipping. Just to refresh the members of the committee's memory on what this is, the Treasury has had a difficult time applying these generation-skipping taxes, figuring them out.

But in a nutshell, what it amounts to is, if a taxpayer willed their estate to a person, there would be an estate tax charged on it. And if that person happens to be a grandchild, then there has been an attempt to tax it as it passed through the generation. And it would appear to me that we should just repeal that, so that when a taxpayer dies he can leave his estate to anybody he wants to, whether it is his good friend who lives down the block, or whoever it is. And there should only be one tax paid on the estate, not two.

I would move that. The committee has voted that way on past occasions. It has been wrestled out in conference. I think it would strengthen this committee's position in conference to accept this amendment, also.

The Chairman. Mr. Secretary?

Mr. Mentz. Well, I think that amendment is exactly inconsistent with your preceeding amendment. If you want to try to get the estate tax rates down, it is going to make it tougher if you go in the direction of effectively precluding application of a generation-skipping transfer tax, which has as its principal purpose the ensuring that there is an estate tax paid at every generation.

Senator Symms. How much has been raised with that, though?

Mr. Mentz. Well, the present version of the generation-skipping transfer tax has got some problems with it, and we recognize that. We made some proposals, and the House accepted a version of that last year.

But the purpose of a generation-skipping transfer tax, Senator Symms, is to make certain that there is an estate tax payable or a transfer tax payable at every generation. And under current law the extremely wealthy are able to skip generations, and effectively they are only paying half the tax that everyone else of more modest means is paying. Now, that seems to me to be a fair objective and one that is worth continuing and worth improving.

I think if you don't do this, you are losing large revenue out of the estate tax. And if you lose large revenue out of the estate tax, I just don't see how you are ever going to get the rates down below 55.

Senator Symms. How much revenue has ever been raised out of the generation-skipping thing?

Mr. Mentz. The generation-skipping transfer tax, if that had been in place 20 or 30 years ago so that it would have applied to the large fortunes that have been bequeathed over the course of time, you would be talking about a significant increase in the current estate tax revenues. It is in the billions, Senator.

Senator Mitchell. Mr. Chairman?

The Chairman. Senator Mitchell?

Senator Mitchell. Mr. Chairman, with deference to my friend from Idaho, I would like to urge the committee to oppose this amendment.

We are here losing perspective on what our objective is. And our objective is to reduce tax rates, at least that is one of our objectives, and hopefully make the burden of taxation less on the overwhelming majority of Americans who make up the middle class and the working members of our society.

This amendment would benefit a very small minority of Americans who, by the very nature of the amendment, must be those at the very highest levels of wealth and income in our society.

It seems to me that they are not the persons who ought to be the beneficiaries of our concern.

Senator Symms. Would the Senator just yield? Let's say the taxpayer has $700,000 saved, cash, and chooses to will it to the grandson, or he chooses to will it to the janitor that works in the building that he has worked in for his entire life. Why should the grandson have to pay a higher tax than if he willed it to the janitor? That is the question. It would be $37,000 of tax that would be paid if you pass it to a citizen. If the citizen happens to be your grandson -- or a person, I should say, not necessarily a citizen -- if the person happens to be your grandson or your granddaughter, he is expected to pay double. That just doesn't make sense to me.

Senator Mitchell. Well, I will respond by saying --

Senator Symms. And the Treasury has not ever figured out how to effectually treat the past generation-skipping tax bill; they have raised no revenue with it. I say let's clean it up and make a simple transfer tax, if you are going to have one, and not confuse it.

Mr. Mentz. We would not suggest that be passed.

Senator Mitchell. If I may just respond. The example I think demonstrates the truism that there is no limit to the ingenuity of lawyers, accountants, and I guess politicians, to make up hypothetical examples that might be used in defense of mechanisms whose principal if not exclusive purpose is to avoid tax liability. That is what this mechanism is.

There is no disputing the fact that it would benefit a very narrow segment of American society, by definition those who are persons generally of extreme wealth in relation to all other Americans.

I just think that we ought not to lose sight that part of our purpose is to provide tax rate reduction for working Americans, who aren't going to be concerned about this kind of thing under almost any circumstances, to whom we are trying to say, "You ought to be able to keep more of the money that you earn through your labor."

So, with due respect to my friend, I just think this is not the kind of amendment we should be engaged in. It will lose substantial revenue, as the Treasury has indicated, make the ultimate task that much more difficult, with very little compensating advantage in terms of our overall objective or our nation's interest.

The Chairman. Further discussion?

Senator Symms. Well, Mr. Chairman, I just want to say one last thing, that Treasury has said here they haven't raised any revenue with the generation-skipping transfer tax. So, I think the committee should understand that if they haven't raised any revenue, how can it lose any revenue?

The Chairman. Well, I think this is one of those where I assume the outyear projections are greater and greater and greater.

I realize we are not going beyond five years, but what the Secretary said was, had we had this in effect for the last 20 or 30 years, we would be raising a lot more, a significantly greater deal of revenue.

Mr. Mentz. That is right. Also, the present generation-skipping transfer tax has got some defects in it, and that is why there has been a fair amount of attention on this. Chairman Rostenkowski in the House had a proposal, and it has been worked over pretty thoroughly by the Ways and Means Committee.

The Chairman. Questions on the amendment of the Senator from Idaho? Do you want a rollcall, Steve?

Senator Symms. Well, I would like to pass the amendment. I don't know how.

The Chairman. I think the Clerk had better call the roll on this one.

The Clerk. Mr. Dole?

(No response)

The Clerk. Mr. Roth?

Senator Danforth. Aye, by proxy.

The Clerk. Mr. Danforth?

Senator Danforth. No.

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

(No response)

The Clerk. Mr. Wallop?

(No response)

The Clerk. Mr. Durenberger?

(No response)

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye.

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. Aye.

The Clerk. Mr. Bentsen?

Senator Long. Aye, by proxy.

The Clerk. Mr. Matsunaga?

Senator Matsunaga. No.

The Clerk. Mr. Moynihan?

(No response)

The Clerk. Mr. Baucus?

Senator Baucus. No.

The Chairman. Moynihan is No, by proxy.

The Clerk. Mr. Boren?

(No response)

The Clerk. Mr. Bradley?

Senator Bradley. No.

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

(No response)

The Clerk. Mr. Chairman?

The Chairman. No, and Senator Durenberger, No.

Senator Heinz, No.

The Clerk. Six Yeas, 10 Nays.

The Chairman. The amendment is defeated.

Are there other amendments to the trust and estate section?

Senator Chafee. Yes. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. Mr. Chairman, this deals with disclaimers. It is a matter that we have passed here in this committee before. It has no revenue effect.

Basically, we are dealing with the following kind of case, and this is a specific case:

In 1937, a contingent property interest was created by the death of an individual. In other words, by a "contingent interest" it says if so-and-so happens, then person-A will receive some money. If she survives, she will receive it.

If she doesn't survive, she won't receive it -- if somebody predeceases, and so forth. It is a contingent interest.

In 1970, which was 33 years later, the contingent interest became vested. The circumstances worked out so that it became vested in this individual, and five days later she disclaimed it.

Now, in the interim, the IRS regulations said, "The disclaimer must be made within a reasonable time after knowledge of the existence of the transfer." And between the time that regulation was issued and 1972, the regulation was interpreted in accordance with local law, which most local law said that the disclaimer must be made within a reasonable time after it vested -- in other words, after the person got it, knew she was going to get it, she had to disclaim within a reasonable time.

Now, in 1972, 14 years after the IRS published the regulation, the IRS said the disclaimer had to be made "within a reasonable time after it was created." Now, that was litigated, and in the Eighth Circuit, in the Kanathe Case, it said that the disclaimer must be made within a reasonable time after vesting.

Now, in 1976, Congress got into this matter, and they changed the law prospectively. They said that in order to disclaim prospectively, it must be made within nine months after created, or when the person reached 21. And furthermore, Congress made it very clear that the reason they were making this prospective was because they believed that what the law was was the Kanathe Case -- in other words, the disclaimer must be made a reasonable time after vesting.

Now then, along comes the Supreme Court in 1982 and upheld the IRS and overturned the Eighth Circuit.

All I can say, Mr. Chairman, is this has resulted in tremendous inequities for a few people. Some people disclaimed. You have brothers and sisters. One disclaimed or took the case before the Eighth Circuit, and the Eighth Circuit sustained them, and then the statute of limitations passes. And the other didn't and now is saddled with incredible gift taxes that were imposed because the mother didn't disclaim in accordance with what the Supreme Court says -- in other words, soon enough after vesting.

We have had this before us many times in the past, Mr. Chairman, and what my provision is: The reasonable time after knowledge of the transfer, that shall be satisfied if the disclaimer was made in writing before the Jewett Case, the Supreme Court case.

Treasury, are you familiar with this matter?

Mr. Mentz. My understanding, Senator, is that this has come up before, I think in TEFRA and in the '84 Act. I believe it was in the Senate provision of the '84 Act.

Senator Chafee. That is right. I think we might have passed it twice. Do you know, Mr. Brockway?

Mr. Brockway. I believe you have done it twice, once in a modified form. But it has been up.

Mr. Mentz. Both times over the objection of the Treasury Department, I believe.

Senator Chafee. Well, yes.

The Chairman. You have won an awful lot today, Mr. Secretary.

Mr. Mentz. Maybe I had better not press my luck, huh?

The Chairman. I think this is one you ought to give on, just out of a spirit of comedy.

Mr. Mentz. You have never detected that spirit in me, have you?

(Laughter)

Senator Chafee. Mr. Chairman, we do have incredible inequities come up out of this. One person was meant to have disclaimed, and it turns out he was in Iwo Jima being shot at at the time his disclaimer was due.

The Chairman. Oh. Is this where he didn't learn about it until years later?

Senator Chafee. That's right. We have those situations. And suddenly the person is saddled with these taxes, and the money is gone.

The Chairman. I would be in favor of accepting the amendment. Discussion?

(No response)

The Chairman. Those in favor of the amendment, say Aye.

(Chorus of Ayes)

The Chairman. No?

Senator Bradley. No.

The Chairman. The Ayes appear to have it.

Senator Chafee. There is no revenue effect.

The Chairman. No, there is no revenue impaired.

The Ayes have it.

Are there further amendments to the trusts and estates section?

(No response)

The Chairman. Then I wonder if we might very briefly move to the bond section. There will be not votes on bonds, and there will be no votes this afternoon.

Yes?

Senator Bradley. Before we go on, on the trusts and estates section, there is a special undersea exemption from tax.

The Chairman. What page?

Senator Bradley. Page 216.

The Chairman. Yes?

Senator Bradley. The generation-skipping transfer tax is there for a purpose, and under current law there is a complicated credit and grandchild exclusion. And in the

President's proposal there was a specific exemption of one million per transferor. And I think under your proposal it is the same as current lat. Is that correct?

The Chairman. That is correct.

Senator Bradley. So, there is not the two million per grandchild exclusion from a direct skip?

The Chairman. We just keep the present law.

Senator Bradley. So there is not the two million for a grandchild?

The Chairman. If there is not in the present law, there is not.

Further discussion on this section?

(No response)

The Chairman. If not, let's go to bonds. And the reason I suggest is that Senator Durenberger has taken a lead in I think improving some of the proposals I had, and I think many of them will meet with favor in the committee. We might be able to finish the discussion on the bond section, maybe, in a relatively short period of time -- the discussion; no votes today.

Mary Francis, your turn to do duty again. What page are the bonds on?

Mr. Colvin. It starts on page 186, Mr. Chairman.

The Chairman. Thank you.

Senator Durenberger. Mr. Chairman, if I might, while

Mary Frances and John are getting settled, let me say that while it was difficult coming to agreement with you, which is not unusual because of the dollars involved, I don't think there was a lot of disagreement on the basic principle that state and local government in this country is to a degree, in the current markets, dependent on tax policy for the maintenance and the construction of infrastructure.

We had a hearing on this subject in this committee before we started this markup. I appreciate the fact that you have accommodated in our agreement, which I understand will be explained to us here this morning, you have accommodated many of the principles embodied in my tax-exempt bond legislation, S. 2166, and kept it within the revenue constraints of this bill.

I would like to note some of the important improvements we have achieved through this agreement. Of utmost significance, I think, is the agreement to maintain the 25-percent use and security interest tests in current law. That will enable state and local governments greater flexibility in providing necessary services, because the 25-percent test, when coupled with liberalized management contract rules, allows local governments to move further in working with the private sector to deliver community services.

Our agrement further provides that bonds issued for multi-family housing projects will not be included in a state volume cap. That, Mr. Chairman, is incredibly important in this time of the need for providing adequate shelter across this country.

I believe it is vitally important that state and local governments be allowed to expand the nation's housing stock, particularly for those who need decent, affordable shelter. And this agreement gives them that opportunity.

We have also taken steps to safeguard the right of state and local governments to finance infrastructure like water, sewer, and solid waste. Publicly-owned facilities will not be subject to any restrictive state volume cap, and those facilities that are privately-owned will continue to enjoy improved depreciation.

The growing problem of hazardous waste disposal is also addressed in our agreement Governmentally-owned facilities are not restricted by the state volume cap, while private operators of hazardous waste facilities that are covered under the volume cap will be able to take advantage of the benefits of accelerated depreciation, as well as qualifying for tax-exempt status.

By the way, Mr. Chairman, this is incredibly important, because last November 8th, when we announced the new regulations under RCRA for groundwater monitoring and so forth, of the 1500 hazardous waste sites in this country, a thousand of them announced they were going out of business, leaving us with 500. Of those 500, only three have permanent licenses. All the rest are still on interim licensing.

This is a very, very difficult business to get people to go into, and so I appreciate your sensitivity to that particular need.

In addition, of critical importance to our nation's future and our international competitiveness, in particular, is our ability as a society to provide the best educational opportunities for today's students. Our agreement not only provides for the continuation of tax-exempt financing for a federally-guaranteed student loan program but also allows tax-exempt financing for state supplemental loan programs.

Mr. Chairman, the issue of true abuses of tax-exempt financing is an important one. We have also reached a workable agreement that addresses how, if at all, state and local governments that violate the restrictions on arbitrage will be penalized.

We have agreed that the Treasury must notify state and local issuers of these bonds when it appears they have violated arbitrage restrictions. Issuers will then be given a six-month period to cure any defects in their investments. And if the defect is not cured, they will have to rebate arbitrage profits to the Federal Government. Failure to rebate will result in a penalty imposed on the issuer; however, the Secretary of the Treasury will have discretion to waive the penalty.

Mr. Chairman, the alternative to that, of course, was a penalty that fell on the purchaser of the bond, which in effect raised the cost of the bond to the local government. This agreement gives us a workable penalty and one that will continue to hold down the costs to local government and the taxpayers of tax-exempt bond financing.

The Chairman. I want to thank Dave Durenberger. There is probably nobody who has spent more time on inter-governmental relations or the necessity for financing local governments than you have, and I think the suggestions you have made are capital, and I think it makes the bond provisions we have a very good package.

Senator Durenberger. Thank you, Mr. Chairman.

The Chairman. Discussion? You will notice hazardous waste is in there.

Senator Bradley. Mr. Chairman, I noticed hazardous waste is in there, and I think that is a very important addition.

As Senator Durenberger points out, there are literally hundreds of sites across the country, and we are going to have to decide how we are going to dispose of them. I think this provision will help us get an answer to the question of how to dispose of toxic wastes. It is a problem that faces every state in the country, and I think that this will facilitate us building those facilities that will permanently destroy toxic waste, not simply move it from one form to another or from one place to another.

I might say, Mr. Chairman, that I have a concern on this section, though, as it relates to solid waste. As I understand on the hazardous waste issue, it is covered appropriately. But on the solid waste there is a choice that has to be made -- is that correct? -- between tax-exempt status or depreciation?

The Chairman. You cannot not double-dip.

Senator Bradley. You have to choose one or the other, is that correct?

The Chairman. Mary Frances?

Ms. Pearson. Would you repeat that? By "solid waste" are you speaking of hazardous waste?

Senator Bradley. Solid waste, garbage.

The Chairman. You have to make a choice between depreciation and tax-exempt status.

Ms. Pearson. Right; exactly. If you are outside the cap. If you are under the cap, If you are under the cap, we haven't decided the rule. The staff is still talking about depreciation with reference to being under the cap and getting depreciation.

Senator Bradley. And if you are under the cap, you are a non-government entity. Is that correct?

Ms. Pearson. You would be an IDB, yes.

Senator Bradley. Government entities are outside the cap up to 25 percent private ownership, is that correct?

Ms. Pearson. Yes.

Senator Bradley. And they then have tax-exempt status, but they do not get the depreciation. Is that right?

Ms. Pearson. Right. If you are governmentally-owned you don't get depreciation.

Senator Bradley. Up to 25 percent private.

Ms. Pearson. Yes.

The Chairman. You lost me there on your question.

Mr. Hardock. I believe the 25-percent test is a use test, not an ownership test. There could be situations where the use by the private party of say 24 percent of the facility might rise to a level of ownership, and therefore he might get the depreciation, whatever the depreciation that is chosen for tax-exempt finance property is. But in most cases the use will not rise to that level, and you will not get depreciation in a situation where a facility is 76 percent governmentally-owned.

Senator Bradley. Mr. Chairman, at some point I would like to come back to this.

The Chairman. We will be voting on this on Thursday morning. Again, I have four or five amendments that members have said they had -- Senator Baucus has one, I know, and

Senator Heinz has one. If they want to talk about them now, I would just as soon talk about them. And then we will vote on Thursday morning and try to dispose of this section.

Senator Boren and then Senator Baucus.

Senator Boren. Mr. Chairman, I may well. As I understand, the compromise proposal does not change the staff draft in terms of advanced refunding. Is that correct?

Mr. Colvin. That is correct, Senator Boren.

Senator Boren. I do have some concern about that. I may want to offer an amendment in that area, with the economic conditions that we are facing. The fact that the funds are invested back in escrow in government securities, this often has some residual benefit back to the Treasury.

But those areas of the country that are having a great deal of trouble with the flow of capital right now, in order to meet the local needs, are having to consider reliance, increased reliance, on refunding in certain circumstances.

We have had an actual shrinkage of the amount of private debt outstanding in our state, you might say an actual contraction of credit. In the past three years it has been rather astounding. Usually credit outstanding and the availability of credit will grow in a healthy economy, something like five percent a year. We have been having actual contraction, which is making it more and more difficult for us to meet both the private and the public sector needs.

So I just raise that question. I am not prepared at this time to know what I think the solution ought to be, but I do think it is a problem.

The Chairman. Let me take Senator Baucus.

Max, you had a question on research grants at universities, and I think in a discussion right here we might be able to settle it satisfactorily, and you won't need an amendment, if you want to raise that issue.

Senator Baucus. -- mainly the Irish dairy subsidies.

The Chairman. This is the "kill the cow" amendment?

Senator Baucus. That's right, the kill the cow amendment.

The Chairman. You are not the only one that has mentioned that subject to me in the last few days.

Senator Baucus. I have an amendment which I will offer.

The Chairman. All right.

Senator Danforth?

Senator Danforth. Mr. Chairman, as I understand the proposal, there is a $150 million institutional cap for private institutions.

The Chairman. That is correct, on the theory that $150 million for one institution, considering that they are obsoleting the 501(c)(3) kind of aid?

Senator Danforth. Yes.

The Chairman. Considering that they are outside of the volume cap, anyway; it was a pretty good cap.

Senator Danforth. Right. But there are certain private universities, particularly those with medical schools, that are already at or over the $150 million. The concern is that if they are brought within an institutional cap, the result will be that they will be in a disadvantageous position relative to public universities.

I wonder if there would be a possibility of eliminating this cap for educational institutions?

The Chairman. That is an amendment that is going to come up. I don't know if you would want to say for every 501(c)(3) there is no limit -- 250, 350, 450 -- period.

Senator Durenberger. Mr. Chairman, as I understand the concern, there is some legitimacy to the concern -- that is, the discriminatory effect of a $150 million cap on private universities that doesn't exist on public universities.

When I first heard about that, my first reaction was to impose the same limit on both. I mean, that is one way out of the discrimination problem, and I don't think there is automatically any great value to subsidizing bigness or largeness.

If we aren't deciding the issue right now, that is an alternative.

Senator Danforth. Are we?

The Chairman. We are not going to vote.

Senator Danforth. Right, but if we can discuss it just briefly, it seems to me that if one of the things we are going to try to do in this country is to encourage education and research, and if a number of these universities already exceed the cap, we son't want to put in place a system which imposes a cap for the future which is an absolute one.

The Chairman. Mr. Secretary?

Mr. Mentz. Mr. Chairman, I would just like to mention that item 7 would require that the Treasury SLGS program, the state and local government series that are issued currently to comply with the rules involving restricted yields, could be modified as of 1-1-87, I think, first of all, that is too tight a time schedule. But maybe the better way to go here would be to see where we come out with the tax legislation and what the restrictions are, how they end up on restricting yield. Because it is just the restricted yield obligations where you need Treasury SLGS. And where an issue is unrestricted, having the Treasury window open for that issue, and particularly making it available on kind of a demand basis, I am told, puts a major strain on domestic finance, Treasury's domestic finance office. So I would just like to raise that one with you.

The Chairman. The point is well taken.

Mr. Mentz. Thank you.

The Chairman. Further discussion on the bond section?

Senator Danforth. Well, coming back to the same subject, I wonder if there would be a possibility of taking care of this problem.

The Chairman. What is the Treasury's view on a \$150-million cap, a private cap, to 501(c)(3)s?

Mr. Mentz. We are supportive of the cap, of the \$150 million, even though it affects your institution and mind, Senator.

Senator Danforth. Well, I am not raising it for that; I am raising it for a different institution.

Mr. Mentz. I know.

Senator Danforth. I would think that one thing we would want to do, if we are just restricting it. I am not really raising it with respect to all 501(c)(3) organizations, but with respect to universities.

If we are interested in having first-rate universities, first-rate research institutions, recognizing that the construction of research facilities is going to be very expensive, and that some of these organizations are at their caps now, it would seem to me that we would not want to have the cap.

Also, I would think we would not want a situation where one kind of a university can take advantage of tax-exempt bonds, and another cannot.

So, as a matter of equity and also a matter of trying to foster high-quality research and up-to-date laboratories and university hospitals, and the like, it would seem to me this would be one thing that we could change.

Is there a revenue effect? Does anybody know what the revenue effect would be of removing the institutional cap for universities?

Mr. Brockway. Our estimate is that that raised point-one in the Chairman's package, so eliminating it would lose point-one off the package.

Senator Danforth. Point-one if it were limited to universities? If we just removed the cap?

Mr. Brockway. That would be the entire rule, I think.

Senator Danforth. For all 501(c)(3)s?

Mr. Brockway. But basically where I think it comes up as a significant issue is for universities, because hospitals themselves are out, so that where this would have an impact would be a number of large universities.

Senator Danforth. And those with medical schools.

Mr. Brockway. Right.

Senator Danforth. I mean, the hospitals might be out, but the medical school would be in.

Mr. Brockway. The medical school would be in the hospital. If it is associated with it, it would be out.

Mr. Mentz. Mr. Chairman, it is worth understanding a little bit of the rationale of that 150 million.

For a university that is well-endowed, there is an arbitrage opportunity, where if tax-exempt bonds are floated and the endowment is invested at taxable rates, there is an arbitrage opportunity there, Senator Danforth, and I believe that is the genesis of the proposal.

Senator Danforth. You mean, in other words, you are saying what they should do is to sell their endowment rather than borrow?

Mr. Mentz. Well, I am saying if they continue to borrow $200,300,400 million and are investing a substantial part of their endowment at taxable rates, there is an arbitrage benefit to the university and a corresponding loss to the Treasury.

I guess what I am saying is, if they need financing, once you get past $150 million --

Senator Danforth. But isn't this a fine line to draw? In other words, if we are to say, "Well, let's start drawing lines between well-endowed universities and not so well-endowed universities, let's draw lines between public and private institutions, isn't that cutting it a little thin?

Mr. Mentz. I think the 150 is fairly generous; but, you are right, it is a line drawn. It is just a point where you say up to 150 it is okay, but beyond that you have to borrow taxable, is really what the basic message is.

Senator Danforth. The problem here is, as I understand it, is around 15 to 20 universities. And if we hit the target, it is not exactly a great matter of tax reform; it is just saying, "Well, here are 15 to 20 targets we want to hit," and they happen to be at private universities, particularly those with substantial investment and research facilities, ans so forth.

And if the revenue effect is point-one, it seems to me to be a very small revenue effect for a significant impact on some of our finest educational institutions.

Is somebody going to offer an amendment, did I year you say, Mr. Chairman?

The Chairman. No, I was talking about an entirely different subject. Somebody is preparing to offer an amendment on the 150, but we are not taking any amendments today because we are not going to vote today.

Senator Danforth. Well, I am going to try to work this out with Senator Durenberger in the hopes that he will continue to take the lead in this.

The Chairman. Senator Grassley just asked what we are taking up. We are taking up individual this afternoon -- individual rates -- but not the rates, the exemptions, the standard deduction, or earned income credit. That will be at 2:00, and there will be no votes this afternoon.

Any other business?

Senator Durenberger. Mr. Chairman, quickly, on page 187 of the spreadsheet, the definition of private loan bonds?

Just to make it clear to everybody.

I think our agreement is that we are going to try to go back to pre-Technical Corrections Act language in our definition of private loan bonds. That is something that we got ourselves in trouble with, trying to define those restrictively.

I think our agreement is that staff is going to try to work out a specific definition.

Ms. Pearson. Our agreement is staff is going to consult with Treasury and try to determine what present law is pre-technical corrections. There is some question.

Senator Durenberger. It could be a difference between what I said and what you said, I take it.

(Laughter)

The Chairman. But hopefully we might have something by the time we start to mark this up.

Senator Durenberger. All right. Thank you.

Ms. Pearson. Yes, sir.

The Chairman. We are in adjournment until 2:00.

(Whereupon, at 12:20 p.m., the meeting was recessed.)

AFTERNOON SESSION

(2:13 p.m.)

The Chairman. The meeting will come to order, please. John, let's start down the list of things we have to consider this afternoon, skipping the rates and the earned income credit, the standard deduction, and the one other issue we are going to skip.

Mr. Colvin. That means you are starting on page 3?

The Chairman. Right.

Mr. Colvin. The first issue is the limitation of the value of itemized deductions and the personal exemption to 25 cents on the dollar.

The proposal would not apply to mortgage interest, real property taxes, or charitable contributions but would apply to other itemized deductions and the personal exemption.

The Chairman. And that raises about $21 billion?

Mr. Colvin. That is correct.

The Chairman. Next?

Mr. Colvin. The next issue is repeal of the marriage penalty relief provision. The marriage penalty relief would be provided through the standard deduction and rate schedule changes. The next issue is --

The Chairman. And that picks up $27 billion?

Mr. Colvin. That is correct.

The Chairman. The reason I mentioned these is that we are now into immense numbers, all of which are --

Senator Danforth. You had better move fast before everybody gets here.

(Laughter)

The Chairman. John, we can give all of these away very quickly if they get here.

Now, we are starting to get into the "wheat," as I call it, of what provides the revenues for the rest of the bill. And at any stage when we start tinkering in any immense a way with some of these, again, we are deeper and deeper in the hole.

Earned income credit?

Mr. Colvin. That, you would pass over for now?

The Chairman. Oh, that is right, although we lose $12.6 on it with the way we have changed it.

Mr. Colvin. The next issue is the repeal of income averaging.

The Chairman. That is the same as the President's proposal.

Mr. Colvin. Then, on page 5, there is the question of exemptions for the elderly, and the proposal is the same as the House bill to provide a $600.00 extra standard deduction for each person over age 65 or blind.

The next issue is on page 6, unemployment compensation; and the proposal is the same as the President's proposal and the House bill to tax all unemployment compensation without the dollar threshold as provided in current law of $12,000 for singles and $18,000 for marrieds.

On page 7, the proposal retains the current exemptions or exclusions for workers' compensation and Black Lung disability benefits.

On page 8 is the issue of scholarships and fellowships. The proposal generally taxes scholarships and fellowships except those which are directly for tuition payments.

The Chairman. Senator Danforth?

Senator Danforth. Mr. Chairman, obviously, this is going to be a controversial item. I know Senator Baucus has expressed a concern about it. I have a concern about it.

How much revenue is picked up by taxing scholarships?

Mr. Weiss. It is about $600 million over the period.

Senator Danforth. I again wonder if this is really the kind of thing we want to be doing. I mean, to tax scholarships income, even if it doesn't cover the tuition part of the scholarship, seems to me to be the opposite kind of policy we should be adopting.

Senator Moynihan. Would the Senator yield, please?

Senator Danforth. Yes.

Senator Moynihan. I think we have all of us had college administrators call on us to make the point that scholarship recipients who would be most affected by such an act would be probably those who were most in need of scholarships.

I think it takes on an unintended, but a real, bias against those in the very expensive graduate schools, such as medicine. It does take on a real bias against precisely the group of people you think you are helping and want to help with scholarships.

Senator Danforth. I have a memo here from Yale University, and I would just like to read one paragraph because it gives their projections of what this would mean:

"It is estimated that approximately $6.12 million currently received by 1,092 of Yale's graduate and professional students for nontuition expenses would be considered taxable income if the Finance Committee draft proposal were enacted.

"This would mean that a National Science Foundation graduate fellow with no other income in 1986 and a stipend of $11,100 could be obliged to pay $990 in taxes. This would reduce his or her stipend won by merit in a national competition to $10,110, or $300 below estimated living expenses for a single student.

"A university fellow receiving a stipend of $6,000 for nine months would pay at least $215 in taxes, $1,700 short of living expenses."

I would hope that maybe we could not go forward with this suggestion.

Senator Moynihan. Could we ask if the--

The Chairman. Senator Moynihan?

Senator Moynihan. Do we really believe that there is $600 million?

Mr. Weiss. Senator Moynihan, our estimate is that there is about $100 million a year of additional tax collected from these scholarships.

And this proposal is not only for degree candidates, but it is also for nondegree candidates because those are allowed some exclusion under present law.

So, there is a substantial amount of revenue here. It should be pointed out, of course, that this only applies to the extent it is above personal exemption and whatever standard deduction the individual might be entitled to.

Senator Danforth. But it still comes out of students'-- Mr. Chairman, one point that I think deserves making is that in our whole approach to the budget, obviously we pay interest on the national debt, and we have decided to hold the Social Security harmless, and whatever we do on national defense will be a break-even or around a break-even.

And that means that we are targetting for special cuts in the budget those areas in Federal spending that deal with the future of the country on the domestic side.

The President's budget will not be adopted, but the President's budget targets for a reduction of 18 percent, that very small fraction 9 percent of total Federal spending which is investment in the future.

And I think that at a time when, for budget purposes, we are being particularly strict on the future, on our kids, we shouldn't be reducing our tax rates for us and at the same time picking up the lost revenue by taxing those scholarships.

Senator Moynihan. Would the Senator from Missouri agree that this would have to have the effect of reducing the number of qualified students in graduate schools? I mean, we will have fewer men and women in physics, medicine, and the varied and complex activities which I think cost upward of $1 million to produce a Ph.D. in astrophysics now, and they are getting less help from the Federal Government.

And the students can't afford it either, or they have to give more to make it possible; we give less in the way of higher education in very important fields.

Senator Danforth. I mean, this is to say that we are essentially taking $600 million over five years out of higher education to help finance the general rate reduction, and it seems to me to be not a good approach.

The Chairman. I think your point, I am not going to say is well made because I am going to defend this position, but I know there is going to be an amendment offered when we come up. So, why don't we pass on because we have more controversial issues--additional controversial issues to talk about.

Senator Chafee. Mr. Chairman, could I just ask one question? I am sorry I missed the first part of this discussion. What about something like, say, the so-called MacArthur fellowships? Have you discussed those?

The Chairman. Not yet.

Senator Chafee. Those are very, very generous. As I understand it, they take several years off to follow a pursuit that of course you design for yourself; no requirements on it. Most of them are scholars.

Is that a scholarship, or is that a fellowship? And if so, what is the difference, and what are the tax consequences?

Let's say that Senator Danforth's view prevailed on that also. Would that be tax-free?

Mr. Weiss. There is a related provision that the committee discussed yesterday on prizes and awards; and under the chairman's proposal, prizes and awards would be taxable as well as scholarships and fellowships.

So, it really wouldn't matter whether it was considered a scholarship, fellowship, or prize under the chairman's proposal. There would be no difference in tax treatment according to this categorization.

Senator Chafee. Now, what would happen under Senator

Danforth's proposal, or following the line of inquiry he is pursuing, and Senator Moynihan? What would happen, say, to the MacArthur fellowships?

I think they are very substantial: in the neighborhood of $30,000 to $50,000 a year, aren't they?

Mr. Weiss. That is correct. And Senator Danforth would have to draw the line that you are suggesting be drawn, whether for example this proposal would apply only to degree candidates or whether it would apply to people who are formally enrolled in school or whether it would apply to all such cash grants for the purpose related to education.

So, those are the kinds of lines that would have to be drawn.

Senator Chafee. Mr. Chairman, I am sympathetic to the thought that is being expressed here, trying to tax these scholarships for, as I understand, the nontuition portion of it.

It presents problems, although I suppose on the other side of the coin you could say that we are taxing unemployment compensation. Was that mentioned?

We are taxing the guy who doesn't have a job on his unemployment compensation.

The Chairman. On that, though, I think the Administration's proposal and the House bill argument was this. If he or she were working, they would be taxed.

Senator Chafee. Yes.

The Chairman. The unemployment compensation is a substitute for the income they make by working.

Senator Chafee. Right. I am not opposed to that.

The Chairman. All right.

Senator Chafee. I am not opposed to it. I am just saying that you can get into sticky situations here. Frankly, I think in the best of all worlds, you would be taxing all income that is received, and that is fairness.

But I do think we have to be aware of the difference between somebody who is pursuing a degree and somebody who has received one of these very generous fellowships which has run up into-- What is the MacArthur fellowship? Is it $50,000? I haven't received one. How about you, Senator Moynihan?

Senator Moynihan. I am open to one.

Senator Chafee. I didn't say I wasn't open. I just said I hadn't received one.

Senator Moynihan. They really aren't scholarships, are they?

Senator Chafee. They are fellowships.

The Chairman. They are rewards.

Senator Moynihan. They are grants.

Senator Chafee. Grants.

Senator Moynihan. A few are--post doctoral --

Senator Chafee. I don't think they are limited to post-doctoral things. If you so chose to get your doctorate --

Senator Moynihan. What I mean is that they are for established scholars, and they are recognized as such.

The Chairman. They are almost rewards for extraordinary service performed in the past; take the money and do what you want because you have proven that whatever you are doing is worthwhile.

Senator Moynihan. They are not in the sense that we mean scholarships. They are something different. We are talking about training people who are in graduate schools, or undergraduate schools for that matter.

Senator Chafee. All right. Thank you.

The Chairman. Let's go on to the deduction of State and local taxes.

Mr. Colvin. On page 9, the proposal would repeal the itemized deduction for sales and personal property tax. It retains the deduction for real property tax, and I would just refer you, with respect to the income tax, that it would be affected by the limitation in the value of deductions to 25 cents on the dollar.

The Chairman. Roughly, you are saying that there would be a slight limitation on the income tax deduction for those people making above--at least on a joint return--about

$70,000 to $75,000.

Mr. Colvin. With a family income of about that amount or higher.

The Chairman. Yes. I want to ask the Treasury a question. Let me ask you a question first, John.

The revenue estimate on this is supposed to be $27 billion, isn't it?

Mr. Colvin. If you include the income tax portion, that would be $19.8 billion from sales and personal property.

The Chairman. Right.

Mr. Colvin. And about an additional $10 billion from the income tax.

The Chairman. The income tax is not under number one?

Mr. Colvin. It is counted in the item limiting the value of the deduction to 25 cents on the dollar.

The Chairman. All right. So, you get about $27 billion for all of them. Now, I want to ask Treasury a question.

The President's proposal, as initially introduced, drew rather good comments from a lot of tax reformers.

Mr. Mentz. Drew what?

The Chairman. Good comments from a lot of good tax reformers. And yet, some of those who have blessed it and criticized us have been some of those who have absolutely blistered any elimination of any State and local tax deductions.

What would you have done, had you had to produce a bill for the Administration but would not have had the $112 billion that the President achieved by a total elimination of the local tax deductions?

Mr. Mentz. I guess we would have looked for some other source of revenue.

The Chairman. I understand that. Where would you have looked?

Mr. Mentz. We might have looked at excise tax.

(Laughter)

The Chairman. It is amazing how you come full circle.

Mr. Mentz. Isn't it?

The Chairman. What was the full figure on elimination of the State and local? I notice on my chart it is $111, as opposed to our $19. Is the income tax someplace else in that, John, and it would make the Administration's more than $111?

Mr. Colvin. This includes the income tax.

The Chairman. Theirs does include it? All right.

Comments. As I say, we are not into million dollar items now, or even $500 million; we are into billion dollar items.

Senator Moynihan. Mr. Chairman, let me begin. As you know, some members of the committee --

This is the first issue of taxation relating to the issue of Federalism. Our first income tax was adopted in

1862, a one-year tax to finance the Civil War. At that time, the chairman of the committee on ways and means was Justin Smith Merrill; the Merrill Act that we have talked about.

And in his bringing the bill to the floor of the House, almost the first thing he said was that no Federal tax will be levied on any tax paid to a State government or a subdivision thereof. He made clear his judgment at a time when these issues were at the very center of the national life.

This would be a genuine invasion by the Federal Government of the autonomy of State governments.

And a century later, a century and a quarter later, I am one who is for the principle to continue. If we are going to have a Federal system in which State and local governments have initiatives, have the capacity to do things other than those the Federal Government authorizes, they have to have the resources. You know that argument.

Let me ask on another level. We have had before us some testimony. Martin Feldstein, the former Chairman of the Council of Economic Advisors under President Reagan, who made to some of us the compelling argument that there won't be anything like the revenue gain that is indicated by a static assumption that no State or local government will change its behavior--its tax pattern--in response to our changing the treatment of those taxes.

He said when the proposition was to abolish the State and local deductibility all together, he said far from gaining revenue, he could see a situation--and this, he was speaking as President of the National Bureau of Economic Research--he could see a situation in which we would lose revenue.

The simple fact would be the States finding that they could not deduct, that no longer having the individual deductibility of their taxes would shift to businesses to tax businesses where it wasn't covered.

And we have here at the very heart of our whole discussion: What will be the fiscal effect of our tax bills going up? Are we going to just deepen the deficit situation?

Are we going to assume revenues that aren't going to be forthcoming? Are we going to go through an exercise we have gone through before?

And I would like to ask the Joint Committee, Mr. Weiss, and ask Mr. Mentz: How do you respond to the proposition that States will change their own pattern of their taxes in such a way that the revenue will not be gained by the Federal Government? And we might indeed end up worse off than we are now.

Mr. Weiss. I guess, as a matter of constructing the revenue estimates, I guess there were a couple of things we took into account.

First of all, certainly, it would be possible that States could adjust to the change in the rules for deductibility. However, it would seem that any such adjustment would take a fairly long period of time.

The States presumably would not automatically and immediately adjust, even if they were to adjust in the future.

So, just as a matter of estimating, we assume in effect that any such adjustment would take place beyond the five-year window that the estimates have concentrated on.

Now, with respect to the particular estimates that the chairman's proposal includes, I guess there are two issues: the repeal of the deduction for sales taxes and the effect of the limitation on State and local income taxes.

Now, on sales taxes, we note that roughly three-quarters of all the sales taxes that State and local governments collect is already not reported by itemizing.

So, three-quarters of the sales tax, because that is largely paid by middle-income and lower-income people who are either nonitemiziers or nonfilers, in effect, a lot of that adjustment could already have taken place because the itemized deduction for sales tax does not seem to be a dominant force, at least insofar as when you compare itemized deductions to total sales tax collections.

With respect to the income tax, again, I guess --

The Chairman. Let me go over that again, Randy. The upshot of it is, you are saying, so few sales taxes are itemized now that the loss of the deduction would hardly be the inducement for States to totally get out of the sales tax business.

Mr. Weiss. That is correct. Only about a quarter of the sales taxes show up as itemized deductions. Then, the effect can't be that large, even if there is to be one at all.

The Chairman. As I look at, in 1984 $81 billion in general sales tax was collected State and local; $18 billion was claimed as deduction, which puts you down about 22 percent.

Mr. Weiss. That is right.

Senator Durenberger. Mr. Chairman, can we explore that just a little bit? I mean, what is the proof for the statement, Randy? The rationale there is that people in the lower and middle income brackets just don't deduct?

Why isn't the fact that you want to know what your real estate property tax deduction is? You have a statement. You just look at it, and there it is.

And with regard to income tax, you have that same sort of thing; but with the sales tax, you don't.

How do you know just who doesn't report it?

Mr. Weiss. It is a matter simply of comparing two numbers. First of all, we can tabulate the total sales tax deductions claimed on individual income tax returns.

And we can then compare that to the figure which the Cencus Bureau says is the total collections by State and local governments of general sales taxes.

And in simply comparing those two numbers, we find that itemized deductions actually showing up on individuals' returns are about one-fourth of the total collections that State and local governments actually report.

So, it is simply the comparison of those two figures that I am reporting.

The Chairman. Whereas on the income tax, if I look at it, you have got $66 billion in State and local income taxes, but $57 of it is claimed as a deduction.

Mr. Weiss. That is correct.

The Chairman. Mr. Secretary?

Mr. Mentz. I would like to respond to Senator Moynihan. I can always tell whether Senator Moynihan is throwing me up a nice slow pitch or a fast curve ball; if he calls me "Mr. Secretary," I know it is a slow pitch; and if he calls me "Mr. Mentz," I know it is a fast curve. And if you noticed, he referred to me as "Mr. Mentz" in this question.

(Laughter)

Mr. Mentz. To start with the federalism point that you made, and I think quite eloquently, federalism is a dynamic concept. It used to be that there was a view of federalism that it would be unwarranted and improper for the United States Government to tax the salaries of State employees, and it would be similarly improper for a State government to tax income of Federal employees.

I think that is pretty well by the boards.

The question of whether income on municipal bonds should be subject to Federal taxation, whether it can Constituionally be subject to Federal taxation, is certainly a federalism issue. And I would say it is certainly not one that has been absolutely answered since the Congress has never chosen directly to tax such interests, although by amending the provisions of the Internal Revenue Code dealing with Section 103--dealing with tax-exempt bond interest--clearly there is a Federal regulatory, or a least a statutory overlay of the concept, and therefore the concept has changed.

It has certainly changed since 1968 where we had a very pure provision in the Internal Revenue Code--just one little line. It said "Gross income shall not include interest on the indebtedness of States and municipalities."

I think where we are going historically on the issue of deductibility of State and local taxes--I think the chairman's proposal is moving in the direction that has already started.

We had, I think back in the 1960s--it might have been 1964--a repeal of the deduction for the gasoline, State and local gasoline, taxes.

That repeal perhaps had maybe a little issue of Federalism there; I don't know, but the basis for the repeal, I think, was a very good one.

It is very hard for a taxpayer to figure out his receipts, or how much he paid for his gas and have a receipt every time he goes to the gas station; and itemizing those deductions was a serious compliance problem.

Senator Durenberger. If you will pardon me, the same thing is true of the sales tax.

Mr. Mentz. I was coming to that, Senator Durenberger.

Senator Durenberger. Right. Go ahead.

Mr. Mentz. The same thing is true of sales tax, and the IRS tells me that in their full-blown taxpayer compliance audit, for taxpayers who have taken deductions for sales taxes, 41.5 made errors, or at least there were adjustments in those cases; and had they projected that same statistical error rate, there would have been $107 million more revenue raised out of the sales tax deduction, were that kind of audit possible across the board.

Of course, it is not. That type of audit is merely a small microchasm of the array of taxpayers.

So, for the sales tax, I would suggest to you that it is going in the direction of the gas tax. It is very difficult for taxpayers to keep records of sales tax deductions.

Sales tax itself is somewhat regressive since lower income people generally spend a higher portion of their revenues on items that are subject to sales tax.

And by allowing a deduction which is generally taken only by the one-third--the highest one-third--of the taxpayers, in effect the sales tax is being made more regressive through its interaction with the Federal income tax.

So, I think the chairman is very much on the right track in proposing the elimination of the deductibility of sales taxes and personal property tax, which is a fairly minor item.

When you get to real property taxes and personal income taxes, he of course does not repeal those; the President would. The Administration proposal was sort of a full boat --eliminate all individual tax deductions for State and local taxes--on the theory that that is a benefit that is realized again by the highest income individuals and a similar benefit is not available to lower income individuals.

That argument has met with--well, a lot of people strongly agree with it--a lot of people violently disagree with it. And I suspect that there would be at least that division on the committee.

I can think of one who would violently disagree with it, but I think the better way to deal with this problem, just like you deal with any problem when it is a hard problem, is you sort of parce it into sections where they are a little bit easier to understand.

And I think what the chairman has done is he has taken out two deductions that clearly ought to be out. They are problems in current law. You get rid of the sales tax. You get rid of the personal property tax.

You are improving and you are simplifying the tax law; and by reason of the rate reduction, you are significantly improving the tax law and not adversely affecting many, if not all, of the people who are in the position where they are taking those tax deductions today.

Now, on the revenue question, we considered the very point that Marty Feldstein made, which is wouldn't it be possible for States and localities and municipalities to shift into other forms of taxes.

And the answer is: It is not that easy. It is not easy for a municipality, for instance; it is raising its money for its school system through a local property tax, to somehow change that into a business tax.

They may not have business in that community. It may not be a situation where that can be easily adjusted.

You take a State that has a high income tax. It perhaps would be possible over time--for instance, New York, let's say--to switch from an income tax on individuals to perhaps a business tax that would effectively be imposed on the employer rather than the employee.

Theoretically, that is possible; but as a practical matter, you are going to have individuals and businesses making decisions, you know: Do we stay in New York? Do we move?

There are other decisions that will probably overtake the governments involved in making that decision.

So, I think in a kind of a theoretical world, maybe you could have some shifting back and forth and some reorienting of the tax system so that you get a fully deductible tax, even though you started out with one that wasn't; but at least from the analysis the Treasury did--and we were concerned about the revenue because, as the chairman mentioned, it is a big item in our package--our analysis was that there wouldn't be very much shifting, and indeed we could hold most of that revenue.

I think that is particularly true in the chairman's proposal which, of course, doesn't go as far as ours. And I think Secretary Darman would like to add some remarks.

Mr. Darman. Senator Moynihan, this is just with reference to the question of the revenue estimate, in your citing the distinguished President of the National Bureau of Economic Research as a source.

I would say the distinguished Senator from New York is a source on the fallability of economic estimating, first. Then, in this particular case, I would call to your attention that this source forecast a growth recession for 1984, which did not materialize.

He forecast that if money were loosened in 1984, we would have substantially rising inflation in 1985 and 1986. We have, of course, had money loosened and inflation has been falling.

But then, I would suggest further that, on the particular point about shifting to corporate taxation, one of the strongest, common sense arguments against that as a likely pattern of behavior is the Federalist argument itself.

To a substantial degree, the States are in competition with each other. Among the things they compete for are businesses to be located within their States.

And it would not generally be judged these days to be in their interest to shift the burden of taxation to business within their States and thereby disadvantage themselves relative to competing States with respect to the location of additional plants, new plants, and so on.

The best case in point, in fact, is the State from which the President of the National Bureau comes, the State of Massachusetts, which used to be known as the State of "Taxachusetts," as you know; and in more recent years has decided to compete with its tax program, to compete for businesses; and it now has the lowest rate of unemployment in the nation and a very high degree of business formation within the State. It is a net winner.

Senator Moynihan. First of all, I don't want to speak to what anyone else does. First, the point that Mr. Weiss made about it takes time, and Secretary Mentz made the same point.

I think that goes to the out-year problems that Senator Danforth was talking about just the other day in terms of depreciation.

On the one general proposition that taxing affects behavior, for two weeks now we have been amending the chairman's proposal on the grounds that it will have some desirable behavioral effect in businesses and individuals.

And you know if you change tax patterns, you will change behavior. You can't always predict in what direction, but you will change it.

I will make this point: that the President's original proposal--Treasury I and Treasury II--which eliminated the deductibility of property taxes, it didn't take long before the 13,000 school boards looked up and said: Regardless of whether we are in a high-tax State or in a low-tax State, this would have a devastating impact on a system of government.

And I think we have to pay attention to such things. The United States is alone among the democratic states of the world, which runs its school system in the main by locally elected, nonpartisan school boards.

I have said that if there was room for one more statue in Washington, it ought to be put up to an elected member of a school board with a listed telephone number.

And they would do it; they would do it entirely as a public service, and the result has been true local--and to an extraordinary degree--local control of education.

And they looked up at this proposal, which was just part of a shuffling around of the revenues in the Federal Government, and thought it really did jeopardize that whole system of managing our schools, which is the largest public service we provide our people.

And that has disappeared, and for a good reason; and I thank the chairman in advance. I mean, it would have been devastating to education at just the time when we have been talking about--and Senator Danforth had mentioned--the Federal Government is cutting back in the provision of assistance in these areas. We know it.

Let me just conclude by saying: Will we not have the same effect if we do this to the State and local --

The Chairman. Let me explain how I came to this conclusion. One, on real property taxes, I think everyone understands why I left them out. Real property taxes are the backbone, by and large, of most local governments, most school boards, most sanitary districts, and everything else.

Senator Moynihan. Most, but it took some arguing to get that point across.

The Chairman. I understand. I understand, but in response to the theory of Federalism and not allowing the deduction of taxes, I mean, my gosh, we don't allow the deduction of the automobile tax, the gasoline tax, the cigarette tax, the liquor tax, the driver's license tax----there may be a couple of others that I haven't mentioned.

So, it is not like we are not pregnant. We have indeed been disallowing a variety of State taxes and local taxes over the years.

Secondly, in terms of the theory of Federalism, Federalism I thought was a two-way street. And you have 37 States that will not allow the deduction of any Federal income tax. Oregon is one of the 13 that allows a partial deduction of it.

But I toyed with the idea of saying, all right, let's give it a State option, on the theory of Federalism, and we would allow the deduction of the Federal income tax in those States to the extent that those States allowed the deduction of the Federal income tax, and go both ways.

I have no idea what the revenue is, and I didn't put that in, but I toyed with that, if indeed the theory of Federalism is the theory that really bothers people.

Senator Moynihan. Mr. Chairman, do I have a sense of agreement --

The Chairman. No, because I have no idea what the revenues are, but I thought if a State will allow you to totally deduct your Federal tax--totally--then the Federal Government could totally allow you to deduct your State tax.

Senator Durenberger. Mr. Chairman?

The Chairman. Senator Durenberger?

Senator Durenberger. I would suggest that is a theory of reciprocity, not a theory of Federalism. The theory of Federalism--I mean, there are lots of theories of Federalism.

I think the reality is summed up in the tenth amendment to the Constitution, and variance on that that the States in this country have delegated certain authorities to the Federal Government and then delimited them in one way or another in terms of the authority that that government has over the individual members of our society.

But I don't think it is a quid pro quo. The reason the 37 States do not permit Federal tax deductibility is that they need to raise revenue via income taxes in those States.

They have chosen, for one reason or another, to rely more heavily on the income tax and to permit Federal deductibility would be to decrease the amount of income taxes they can raise in those States.

Why do they do that? Well, here is why they do it. As I recall, when the Secretary of the Treasury was in here talking about rich man,poor man, beggar man, thief, New Yorkers are stealing from Wyoming, I sent a staffer out to find out, for example, how many--in this theory that all 50 States are equal.

I said: Would you please go out and call the mayor of New York or somebody and ask them how many illegal immigrants there are in the City of New York or undocumented workers?

And the answer came back about 15 minutes later that there are 700 and some thousand because of national policies. There are 700 and some thousand people illegally in the City of New York, using their hospitals, using all of their public services.

And I said, Mr. Secretary, do you know that is about 250,000 people than there are in the whole State of Wyoming?

That is more of an element of Federalism than you do this and I get to do that kind of theory, or the rich man, poor man, beggar man, thief.

And I respect the direction the chairman is heading on this. At least it has some logic to it.

I don't necessarily understand the logic of the Administration in getting rid of deductibility entirely because there, I think we can debate Federalism. We can debate 50 different States situated differently, competing with each other or whatever; but having to do a certain basic thing, beginning with education.

Now, where do you buy education? You don't buy that in Washington, D.C. No way. You get five percent of education if your child is retarded or disabled in some other way and maybe a little bit extra spiff someplace else; and you get a little tax deductibility on your real estate taxes or your income taxes.

But 95 percent of it is bought right at home in New York City or Minneapolis or wherever. And so forever, since we have been a nation and said we want to begin by educating our young so they can grow up to be Dick Darmans and Roger Mentzes--all that sort of thing--

(Laughter)

Senator Durenbeger. That everyone wants to be. Education is important. Where do you buy education? Well, you buy it by going to work. You go to work and you earn some income, and you peel off a part of that income and you pay it to the local school board in exchange for an education for your kids.

And so, this nation said to do that, and to do it as equally as possible across a country that is as diverse as Caspar, Wyoming and New York City, we are going to permit against our Federal tax liability, a deduction for all those millions of payments that are made every day and every year to the local school board to educate those kids.

Now, I can walk through a lot of other public services, a lot of other reasons why I go to work every day; and where I buy those services is not here in Washington. I don't buy them out of a drugstore or a grocery store, but I buy them from some local unit of government.

I buy protection for that home of mine that I pay the real estate taxes on. I pay to have a street in front of my house so I can get to work. I pay for sewers. I pay for water and clean air, and a whole lot of things.

And I buy that at the State and local level, and it is a different purchase if you are in Palm Springs or Prince Georges County or Fairfax or Montgomery or Prince Georges County.

And you can get rid of a whole lot of deductions, but as long as you preserve income tax deductions and real estate tax deductions, but get rid of everything else, you are in effect favoring Palm Springs and Fairfax County and so forth over a lot of other places that have a much more difficult job of raising taxes.

So, I would like to hear a real Federalism discussion from the Administration.

Senator Danforth. Can I just ask you a question?

Senator Durenberger. Yes, certainly.

Senator Danforth. I understand your argument up to a point, but I don't understand why it follows that some people should get in effect a rebate from the Federal Government for State and local taxes paid and why, because of graduated tax rates, people who have high incomes should get a higher rebate than people who have low incomes.

That is why I don't see the connection. I mean, the Federalism argument and the reality.

Senator Durenberger. I am not sure who it is that is getting the rebates. I suppose the people in --

Senator Danforth. The people who itemize their deductions are getting the rebates.

Senator Durenberger. People in the zero bracket get a rebate to the tune of the ZBA. Everybody in this country gets some subsidy against their income tax liability for a variety of services that are purchased through the tax system or --

Senator Danforth. Have I missed something in this regard, Mr. Mentz? I mean, it seems to me that the value of a deduction is related to whether or not you itemize.

Mr. Mentz. Yes, I think so. And I think in the more affluent communities, such as Palm Springs, you are going to have a much higher proportion of people itemizing; and therefore, proportionately, those people are getting a better deal. They are getting or buying their services at a cheaper price, which is, I think, your point, Senator Danforth.

Senator Moynihan. I wonder if my learned friend would let me make a suggestion? You asked are you missing something. I would suggest that you are missing the sixteenth amendment.

It was pretty explicit, I suppose, that the Constitution as drawn required taxes to be on a per capita basis; and there was some argument that it really wasn't necessary to amend the Constitution, but President Taft and others thought it was; and we did.

Now, once you have introduced the principle of progressive taxation, then some persons will pay more than other persons. And it will be income related; and the higher your income, the higher will be the rate of taxation.

You automatically introduce the effect that there are deductions to be taken. They will be higher proportionately for the ones who are already proportionately higher taxes.

Isn't that a necessary accompaniment to progressive taxation?

Senator Danforth. Yes, but I don't understand why it is a violation of some principle to say that we are not going to permit the deduction for some State and local taxes paid.

In other words, it seems to me to be a form of subsidy to taxpayers, rather than to school districts.

Senator Moynihan. That appeared in Treasury I. The deductibility of State and local taxes was a Federal subsidy.

I cannot imagine a notion further from what I understand the President's views to be about the nature of our Government. It assumes that the Federal Government owns all that revenue, and what it lets you keep is a subsidy.

Senator Danforth. No.

The Chairman. Let me interrupt, if I might, because I would like to walk through the rest of this section, and we have a lot of other controversial parts in it. And I think the arguments--of all the things in this bill--I think the arguments about the deductibility of State and local taxes is well thought out in most of our minds.

I would like to go through the rest of it if I can; and if we have time, get back to it on this issue. But there are some other controversial things to discuss as we are going along.

Senator Chafee?

Senator Chafee. Mr. Chairman, just one final question on this, on a separate facet of it. Our State has a State sales tax at six percent, which is relatively high, applying to everything except food and clothing.

And I am just a little bit worried about the effect of this provision of not allowing the deductibility of the State and local sales taxes.

Yet, on the other hand, I can see the argument that in many cases it is de minimus. But when a person buys an automobile, that traditionally is the big ticket item that comes up with the sales tax in our State.

And people who don't use the schedule provided in the forms do deduct the sales tax on a new automobile.

Do you have any thought about what the effect would be if you had a certain exemption on the deductibility of the sales tax, the first $100.00 or $150.00 not deductible, or whatever it was, so that you could then pick up these folks that did buy an automobile during the course of the year.

A $6,000 automobile, which is hardly a high-priced automobile these days, would be $360.00. What do you think of that, Mr. Weiss?

Mr. Weiss. You are suggesting in effect a floor under the sales tax?

Senator Chafee. That is right.

Mr. Weiss. So that you could, I guess, structure that in a variety of ways, depending on --

Senator Chafee. If you are an itemizer in the 35 percent bracket, you are already doing something a little odd with your State income tax. You could only deduct those at to 25 percent level. Right?

The Chairman. Which is an idea I took from Senator Bradley's bill.

Senator Chafee. Sure. I mean, I am not objecting to it; but there are different juggling factors that go into these deductibilities for an itemizer on these taxes.

So, I am looking at this sales tax as a possibility for having the so-called floor.

Mr. Weiss. One thing to keep in mind is that, if your objective is to pick up only the people who have automobiles and other big ticket items which are allowed in addition to the table, that the table amount rises with income. So, for the higher income people, a relatively small floor would tend to allow them some of the ordinary deduction in addition to the autombile.

So, if that is your objective, I guess there is a question of how to structure the floor so that perhaps it could vary with income, for example, if you are trying to sort out the extraordinary expenses from the amount that is in effect built into the table.

Senator Chafee. That is what I am trying to do, and I don't quite know how to do it; but I am investigating this business with the so-called floor. Then, the person who does have a big ticket item, and as I said normally it is an automobile--we don't want to exclude the possibility of buying a boat also--but there it is, a big item that I think they are used to being able to deduct; and if they couldn't deduct it, then it would be sort of a setback.

The Chairman. Let me suggest we walk through the rest of this.

Senator Chafee. Yes, I will be glad to.

Senator Moynihan. Mr. Chairman, could I say that Mr. Wilson has developed for us a form 1040 that will be necessary, should the President's provisions be put in place. This is April 15, and it might be cruel and unusual punishment to suggest that the tax forms could be even more complex than they are.

But could we reserve the opportunity? Could we put them up here and just let them be seen?

The Chairman. Why don't you put them up there? But I would ask -- I would suggest this, however. If he is talking about a 1040, my hunch is that none of those or very few of those would appear on a 1040.

Senator Moynihan. Well, I am saying we will put them up for viewing purposes.

The Chairman. But I wouldn't want anybody looking at them and then assume that if he is talking about an addition to a 1040, that isn't where it is going to appear to begin with.

For those who weren't itemizing, they don't have to worry about any of this; and that is two-thirds of the--is it two-thirds? That is two-thirds of the tax returns in the country, anyway.

Senator Moynihan. It is about half of the real taxpayers. But we can come to this at another time.

The Chairman. Let's go on then.

Senator Bradley. Mr. Chairman?

The Chairman. Yes?

Senator Bradley. Just in response to attribution for this element of the bill, let me say that I hope that, before this is over, you might choose other aspects of the bill and perhaps delete this aspect of the bill.

The Chairman. As I recall, you allowed all deductions against the 14 percent level?

Senator Bradley. That is right. That is right, and we had about 85 percent of the people retaining full deductibility.

The Chairman. Whereas we have it--I am trying to take a guess--75,000 or above; or what percent would retain full deductibility?

Mr. Weiss. That would be about-- That provision affects only about seven percent of all taxable returns.

The Chairman. All right. Let's go on through. Charitable deductions.

Mr. Colvin. The proposal would make permanent the above-the-line deduction for charitable contributions.

The Chairman. In fairness, this is the Moynihan-Packwood 1981 provision. It is a difference of about $9.5 billion from Treasury, a difference of about $4 billion from the House bill.

Senator Chafee. Mr. Chairman, I was against it then, and I am against it now. It is a big ticket item.

I must say no one will ever accuse you of being chinzy.

(Laughter)

Senator Chafee. When you step in, you get the big ones. You get the big ones on increasing the expenditures. I haven't seen you get the big ones on savings yet, except for your --

The Chairman. State and local.

Senator Chafee. Well, you got a little something there.

(Laughter)

Senator Chafee. Your nondeductibility of the excise tax. I just have never understood the rationale behind this.

If there is ever a two-way winner, it is the person who does deduct who has already gotten an advantage through his nondeductibility and then goes on and makes a charitable contribution and gets the deductibility again.

And I know the arguments about the United Way and the Cancer drive and all that; and therefore, you can have some kind of a--and indeed we did it.

Well, in 1985, 50 percent of the amount contributed was deductible. That is something in there.

Has anybody shown any empirical evidence that the presence of this greatly increases the contributions --

The Chairman. I hate to mention the name to Treasury, but Marty Feldstein has.

Senator Moynihan. Yes.

Senator Chafee. Did he? Well, this is the first time you have accorded him any excellence --

Senator Moynihan. I have been consistent in that regard.

Senator Chafee. Have you? Mr. Mentz didn't--

Senator Moynihan. Mr. Darman didn't.

Senator Chafee. No, Secretary Darman. Well, I just don't get the rationale for this. If you want to put a limit on it of $100.00, all right, or something like that; but under your proposal, Mr. Chairman, which adds how much to the House bill? What is the chairman's cost here?

The Chairman. About $4 billion, $4.5 billion.

Senator Chafee. $4 or $4.5 billion, and there there was a floor of $100.00. To me, there ought to be a straight naked, just like we did or the same theory we had in 1982 and 1983 and 1984, namely, a maximum amount that the person can take.

Make it $100.00, but there ought to be some cap to it. Does Treasury have any figures on that? Or the Joint Economic Committee?

We have already had experience with it with the $75.00 in 1984, so it shouldn't be hard to extrapolate up to the $100.00, should it? You don't have to give it to me now.

The Chairman. Why don't we move on? And Treasury can give us those figures. I want to get to the deductions on meals and theater events and whatnot, or at least discuss that today.

Senator Chafee. Just to refresh my recollection, I remember you pressed this in years past, you and Senator Moynihan. I assume you did not succeed; is that right?

The Chairman. No, wait. Did not succeed in what?

Senator Chafee. In getting this.

The Chairman. We got it in 1981.

Senator Chafee. That is right.

The Chairman. And when the law passed, it phased out at the end of 1986. And what we are doing now is trying to make it permanent.

It went from $25.00 to $50.00 to $75.00 to $100.00, but then it sunsetted.

Senator Moynihan. So, we are not changing present law in effect; we are just continuing it.

Mr. Darman. It is scheduled to expire.

The Chairman. The reason, you understand, that it is allegedly such a large revenue is that I believe it is played off the assumption that the law is going to terminate.

Senator Chafee. Yes, you might have gotten some votes on that basis.

Senator Bradley. Mr. Chairman, could I inquire of Joint Tax or Treasury when it was first put into law in 1981, what was the expected or predicted revenue loss, and how has it tracked the prediction?

Mr. Weiss. Senator Bradley, I don't --

Mr. Darman. I was going to say, Senator, I don't think we estimated it. My recollection is that it came in in the last-- It came in along with about 117 other items in the last 48 hours in the production of that bill.

Senator Bradley. Did Joint Tax do a revenue estimate at that time?

Mr. Weiss. We did at that time, and I am not sure that we followed the difference between our estimate and what actually happened; but my recollection is that these numbers are not very different from what we have actually observed.

Senator Bradley. This is not like the IRA where you estimated it to be $3 billion, and it is $14 billion?

Mr. Weiss. That is correct. I mean, to the best of our information, these numbers are consistent with the kinds of numbers we were showing back then for a fully effective --

Senator Bradley. Do we know how many taxpayers use the deduction?

Mr. Weiss. I don't have that right here, but I can provide that later.

Senator Danforth. Can you also provide what it yields in charitable contributions? If Martin Feldstein has studied it--you say that he has, but I don't know what the study shows.

The Chairman. Secretary Darman?

Mr. Darman. Mr. Chairman, I take it you want our analyses later, which we would be happy to provide.

Senator Danforth. Can I just ask if there is any?

Mr. Darman. Yes.

Senator Danforth. If there is information as to what the yield is for charities, or whether this is --

Mr. Darman. Yes, we have all of that information. Why don't we put together a memorandum and provide it? But what I was going to suggest, if I could, is that this is another one that needs to be disaggregated.

The largest effect in all these studies--the effect on charitable giving--is the function of the rate reduction, not of these other decisions.

(The prepared memorandum follows:)

Mr. Darman. Senator Chafee was raising a question with respect to the possibility of a floor, or this provision that came in in 1981.

The effects on that provision from rate reduction may be dramatically different from the effect on giving by itemizers.

The effect on the treatment of appreciated property in a minimum tax may be dramatically different than the effect on these other provisions.

The answer is not the same for each particular provision, but we will provide a supplementary memo with the analyses.

The Feldstein analysis depends extremely heavily on a criticism of the rate reduction.

Senator Moynihan. Could I just make a point here that I think we should keep in mind?

There is pretty good evidence that middle-range income people will make contributions at about a steady rate after tax as marginal rates of taxation go down.

The pressure will be downward on gifts. And that is why I think that -- Do you follow me, John?

Senator Chafee. Oh, yes.

The Chairman. All right. Let's move on.

Mr. Colvin. On the bottom of page 9, the next issue is that the chairman's proposal retains the itemized deduction for adoption expenses for children with special needs.

On page 10, the chairman's proposal includes the House provision to allow the deduction for mortgage interest and property taxes to ministers and military personnel even if they receive a tax-free housing allowance.

On page 11, the chairman's proposal includes the House provision to limit the deduction for meals and entertainment expenses to 80 percent. It also includes the stricter business purpose definition in the House bill.

The Chairman. Questions on that subject?

Senator Mitchell. Are you inviting questions at this time?

The Chairman. I am.

Senator Mitchell. What is the logic of a percentage deduction as opposed to a cap, which I believe was the original Administration proposal, if I recall?

The Chairman. By cap, you mean $15.00 breakfast, $25.00 lunch?

Senator Mitchell. Right.

The Chairman. All right.

Senator Mitchell. It seems to me that the threshold question is whether or not it is a legitimate business deduction; and if it is, then it ought to be deductible up to a reasonable and necessary amount.

I think the arbitrary 80 percent--and I assume that is an arbitrary figure--it could easily have been 70 or 90--acknowledges the business nature of it, but provides a percentage.

If there are abuses, and I believe there are, wouldn't we be better served by imposing a cap that would, in effect, define statutorily what is reasonable and necessary --

The Chairman. And allow 100 percent of the deduction?

Senator Mitchell. And allow 100 percent of the deduction.

Mr. Mentz. To start with, the Administration proposal, I think what has happened here is this proposal has evolved into one that turns out to have a greater rationale in the House bill.

In other words, I think the House bill is preferable to where we started out. We started out, Senator, with a view --I am talking about meals now--you would basically allow $25.00 times the number of participants; and anything over that would be disallowed on the theory that anything over that was --

The Chairman. For every meal? Breakfast or dinner?

Mr. Mentz. For any business meal. That is right.

The Chairman. Yes.

Senator Mitchell. I think Treasury I had a scale, did it not? Different for breakfast, lunch and dinner?

Mr. Mentz. Yes, I think that is right. And one of the main problems that we found with that very quickly is a major administrative problem.

Someone can go out and have a meal with one other customer, and he can put down that he had dinner with four other people. And you multiply four times 25, and that is $100.00; and he has a $100.00 meal for two. Basically, he takes a full deduction.

It is very, very difficult to audit, to have compliance with that kind of an absolute rule. Furthermore, I think the theory of it evolved that in any meal, any business meal or any business entertainment, there is always inherently some element of personal consumption.

If a lawyer goes out and takes a client to lunch or dinner or to a play or what have you, even though it is business, even though he is working, even though it is advertising, or however you want to characterize it, it is fully legitimate and it is not extravagant and passes all the tests of current law, so that under current law it is fully deductible, there still is an element of personal consumption in that expenditure.

And the theory of the House--of the Ways and Means Committee--was let's just kind of make an arbitrary determination that 20 percent--whatever the cost of it is--is going to be lopped off as personal consumption.

And at one point, it was 80 percent for meals and 50 percent for entertainment. They finally concluded, and I think very rationally, that it is better to have the same rule. That way you don't have to determine whether it is meals or entertainment.

And that is how it ended up being 80 percent.

I might mention that in some other countries this same issue has been subject to debate and discussion. Australia has concluded that all business meals and entertainment should be nondeductible.

Their approach is that there is an element of consumption and it is inherently personal. So, no matter what the circumstances--a person goes out and takes a client to dinner or to lunch--that is just fully nondeductible.

In the U.K. there is no deduction for entertainment expenses. They do not disallow business meals, but they do disallow 100 percent of entertainment.

My own personal judgment is that the better approach is the approach taken by the House, that you take an arbitrary percentage--and they fixed it at 80 percent--and say that part of it is acceptable and deductible, but the other 20 percent is effectively an item of personal consumption that is inherently nondeductible.

Senator Mitchell. But does not that approach, Mr. Mentz, produce the perverse effect of encouraging higher levels of expenditure because 80 percent of it is in effect subsidized by the taxpayers.

That is, business people who go and and are reasonable, do engage in a meaningful business activity, don't try to run up a big bill with a lot of frills and so forth are in effect being penalized.

And what you are saying is you are getting people to say, what the heck, the Government is paying four-fifths of this.

That is an almost irresistible urge, given people's attitudes, to say, well, let's go have another bottle of wine or --

The Chairman. Just a theoretical--and I say theoretical --answer is, one, if it is not a business purpose, you shouldn't be able to deduct any of it.

Senator Mitchell. Yes.

The Chairman. But what the Secretary is saying is: All right, you have a business purpose; so it is deductible. Inherent in the business purpose is also a social purpose; divide it 80/20. And it is just an arbitrary cut.

Mr. Mentz. If it is lavish or extravagant --

Senator Mitchell. Excuse me. Mr. Chairman, I don't disagree with that rationale. What I do disagree with is the fact that it encourages extravagance and the kind of thing that I think we would all call abuse.

Mr. Mentz. Current law would disallow a deduction for any meal or entertainment or what have you if it is lavish or extravagant. It has to be ordinary and necesary.

Senator Mitchell. But if you are afraid of cheating the way you describe, then it is impossible to police what you have just said.

I mean, that is so highly subjective.

Mr. Mentz. Really, what I am saying, Senator, is that I think the 80 percent rule is a far better rule than current law and produces what I consider to be a pretty reasonable result.

I think inherently in any business context probably the preponderance should be deductible. It is business related. Postulate that; if it is not, you shouldn't get any deduction.

But inherently, there is a personal element in any business meal or entertainment, and you may choose to cut it differently than 80/20, but I think 80/20 is pretty reasonable.

Senator Mitchell. I don't want to prolong the point, Mr. Chairman. I am not disagreeing with your statement that 80 percent is better than current law.

I may at some later time, but I am not now. What I am saying: Do you feel that a cap is better than current law?

Mr. Mentz. No, because I think a cap is so difficult to administer that I would not favor it.

The Chairman. All right. Let's go on.

Senator Moynihan. Mr. Chairman, could I just make a comment? The Secretary mentioned the Australian experience. I believe the Australian experience was also that there was a very considerable fall-off in employment, and there was a business impact and it was quite pronounced.

I think that you would have to agree that there is certainly going to be a very strong business impact here as well. I mean, it is on the entertainment and food industries.

Mr. Mentz. A strong business impact? Perhaps some shift. I may be surprised. I dont' really expect a strong business impact. I don't expect Coat Bass to go out of business, Senator, if this passes.

Senator Moynihan. No. Coat Bass will not go out of business without intangible drilling costs --

(Laughter)

Senator Moynihan. But there are an awful lot of places between Coat Bass and Chock Full of Nuts that will. We can talk about this later.

The Chairman. Let's go on.

Mr. Colvin. On page 12, the chairman's proposal would limit the deduction for luxury water travel to two times the highest Federal per diem. It would eliminate the deduction for travel as a form of entertainment, and it retains present law with respect to the deductibility of travel in connection with charitable organizations.

Senator Danforth. Mr. Chairman?

The Chairman. Senator Danforth?

Senator Danforth. Mr. Chairman, if travel expenses are included as income to the recipient, would they be deductible to the business?

Mr. Weiss. They would be fully deductible if they are included as income. That is the way the House bill is written, and that is picked up in the chairman's proposal.

Senator Danforth. Thank you.

The Chairman. Where are we now?

Mr. Colvin. On page 13, the first change made by the chairman's proposal is that the cost of attending a convention for investment purposes would be made nondeductible.

Then the foreign convention rule: the chairman's proposal would allow Bermuda--this is taken from S. 1718, which was introduced at the request of the Administration --would allow Bermuda to qualify as being in the North American area, even if it does not share tax information with the IRS.

On page 14, the chairman's proposal includes the House provision that imposes a one percent floor under several miscellaneous employee and investment related deductions and also moves several of the employee business expenses to itemized deductions.

Senator Bradley. On the one percent floor, what kinds of business deductions are subject to that one percent floor? Are union dues subject to that?

Mr. Colvin. Union dues is an example.

Senator Bradley. What if I am a worker on an assembly line and I want to get some training in computer skills and I go to a weekend conference? Would that be deductible?

Mr. Colvin. Employee paid educational expenses would not --

Senator Bradley. No, not employee paid. Oh, employee paid, yes.

Mr. Colvin. Employee paid?

Senator Bradley. Yes. I am the worker and I pay for it out of my check.

Mr. Colvin. That is also affected by this.

Senator Bradley. It is not deductible then?

The Chairman. Well, only below one percent, isn't it?

Mr. Colvin. That is right.

Mr. Mentz. Well, you have a question as to whether it is deductible in the first place, don't you?

Mr. Colvin. In your question, you are assuming that --

Senator Bradley. Assuming that it is --

The Chairman. Assuming it is related to a business purpose in terms of the education, so you have crossed that threshold.

Senator Bradley. Then it is limited to one percent?

The Chairman. There is a one percent floor. You could deduct above the one percent. Correct?

Mr. Colvin. That is correct.

The deductions subject to this rule are a large number of deductions which result normally in record-keeping requirements for taxpayers. And this would reduce the record-keeping requirement for taxpayers.

Senator Bradley. I don't know if this is a concern to anyone else, but it seems to me that the way this is written, if you work for a major company and the company pays for your expenses, that is fine.

But if you are an individual or you take it upon yourself to try to get some additional education, conference expenses, whatever, union dues, whatever, and you are not a big hitter, then you are really penalized.

Say, if you make $20,000, on the first $200.00 that you spend on these kinds of legitimate deductions --

Senator Durenberger. Bill, it strikes me that that is our basic policy of the relativity between the self-employed and the employed. Now, we do the same thing with their health insurance.

You work for some big company; you get free health insurance, subsidized by the Government. But if you are self-employed, you have to use your after-tax dollars to go out and buy health insurance plans.

I don't agree with that philosophy, but --

Senator Bradley. But the health insurance --

Senator Durenberger. It seems to be our policy.

Senator Bradley. The health insurance is more or less widely available to people at lower income levels that work for a corporation. These expenses are, by definition, not going to be paid by the corporation.

And these people would not be able to get any deduction whatsoever unless they were able to afford more expenses to exceed one percent of their income.

I mean, it is just a kind of mismatch. It occurs to me that, on the one hand, we are allowing cruise ship conventions and a variety of other things; and then we are saying to the worker out there who is trying to get a little bit ahead that he can't deduct the first $200.00 of his expenses.

Mr. Mentz. Senator Bradley, let me explain where that came from because it started out in the President's proposals.

We have found--the IRS has found--that the compliance rate is pretty bad with regard to employee expenses. They tend to be small expenses, and they are frequently misreported.

The statistics we had--again from the taxpayer compliance audit--was that 63 percent of taxpayers who reported employee business expenses made errors.

So, the notion was--when they were small expenses, such as safety shoes for a production line and that sort of thing --put a one percent floor, just like we have a five percent floor for medical or a ten percent floor for casualty; and the idea would be you would whittle out the little deductions.

If someone has a significant expense, the chances are he is going to have a record of it; and it is not going to be a compliance problem in producing that.

But the theory, at least the President's theory, was to try to sort of take out all these little deductions and, to an extent, I think that sort of is built in to the greater standard deduction and to some extent in the lower rates.

Senator Bradley. Yes. I am not going to spend a lot of time discussing this further. I understand your point, Mr. Mentz, that the increase in the standard deduction maybe sweeps in some of those expenses; but at the same time, if a worker goes out and buys safety shoes or decides to go to a weekend computer conference and does have the records for this, I don't see any reason why we penalize them and say: Now, you can't deduct; but someone who is paid by the company, there is no question asked.

The Chairman. Let me make a suggestion on this because I think there is going to be some controversy on this. When we come to considering it on the votes, if you could have a breakout of (a) through (e) individually because collectively it is a lot of money. It is $14.7 billion, but I don't know the breakout among the different parts (a) through (e).

And I think we can probably pass over the rest of it now, but I have a feeling that some of your complaints may not go to all of (a) through (e).

Senator Bradley. Oh, no, no.

The Chairman. It would be helpful to have a breakout.

Senator Bradley. Hobby losses or home offices?

The Chairman. All right. Let's go on to the political tax credit.

Senator Chafee. Just one quick question, Mr. Chairman. Do I understand on this investment and certain other expenses, if somebody has $60,000 of income and they have an investment advisor of some type, or even I suppose an accountant--there is no question in preparing your return--that is still deductible, isn't it?

Well, just take an investment advisor whom you are paying something to. You couldn't deduct anything except in excess of $600.00. Is that right?

Mr. Weiss. That is correct. All these expenses of that similar type. So, it is not on an expense-by-expense basis, but they would add together.

You know, if you had publications or union dues, all those things are added together before the calculation is made.

Senator Chafee. Oh, I see. You add them all together and if they total more than the $600.00, then you can deduct that difference?

Mr. Weiss. That is right.

Senator Chafee. Thank you.

The Chairman. Political tax credits?

Mr. Colvin. The chairman's proposal retains current law for the political contributions tax credit and the presidential campaign check-off.

The Chairman. I might ask for some discussion on this. The President got rid of it all together. The House changed it to--if I am correct--100 percent credit, or 200 on a joint return, for contributions to Federal races only.

Mr. Colvin. That is correct.

The Chairman. The present law is basically a 50 percent tax credit, but it is for all races, Federal or otherwise, Federal or local. Is that right?

Mr. Colvin. That is correct.

Senator Durenberger. Mr. Chairman, is this the one Bill Frenzel was in here making an argument on?

The Chairman. Yes, I think so.

Senator Durenberger. I can't remember his argument. We represent each other, so I assumed it was a good argument.

The Chairman. Yes. The House had a theory, and I think there is some validity to what they were trying to do.

You want to encourage small contributions. You want to put limits on PACs. You want to get away from the large donations. It would be good for democracy if you could have literally hundreds of thousands or millions of $100.00 and $200.00 contributions.

So, the House said all right; we would like to save some money. Why don't we let the Federal Government take care of its races, and let the States take care of their races; and we will give you $100.00 credit, or $200.00 on a joint return, if the contribution is given to a Congressional candidate in the State of the contributor.

If they were in Massachusetts, and they give in Minnesota, that doesn't count.

I thought there was some validity in the direction the House was going in terms of encouraging small contributions, if that is a direction we want to encourage.

Senator Chafee. What is your rationale for just limiting it to Congressional candidates?

The Chairman. There are two rationales. One is it picks up about $600 million. The other is that if you want to talk about the Federal Government encouraging contributions to Federal races, let the States if they want to encourage contributions to State races, do the same.

Senator Chafee. Yes, but you retained the present law?

The Chairman. Frankly, I had an absolute spectrum of opinion from the committee members. I didn't sense any majority for anything; and so I just left it like the present law when I drafted it.

Senator Chafee. Yes. I think that is good. Half and half, it is deductible?

The Chairman. Fifty percent, although that costs about $1.1 billion if I read the Treasury's figures correctly, the present law. Is that correct?

Mr. Mentz. Yes.

The Chairman. Yes. Whereas the House is limiting it to Federal races, even though they went to 100 percent. It costs $500 million, mainly because they were eliminating all the State races.

Senator Mitchell. I would just like to express my view in support of your provision, Mr. Chairman. I think the House proposal is not a good one.

The Chairman. Just keep the present law?

Senator Mitchell. Yes.

The Chairman. And the presidential campaign check-off. I think everyone knows what that is. I just kept the present law on that. Any other discussion today?

(No response)

The Chairman. We will start mark-ups of pensions in the morning.

CERTIFICATE

This is to certify that the foregoing proceedings of an Executive Committee meeting of the Committee on Finance, held on April 15, 1986, in re: Tax Reform, were held 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.