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SUMMARY OF TREASURY DEPARTMENT TAX REFORM STUDIES AND PROPOSALS

PREPARED BY THE STAFF

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COMMITTEE ON FINANCE
UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

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SUMMARY OF TREASURY DEPARTMENT TAX REFORM STUDIES AND PROPOSALS [1]

Introduction

On February 5 the Committee on Finance of the U.S. Senate and the Committee on Ways and Means of the U.S. House of Representatives published the tax reform studies and proposals prepared by technicians in the Treasury Department. These studies had been requested by the Revenue and Expenditure Control Act of 1968.

There is general agreement today that tax reform in some form is needed. And, no doubt, many of the proposals submitted by the Treasury Department must receive serious consideration because of their far-reaching consequences. For this reason, it can be expected that there will be lively discussion over several of the proposals. While Congress has done much over the past several years to improve our tax structure, this tax reform report clearly indicates that much work is still ahead. As illustrations, several facts, taken from the Treasury report, follow:

First, there are 2.2 million families who receive income below what is considered the poverty level but who are still required to pay Federal income tax. This is inconsistent, it is stated, with our programs to eliminate poverty and the theory that income tax should be imposed only on those who are able to pay it.

Second, there are a significant number of individuals with very high incomes who now pay no income tax, or very little income tax. The fact that some individuals with large incomes are not paying the amount of income tax which their circumstances indicate that they should be paying suggests that the tax law is not working satisfactorily in certain areas.

Third, the Treasury report points out that some income, notably appreciation on capital assets, which is not realized during a taxpayer's lifetime, is not presently subject to an income tax. This treatment is different from that accorded other accretions to wealth received during the taxpayer's lifetime, such as wages. While an estate tax is presently imposed on this appreciation, it is argued that the estate tax also falls on the person whose wealth has been accumulated from salary subject to income tax.

Fourth, many large business organizations are now able to pay corporate income tax at the special rate which was designed for small businesses. This is done mainly by forming a chain of small corporate units and claiming multiple surtax exemptions.

Fifth, some tax-exempt private foundations are being used to accumulate assets and wealth for purposes which are not in keeping with the original theory in granting tax exemption to these charitable

[1] Prepared by the staff, Committee on Finance.

organizations. Because these foundations do not distribute a significant portion of their assets currently to charity, they, thus, deprive charity of the use of these funds for an extended length of time. In a few cases this abuse is compounded further because it appears that the accumulation is being used to further the personal or business purposes of the donors and their families.

A number of the proposals contained in this tax reform report would significantly reduce the amount of tax now being paid by many taxpayers. Examples of these include the proposal for an increase in both the minimum standard deduction and the ordinary standard deduction, and liberalization of moving expense rules. In addition, under the maximum individual income tax recommendation, the income tax of a limited number of persons in higher income tax brackets would be reduced because the report has concluded that even this group would be paying more than their fair share of the tax burden if all the proposals in this report were adopted.

Many of the proposals contained in this tax reform report would, however, significantly increase the amount of tax now being paid by other taxpayers, many of whom are in the higher income brackets. The proposals for a minimum individual income tax, the revision to allocate personal deductions between taxable income and nontaxable income, correction of abuses of farm tax rules, changes in the taxation of trusts, changes in the taxation of capital losses, and changes in the taxation of corporations all tend to increase the tax burden.

If all of the income tax changes proposed in the report were enacted into law the net revenue to the Federal Government would increase slightly. Estate and gift tax changes involve a slight revenue loss, in the early years, but as the transition rules provided for many of these provisions end, the revenue to the Government would increase and there would be a small net gain.

The following portions of this document contain a summary of the proposals in the tax reform studies which were submitted by the Treasury Department. Many technical rules, provisions, and structural details, relating to the subjects which are discussed, have been omitted for clarity. For a thorough understanding of all the implications of each proposal, the publication containing the full tax reform studies and proposals should be consulted.

Following the summary are a series of statistical tables showing the revenue impact (and related data) of the tax reform suggestions.

Individual Income Tax

Minimum Standard Deduction

Many taxpayers who are unfortunate enough to be at or below the poverty level of income often must pay an income tax despite their present condition. The Treasury report suggests that the most effective way to give relief to these families is through an increase in the minimum standard deduction. It recommends that the minimum standard deduction, which is presently $200 plus $100 for each allowable exemption, be increased to $600 plus $100 for each allowable exemption, subject to the existing overall limit of $1,000. Of the 2.2 million families now living in poverty and who are subject to Federal income tax, such an increase in the minimum standard deduction should relieve about 1.25 million from the payment of any Federal income tax. The remaining 1 million families would receive significant tax reductions. It is estimated that the annual revenue loss from this change would be $1.1 billion.

Minimum Individual Income Tax

There are presently in the tax laws certain advantages—in the form of exclusions and deductions—which enable many high bracket individuals to avoid paying a fair tax to the Federal Government. Acting on the principle that every individual with substantial income should make a reasonable contribution toward the cost of operating the Government, the Treasury report recommends that a minimum tax be assessed. This new tax would be computed by broadening the present taxable income base to include amounts which are now omitted because of the following exclusions:

(1) One-half of a taxpayer's net long-term capital gains;

(2) Interest received on State and local government bonds;

(3) The amount of percentage depletion taken each year after the capital invested in the minerals or other natural resources has been recovered; and

(4) Appreciation on charitable gifts of appreciated property to the extent that this appreciation is taken as an income tax deduction.

Against this broadened tax base, a new schedule of rates, graduated from 7 percent to 35 percent would be applied. These rates are designed so that there is thus an effective limitation of 50 percent of an individual's total income which may be excluded from tax. An individual would have to pay this minimum tax only when this tax exceeded the amount he would otherwise have to pay under present tax law. In no event, however, would he be concerned with these calculations if his total income, computed on the expanded basis, is less than $10,000 (or $5,000 for a married individual filing a separate return). This provision would increase revenues by $420 million per year.

Allocation of Deductions

Under the present tax laws, taxpayers who have appreciable amounts of excluded income are able to obtain two tax benefits. First, the income is not taxed. Second, the taxpayer's personal deductions are applied to reduce that part of his income which is subject to tax.

The Treasury report recommends that an individual's itemized nonbusiness deductions be allocated between his adjusted gross (taxable) income and his excluded income (income from those sources which would be taken into account in computing a minimum individual income tax). Only that part of the deductions allocated to the taxable income would be permitted as deductions in computing his tax under the present system. After computation of the tax under the present system, the taxpayer would then pay this tax or the minimum tax (as discussed above), which ever is greater. Because the minimum tax proposal taxes many amounts which otherwise would be excluded or deducted, the allocation rules would not apply in computing the minimum tax. An exemption would be provided to insure that taxpayers with less than $5,000 of the types of exempt income discussed in the explanation of the minimum income tax would not have to make this allocation. This proposal would increase revenues by $405 million per year.

Correction of Abuses by Nonfarmers of Farm Tax Rules

Under present law, farmers are permitted to employ more liberal accounting rules than taxpayers generally. In summary, these rules permit farmers to use the cash accounting method without having to inventory crops and livestock at the end of the year, and also to deduct currently against ordinary income their expenditures for such capital items as the development of breeding herds, or of fruit orchards, vineyards or citrus groves. These rules often create "farm losses," which are not true economic losses but which may be deducted from nonfarm income to result in large tax savings. Moreover, in many cases the expenses deducted from ordinary income relate to capital assets (such as a breeding herd) which when sold give rise to income which is taxed at the lower capital gains rates (generally 25 percent). Indicating that these practices are not only unfair to all taxpayers, but also that they tend to distort the farm economy and hurt the true farmer, the Treasury report recommends that, in any taxable year, the deduction of a "farm loss" against nonfarm income be limited to $15,000. However, there would be an opportunity to carry farm losses back 3 years and forward 5 years. These provisions would apply both to individuals and corporations but would not apply in those cases where the net income from farming is computed by normal rules of accrual accounting with the use of inventories and capitalization of costs. This proposal would increase revenues by $145 million per year.

Taxation of Multiple Trusts and Accumulated Income in Trusts

Present tax law may permit individuals to form multiple trusts. Because each trust is considered a "taxpayer," the sum of the tax paid by several trusts is generally less than that which would be paid by the one individual or a single trust. Even greater tax reduction may be achieved when the trust accumulates income rather than distributing it currently to the beneficiary.

The Treasury report recommends that present trust tax rules be amended so that taxpayers receiving distributions of accumulated income from trusts generally would be taxed as if they had received the income over the years it was earned by the trust with credit being given to the taxpayer for taxes paid by the trust. In addition, in those cases where a trust is established to accumulate income for distribution to a taxpayer's spouse, the Treasury report recommends that the income of the trust be taxed to the taxpayer currently. These provisions would produce a gain of $70 million per year.

Maximum Individual Income Tax

Some taxpayers with large incomes receive almost all of their income from sources that have no tax preferences.

The Treasury report recommends that no individual shall be required to pay income taxes greater than one-half of his total income, computed generally on the expanded basis discussed under the minimum individual income tax. That is, the present taxable income base would be broadened to include amounts which are now omitted because of the following exclusions:

(1) One-half of a taxpayer's net long-term capital gains;

(2) Interest received on State and local government bonds;

(3) The amount of percentage depletion taken each year after the capital invested in the minerals or other natural resources has been recovered;

(4) Appreciation on charitable gifts of appreciated property to the extent that this appreciation is taken as an income tax deduction; and

(5) The value of qualified stock options exercised during the year.

However, the Treasury report does not consider the maximum tax to be feasible unless the report's recommended treatment for the taxation of appreciated assets transferred at death or by gift is also adopted as discussed below. The maximum tax proposal would result in an annual revenue loss of $205 million.

Liberalization of General Standard Deduction

Presently, an individual taxpayer may deduct certain personal expenses by itemizing the actual amounts of these various expenses or he may, as an alternative, claim the so-called standard deduction. Present tax law allows the standard deduction in an amount equal to 10 percent of the taxpayer's adjusted gross income. However, the standard deduction may not exceed $1,000 and may not be less than a minimum of $200 plus $100 for each allowable personal exemption. The standard deduction was used by more than 80 percent of individual taxpayers when it was first established. Now, it is used by only 57 percent.

The Treasury report recommends that the allowable standard deduction be increased from 10 to 14 percent of adjusted gross income because of the increase in the cost of living. In addition, the present dollar limitation of $1,000 would be increased to $1,800. This provision, which would restore the 80 percent utilization rate of the standard deduction, would involve an annual revenue loss of $1.4 billion.

REVISION OF CHARITABLE CONTRIBUTION DEDUCTION

Under present tax law, if an individual utilizes the standard deduction he may not separately claim a deduction for his charitable gifts.

The Treasury report recommends that taxpayers be permitted to claim a deduction for charitable contributions in addition to being permitted to use the standard deduction because an increase in the standard deduction would reduce the incentive for gifts to charity. This benefit would be available with respect to gifts to private foundations as well as gifts to churches and operating charities. Assuming that the proposals in this Treasury report relating to the increase of the standard deduction, increase of the minimum standard deduction, the repeal of the State gasoline tax deduction, and the 3 percent limitation on charitable deductions (discussed below), are also adopted, the enactment of this proposal would create an annual revenue loss of $440 million.

LIMITATION ON CHARITABLE DEDUCTION

The Treasury report recommends, in conjunction with allowing the charitable deduction in addition to the standard deduction, that the charitable deduction be limited to those amounts in excess of 3 percent of adjusted gross income. The report believes that this would reduce significantly the number of returns requiring audit but would maintain tax incentive for more than routine gifts to charity. The disallowance of deductions under the 3-percent level would increase revenues by $1.5 billion.

INCREASE OF CHARITABLE DEDUCTION CEILING

Except in the case of gifts to private foundations, present law allows charitable contributions to be deducted up to 30 percent of the donor's adjusted gross income. Gifts to private foundations, however, may not exceed 20 percent of the adjusted gross income. The Treasury report recommends that the present 30 percent limitation on regular charitable contributions be increased to 50 percent of an amount equal to the taxpayer's adjusted gross income plus his items of excluded income (in excess of $5,000) which are taken into account for purposes of computing the proposed minimum tax. This would encourage more substantial gifts to charity. The present limitation (20 percent) applicable to gifts to private charitable foundations would remain unchanged. The effect of this proposal would be a $20 million revenue loss.

UNLIMITED CHARITABLE CONTRIBUTION DEDUCTION

Under present law, if a donor pays out more than 90 percent of his taxable income in the form of charitable contributions and income taxes over a period of at least 8 out of 10 taxable years, he is allowed to deduct all of his contributions without regard to the general limitations.

The Treasury report describes this feature as an abuse because most of the taxpayers who take advantage of the unlimited deduction do so by contributing greatly appreciated property. In such case the deduction is based on the fair market value of the property contributed while the appreciation is not included in the donor's taxable income. In large measure, Treasury reports that the annual incomes of these taxpayers go untaxed.

The Treasury report recommends that the unlimited charitable contribution deduction be repealed with respect to taxable years beginning after December 31, 1979—10 years in the future. The proposal to repeal the unlimited charitable deduction would eventually result in a $25 million annual gain in revenue.

2-Year Charitable Trusts

Under existing law a grantor is not taxed on income contributed to charity where it is earned by a trust he created to hold the corpus and pay the income to charity for a 2-year period. (In other cases the trust must be created for at least 10 years if the grantor is to avoid being taxed on the trust's income.) Moreover, the limits on charitable contribution deductions do not apply. The Treasury report recommends that the provisions relating to the special 2-year charitable trust be repealed, as to trusts created after December 31, 1969.

Other Charitable Deduction Abuses

The Treasury report also contains a series of recommendations to correct other abuses of the charitable deduction provisions. These include proposals with respect to split-interest gifts to charity and gifts of appreciated property. The thrust of these proposals is to deny a charitable deduction where the appreciation is not taxed to the donor. Similarly, charitable deductions would not be allowed for a gift of the use of property (or of income from the property) or the gift element in a bargain sale to charity, where the donor does not realize taxable income or gain.

Repeal of Gasoline Tax Deduction

Under present tax law, State gasoline taxes are deductible in determining an individual's Federal income tax even though they are personal expenses.

The Treasury report recommends that State gasoline taxes should no longer be deductible if they are only personal expenses because the net effect of allowing this deduction is to shift part of the burden of this highway user tax to the general Federal income taxpayer. However, gasoline taxes would remain deductible if they were paid as a business expense. Adoption of this proposal would increase revenues by $310 million annually.

Consistency of Capital Gain and Loss Rules

(1) Under present tax law, net capital gain income is not treated the same as net capital losses. Net capital gains, if they are long term, that is, from the sale of capital assets which were held 6 months or longer, are included in taxable income only to the extent of 50 percent

of the amount of the gains. In addition, net long term capital gains are subject to a maximum alternative tax equal to 25 percent of the total gain. On the other hand, net capital losses, even if they are long term as described above, may be deducted in full from ordinary taxable income, up to a limit of $1,000 per year. Any excess of the net capital losses which were not deducted may be carried forward and treated as if they were capital losses realized in the succeeding year.

The Treasury report recommends that net capital gain income and net capital losses be treated consistently. Each dollar of net long term capital losses would be permitted to offset only 50 cents of ordinary taxable income. This deduction would still be subject to the present $1,000 overall limitation. Thus, if the net long term capital loss for a year exceeds $2,000, a deduction of only $1,000 would be permitted in the year in which the loss is realized. Any loss in excess of $2,000 could be carried over and treated as long term capital loss in a succeeding year.

(2) Under present tax law, in some cases, a couple may presently double their maximum capital loss deduction to $2,000 a year by filing separate returns instead of a joint return. The Treasury report recommends that the annual limitation on the capital loss deduction be lowered to $500 in the case of a married person filing a separate return.

Adoption of these two proposals would increase revenues by $60 million in the first year. As the backlog of existing capital loss carryovers is absorbed under the new proposed rule, the annual revenue gain would ultimately reach $100 million annually.

Liberalization of Moving Expense Rules

Under present tax law, an individual who moves, because of a change in the location of his employment, may deduct from gross income the unreimbursed costs of certain so-called "direct" moving expenses. These "direct" moving expenses consist of the costs of transporting himself, members of his household, and their belongings, from the old residence to the new one. Meals and lodging while en route may also be deducted. Certain prescribed conditions and tests must be met by these employees, however, before these "direct" moving expenses may be deducted.

Employees who are transferred and who receive reimbursement from their employers for their moving expenses are not required to include the reimbursement in income, and correspondingly are not permitted any deduction for their reimbursed costs. However, because no deduction is involved, the statutory conditions and tests applicable to unreimbursed employees are not applicable to the reimbursed employees. As a result, there is a disparity in tax treatment between the two types of employees.

The Treasury report recommends, in addition to the present allowable expenses, that the deduction for moving expenses be liberalized to include:

(1) the cost of house hunting trips;

(2) the temporary living costs at a new location while awaiting permanent quarters; and

(3) certain costs incurred in selling a house.

These additional allowances would have a combined dollar limitation of $1,500. Further, in order to treat all employees alike, all reimbursements of moving expenses would be included in income and all tax allowances for moving expenses would be in the form of statutory deductions from gross income. Adoption of this proposal would create a revenue loss of $85 million per year.

Revised Tax Treatment of Elderly Persons

The present tax laws now contain a number of income tax benefits specifically designed for the elderly. These include an extra $600 personal exemption for those who have attained age 65, the retirement income credit, and an exemption for railroad retirement benefits. In addition, by administrative ruling, the Treasury Department has allowed social security benefits to be excluded from tax. Many of these benefits create a tax distinction between elderly retired taxpayers and those who continue to work after attaining age 65.

The Treasury report recommends that the income tax treatment of the elderly be revised. Those benefits described above would be repealed. In their place, a special exemption of $2,500 would be allowed to all single taxpayers who have attained the age of 65 and a special exemption of $4,200 would be allowed to a married couple if both spouses are age 65 or over. However, income, including social security and railroad retirement benefits, in excess of $6,500 in the case of a single individual and $11,500 in the case of a married couple, would reduce each of these special exemptions dollar for dollar. An adjustment would be made so that at least one-third of social security or railroad retirement benefits would always be tax free. These benefits would be in addition to the regular $600 personal exemption and the related minimum standard deduction (or ordinary standard deduction) which are available to all taxpayers at any age.

For retired individuals under age 65, the Treasury report recommends that a deduction be allowed equal to the amount of social security, railroad retirement, and public retirement system benefits included in the individual's gross income subject to a maximum limit on the deduction of $1,600. Further, this deduction would be reduced in the case of higher income taxpayers by the same formula that would reduce the $2,500 and $4,200 exemptions for individuals who have attained age 65, as discussed above. However, an adjustment would be made so that at least one-third of social security or railroad retirement benefits would always be tax free. Again these benefits would be in addition to the regular $600 personal exemption and the related minimum standard deduction (or ordinary standard deduction) which are available to all taxpayers. These proposals would result in an annual revenue loss of $80 million.

Voluntary Withholding on Individuals

Under present tax law there are various payments of wages and other similar types of remuneration which are excluded from the withholding tax system. These exclusions include wages paid to agricultural and domestic employees, and retirement payments. Those individuals who receive excluded wages and other payments are not permitted to make use of the withholding system even though both they and their employers might wish to do so.

The Treasury report recommends that the present system of withholding income taxes be extended to those situations where both the employer and the employee voluntarily agree to adopt the withholding system.

Corporate Income Tax

ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS

The income of corporations is subject to tax at the rate of 22 percent on the first $25,000 while income in excess of $25,000 is taxed at 48 percent. This lower rate on the first $25,000 of income is referred to as the surtax exemption. It was intended to help small corporate businesses. However, a number of large businesses use the lower rate by organizing themselves into many small separate corporations with each corporation claiming a separate surtax exemption.

The Treasury report recommends that these abuses be eliminated. Generally, each commonly controlled business enterprise would be entitled to only one surtax exemption. Transitional rules are provided so that elimination of the multiple surtax exemptions would be accomplished over a 7-year period. During this period the maximum number of surtax exemptions which could be claimed by a commonly controlled group or chain of corporations would be as follows:

Year:	*Number of surtax exemptions*
1	500
2	250
3	100
4	50
5	25
6	10
7	5
Thereafter	1

This proposal would increase annual revenues by $235 million after the transition is fully effected.

MINERAL PRODUCTION PAYMENTS

In the extractive industry the use of production payments has long been employed as a financing transaction to obtain funds (by "carving out" and selling the right to income from a portion of future production) or to facilitate the sale of a mineral property in an ABC transaction (by the owner "retaining" a right to a substantial portion of the future production, the income from which he applies against the selling price).

The Treasury report criticizes these uses in two respects: First, they permit the 50-percent limit on the depletion deduction to be avoided, and second, they permit the seller (in the case of a carve-out) or the purchaser of the working interest (in the case of an ABC transaction) to meet his obligations under the production payment contract out of income that has not been taxed in the year of payment, although the expenses involved in producing that income are deducted then.

To stop these practices the Treasury report recommends that production payments be treated like loans. Thus, the income from the production used to make the payment would first be taxed in the year of repayment of the loan—after allowance for depletion—to the seller of a "carve-out", and to the purchaser of the working interest in the case of an ABC sale. The expenses of producing the income would be deductible in the same year.

This proposal would increase revenues by $200 million a year.

Mutual Savings Banks; Savings and Loan Associations

In 1962 Congress revised the tax treatment of mutual thrift institutions with a view toward making more of their income taxable. The 1962 act established three alternative methods intended to tighten their deductions for additions to reserves for bad debts. Under the first, they could deduct an amount equal to 60 percent of taxable income. Under the second they could deduct whatever amount is necessary to bring bad debt reserves up to 3 percent of outstanding qualified real estate loans. Under the third they could deduct a larger amount based on actual loss experience. As a result of the second rule Treasury reports that mutual savings banks remain virtually tax exempt.

The Treasury report recommends that the 3-percent rule be repealed, and that mutual savings banks be subjected (over a transition period) to investment standards (which would also apply to savings and loan associations) in general requiring a large degree of mortgages on residential real estate for the full 60 percent deduction to be allowed. Under the proposal, tax deductions under the 60-percent rule would be reduced where the investment standards are not satisfied. This proposal would increase revenues by $40 million.

Subchapter S Corporations

Under present law, certain corporations with 10 or fewer shareholders may elect to have their income taxed directly to their shareholders, rather than paying the regular corporate income tax. While this treatment resembles, roughly, the rules for taxing income of partnerships, there are many special exceptions. For example, there are limitations on the types of income a corporation may receive and still qualify to make the election. Similarly, there are restrictions on the types of shareholders (individuals, trusts, estates, etc.) who may own shares of an electing corporation and on the types of shares it may issue.

The Treasury report makes a host of recommendations for revising the rules governing this election. Some of them are beneficial to electing corporations and their shareholders; others are restrictive in their impact. Virtually all of them, however, tend to aline the rules applicable to these corporations more closely with those applying to partnerships. The more significant suggestions are described here; however, other, more technical recommendations are included in the Treasury report.

Under present law, to qualify for the election, a corporation may not have more than 10 shareholders. Shareholders must be individuals (or an estate) and a husband and wife who own the stock jointly are treated as one shareholder. The Treasury report would permit the number of shareholders to reach 15 and not disqualify the election if (*a*) the corporation has been an electing corporation for 5 consecutive years, or (*b*) the additional shareholders receive their stock by bequest or inheritance. In addition, the death of a spouse who owned shares jointly with his survivor, and the transfer of his interest to his estate, need not result in the survivor and the estate being treated as two shareholders. Moreover, under the Treasury proposal, voting trusts and trusts whose income is taxed to the grantor could be shareholders of an electing corporation.

Under present law, to qualify for the election, all the stock of the corporation must be of a single class. The Treasury report would relax this rule somewhat by permitting differences in voting rights and by providing that certain narrowly defined nonvoting securities—referred to as "obligations"—will not be disqualifying even if determined to be "stock".

The Treasury report would eliminate the requirement that at least 80 percent of the income of an electing corporation must be from active business sources; in the future the receipt of passive investment income (such as dividends or interest) by the corporation would not deprive it of subchapter S treatment. On the other hand, it would require these corporations ordinarily to account for their income on a calendar-year basis, rather than a fiscal-year basis, thus preventing unreasonable deferral of tax on their earnings.

Both the procedural rules for making an election and the retroactive effect of a disqualifying event would be eased by the Treasury report suggestions. For example, contrary to present law the failure of a new shareholder to consent to the election would not terminate the election; under the Treasury report, an affirmative act by the new shareholder objecting to the election would be required to terminate it.

The rules for computing the income or loss of a subchapter S corporation and the timing and allocation of this income to the shareholders would be modified in a number of technical respects conforming more closely to partnership practices. Contrary to the partnership rules, however, except for capital gains and losses, items of income and loss would not retain their separate character in the shareholder's hands. To prevent potential avoidance of social security taxes or income limitations under the social security laws, the Treasury report suggests that the Commissioner of Internal Revenue be authorized to treat all or a portion of subchapter S income as salary for social security purposes.

The Treasury proposals would reduce the benefit of pension plans with respect to shareholders who own more than 10 percent of the stock of an electing corporation. Contributions by the corporation to a pension plan for such a shareholder would be taxed to him to the extent they exceed 10 percent of his earned income or $2,500 per year, whichever is the lesser. (This result is somewhat similar to the treatment of sole proprietors and partners under the Self-Employed Individuals Tax Retirement Act of 1962.) Moreover, forfeitures by other employees which inure to the benefit of such a shareholder would also be taxed to him in certain circumstances.

In addition, the exclusion from gross income for the value of food and lodging furnished for the convenience of the employer would be denied to shareholders of an electing corporation who own more than 10 percent of its stock.

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Tax-Exempt Organizations

PRIVATE FOUNDATIONS[1]

Under present tax law, private foundations, which are devoted exclusively to charitable purposes, are exempt from the Federal income tax. Also, contributions to such foundations are deductible by taxpayers, within specified limits, as charitable contributions. In 1965, the Treasury Department submitted a report to Congress on certain practices in the use of private foundations and recommended that specified corrective proposals be enacted. The present Treasury report again discusses these practices and proposes similar changes in the tax law. The Treasury report proposals discussed below would not apply to the following types of charitable organizations:

(1) Organizations which normally receive a substantial part of their support from the general public or governmental bodies;

(2) Churches or conventions or associations of churches;

(3) Educational organizations with regular faculties, curriculums and student bodies; and

(4) Organizations whose purpose is testing for public safety.

Prohibition against self-dealing

Present tax law generally permits transactions between tax-exempt organizations and their donors if these transactions are conducted at arm's length. The Treasury report proposes that, in the case of private foundations (and certain similar trusts), the tax law be changed to prohibit private foundations from engaging directly or indirectly in any transaction involving the transfer or use of the foundation's assets with a donor (or related parties). The prohibition would apply against such transactions as the following:

(1) Lending any part of its assets to a donor;

(2) Purchasing or leasing its property from a donor; and

(3) Selling or leasing its property to a donor.

The prohibition would apply to indirect transactions as well as direct transactions. In addition, corporations controlled by private foundations would be subject to the same prohibitions as those applicable to the controlling private foundation. Nevertheless, the general prohibition against self-dealing would not apply to—

(1) Reasonable compensation for personal services actually rendered;

(2) Service made available on a nonpreferential basis;

(3) Purchases made by the foundation of incidental supplies (at no more than fair market value);

[1] [CLERK'S NOTE.—At present, the management activities of a private foundation, including prohibitions against self-dealing, required distributions to charity, types of investments and selection of managerial personnel, are regulated almost wholly by State law. The State laws vary widely depending upon the particular State involved and the organizational structure of the private foundation. Many writers in this field believe either that these State laws are not sufficiently restrictive to prevent the abuses which are discussed in the Treasury report or that, in those States where the restrictions are substantial, the laws cannot be adequately enforced because of administrative difficulties.]

(4) Interest-free loans to the foundation and their repayment; and

(5) Purchases of foundation assets (at no less than fair market value), divestiture of which is required under certain specified conditions.

Donors and related parties subject to the prohibition against self-dealing would be—

(1) The creator of the foundation, a substantial contributor to the foundation, or a director, officer, trustee, of the foundation;

(2) Certain persons directly related to persons listed in (1) above;

(3) A corporation, the stock of which is owned in an amount of 20 percent or more by one or more persons, described in (1) and (2) above;

(4) Directors and officers, or persons with a substantial stock interest (20 percent or more), of a corporation which is a substantial contributor to the foundation; and

(5) An estate or trust for the benefit of one or more of the persons described above.

Required distributions to charity—Realized income distribution requirement

The Treasury report proposes that the Federal tax law be changed so that all private "nonoperating" foundations be required to distribute all of their "current net income" by the end of the year following the year in which it is received. A private foundation would be considered "nonoperating" if it does not have more than one-half of its assets devoted directly to charitable activities or does not expend substantially all of its income for the active conduct of charitable activities. Holding assets for the production of income, and distributing this income to charities which are "operating," would not meet the proposed tests. "Current net income" would include income from rents, interest, dividends, short-term capital gains, and after specified adjustments, income subject to the unrelated business income tax. Deductions for expenses directly connected with the generation of this income would be allowed in computing "current net income." Long-term capital gains and contributions would not be considered income for purposes of this test.

In applying the test, income would have to be expended as—

(1) Contributions to publicly supported charitable organizations;

(2) Contributions to privately supported operating organizations;

(3) Direct expenditures for charitable programs; or

(4) Purchases of assets which the foundation devotes directly to charitable activities.

Certain limited exceptions would be provided. This proposal would apply to foundations presently in existence, as well as those to be created in the future, although a 2-year transition period would be provided so that existing foundations could adjust their investments.

Required distributions to charity—Income equivalent

In addition to the realized income distribution requirement, the Treasury report also proposes that if realized income which is required to be distributed, as discussed above, does not equal a specified percentage of the foundation's investment assets, then certain dispositions of its investment assets for one of the four charitable purposes described in the preceding paragraph would be required. This "income equivalent" test would be applied only against the foundation's investment assets. Certain limited exceptions are provided. The test would apply to foundations presently in existence, as well as those to be created in the future, although a 2-year transition period would be provided in order that a foundation could adjust its investments.

Limitation on involvement in business

The Treasury report proposes that the Federal tax law be changed so that a private foundation is prohibited from owning directly, or indirectly, 20 percent or more of the total combined voting power, or 20 percent or more of the total value of the equity, of a corporation conducting a business which is not related to the exempt purpose of the foundation. Similar rules are provided for the ownership of an unincorporated business. The definition of business would be the same as that now used in defining business for purposes of the unrelated business income tax of exempt organizations. However, three activities would be excluded from the definition. They are:

(1) Lending, other than that resulting from the active conduct of commercial lending or banking;

(2) Holding of royalties and mineral production payments as investments; or

(3) Holding of leases of real property (and associated personal property) of a passive nature.

Foundations would be afforded a reasonable period of time to reduce their unrelated business interests below the prescribed maximum limit. Also the general prohibition against self-dealing, discussed above, would not apply to the sale of assets sold by the foundation to meet this requirement.

Donation of controlled property

Under present tax law, a donor to a private charitable foundation is allowed a charitable deduction at the time he gives property to the foundation. The Treasury report proposes, however, that if a donor (or related parties) maintains control of a business, or other property, after the contribution of an interest in such business (or property), to a private foundation, then, no charitable deduction would be permitted to the donor until—

(1) The foundation disposes of the contributed asset;

(2) The foundation devotes the property to active charitable operations; or

(3) Donor control over the business, or property, terminates.

The event qualifying the contribution for a deduction would have to occur within 3 years from the donor's death. Generally, the Treasury report proposes that control of an incorporated business would be presumed if the donor (or certain related parties) owned 20 percent or more of the total combined voting power of the corporation. Control of an unincorporated business would be similarly presumed if the donor (or related parties) owned a 20 percent or more interest in the unincorporated business.

The Treasury report also proposes that the value of the contributed property at the time of the occurrence of the qualifying event would determine the amount of the income tax deduction to which the donor would be allowed. This proposal would be effective as to contributions made to private foundations after the date of enactment.

Unrelated financial transactions—Foundation lending

The Treasury report proposes that loans made by private foundations which are unrelated to their exempt functions be restricted to certain classes. Those loans not related to the exempt function, but which would be permitted, are bank deposits, loans which are fully secured by securities traded upon an exchange or in an over-the-counter market, loans to governmental units, and loans fully secured by first mortgages on real estate. The proposal would apply to all loans made after the date of enactment.

Unrelated financial transactions—Speculating

The Treasury report proposes that private foundations be prohibited from any kind of active trading or speculating with its corporate stocks or other assets. This prohibition would also include investments in "puts," "calls," and "special options." Selling short and trading commodity futures would also be prohibited. The proposal would apply to any transaction after the effective date of enactment.

Broadening of foundation management

Under present law, there is generally no limit upon the life of a foundation or the degree of control that a donor and his descendants may exercise over the foundation. The Treasury report proposes that the Federal tax law be changed so that membership of the managing board of a private foundation be limited so that after the first 25 years of existence of the foundation no more than 25 percent of the membership of the board could be attributed to a donor or related persons. A donor would be any person who has made a substantial contribution to the foundation, who controls a corporation which has made a substantial contribution, or who is the beneficiary of a trust which has made a substantial contribution to the foundation. Related persons would include the family of the donor and persons who have a continuing business or professional relationship with the donor, such as one's law partner. Under the proposal, foundations presently in existence would be required to broaden their management within the required 25-year period or within 10 years from the date of enactment, whichever was later.

Other changes

The Treasury report proposes other minor changes. One change would postpone deductions for contributions of property of doubtful utility to a private foundation. The deduction would be permitted after the utility of the contributed property was assured. Another proposed change would increase the present sanctions applied to private foundations that fail to file information returns.

Debt Financing of Acquisitions

Under present tax law, tax-exempt organzations may borrow money to purchase an asset or, similarly, may purchase an asset subject to an existing indebtedness. In some instances, depending upon the type of property and the type of exempt organization, income received from the purchased property is not subject to tax even though such property is not related to the exempt purpose of the organization. Capital gains treatment is, of course, available to the seller of the property.

The Treasury report proposes that certain changes be made in transactions of this type because income from the property which is being purchased is used to pay off the purchase price without first being subjected to tax. This type of purchase, that is, with tax-free income, is not available to the regular taxpayer and, as a result, the tax-exempt organization is able to pay more for the property than a person who is not tax exempt. The proposed changes would impose an income tax upon the "unrelated debt-financed income" of all exempt organizations. Unrelated debt-financed income would be that income which is—

(1) derived from "debt-financed property"—that is, property acquired or improved with borrowed funds; and

(2) produced from sources which are unrelated to the exempt purpose of the organization. Income produced by investments of an organization's own funds would not be affected by this proposal.

"Debt-financed property" would be all property which is held to produce income with five exceptions. These five exceptions are:

(1) Property all of the use of which is related to the exercise or performance of the organization's exempt function;

(2) Property all of the income from which is already subject to tax as income from the conduct of an unrelated trade or business;

(3) Property all of the income from which is derived from research activities excepted from the present unrelated business income tax;

(4) Certain property all of the use of which is in a trade or business where—

(*a*) Substantially all of the work in carrying on the business is performed without compensation,

(*b*) The business is carried on primarily for the convenience of the organization's members, students, patients, officers, or employees, such as a college cafeteria, or

(*c*) The business consists of selling merchandise substantially all of which has been received as contributions; or

(5) Real property which the organization plans to devote to exempt use within 10 years of the date of acquisition.

Generally, the indebtedness described in this proposal is indebtedness incurred or assumed in acquiring or improving the property in question or indebtedness which would not have been incurred or assumed "but for" the acquisition or improvement of the property.

Only a portion of the total unrelated income received from any property in question would be taxable. The taxable portion would be the amount bearing the same ratio to the total income from the property as the amount of the average indebtedness attributable to the property for the year bears to the average adjusted basis of the property for the year. Deductions used to arrive at "unrelated debt-financed income" would be limited by the same ratio. This proposal would not change the rules presently in the tax law for the taxation of businesses owned outright, that is, without debt, by exempt organizations. These rules, with their present exceptions and exclusions would remain as they are.

Transition rules would be in effect for 5 years from June 27, 1966. Generally, during the transition period, these new rules would only apply where indebtedness has been incurred after June 27, 1966, and only to income received after the date of enactment of the proposal. After the transition period, the new provisions would be applicable to all situations of exempt organization investment borrowing, irrespective of when the debt was incurred. The revenue effect of this proposal is not known because a number of exempt organizations which would be required to pay tax under this proposal do not now have to file information returns.

Taxation of Income From Unrelated Business and From Investments of Certain Exempt Organizations

Under present tax law, an income tax is imposed upon income derived by several types of tax-exempt organizations from the regular conduct of a trade or business which is not related (other than to provide funds) to their tax-exempt purpose. However, several types of exempt organizations, including churches, social welfare organizations, social clubs, and fraternal beneficiary societies, are not subject to the unrelated business income tax. In addition, the tax on unrelated business income does not apply to three specific types of businesses. These exceptions are:

(1) Any trade or business in which substantially all of the work of carrying on the trade or business is performed without compensation;

(2) A trade or business operated by a charitable organization or a college or university, primarily for the convenience of the organization's members, students, patients, officers, or employers; or

(3) A trade or business which consists of the selling of merchandise substantially all of which has been received by the organization as gifts or contributions.

The Treasury report proposes the following:

(1) The unrelated business income tax would be extended to churches and to social welfare organizations. The three specific exceptions presently provided by the provisions of the unrelated business income tax for certain businesses would apply to these organizations;

(2) The tax exemption for social clubs would be limited to income from fees, dues, or other amounts charged to its members for providing such members and their guests with the services and facilities related to the basis of the tax exemption. The present exception to the unrelated business income tax for investment income would be eliminated insofar as these exceptions are applicable to social clubs, and the three specific exceptions pres-

ently allowed under the unrelated business income tax for certain businesses would not apply to these organizations; and

(3) Fraternal beneficiary societies would be taxed in the same manner as social clubs, as described in (2) above, but with certain specific exemptions for income from property committed to providing life, sick, accident, and certain other benefits to the membership.

These proposals, if enacted, would become effective for taxable years beginning after December 31, 1969. The proposals would increase annual revenue receipts; however, the amount cannot be determined.

Estate and Gift Taxes

Taxation of Unrealized Gains Transferred at Death or by Gifts

Under present tax law, income is subject to Federal income tax whenever it is received or accrued. Thus, income from such sources as wages, salaries, dividends, and business profits is taxed upon the receipt of cash or its equivalent or, if the taxpayer is on an accrual method of accounting, upon the receipt of marketable rights or receivables. Similarly, whenever a taxpayer sells a capital asset, any gain arising from the sale is subject to income tax. However, in general, income tax is imposed only if capital assets are sold and proceeds are received or accrued. If a taxpayer holds an asset until he dies, any unrealized gain is not subject to income tax, although the full value of the asset is subject to an estate tax.

The Treasury report proposes that any unrealized gain in the value of assets transferred at death or by gift be subject to an income tax at the time of the death or the gift. Specifically, the proposal provides:

(1) Only unrealized gains attributable to periods occurring after the date of the enactment of the proposal would be subject to income tax. Unrealized gains attributable to periods prior to the date of enactment would not be subject to an income tax;

(2) Any income tax on the unrealized gain in the value of assets transferred at death would be allowed as a deduction in determining the taxable estate of a taxpayer for estate tax purposes;

(3) No income tax at all would be imposed on unrealized gains where the total value of the assets transferred at death is $60,000 or less. If the total value of the assets transferred at death exceeded $60,000, then the unrealized gain to be taxed would be limited by the amount that the total value of the transferred assets exceeded $60,000;

(4) Complete exemptions to the income tax on unrealized gains would be allowed for transfers between spouses or to charity;

(5) Exemptions from the income tax would be allowed on unrealized gains in the value of assets transferred at death to an orphan child (a minor child where the decedent was the last surviving parent) to the extent that the value of the property transferred does not exceed an amount equal to $3,000 multiplied by the number of years remaining until the child re[illegible] age 21;

(6) Exemptions from the income tax on [illegible] would be allowed on the transfers of ordinary [illegible] personal effects that have a value of less than $[illegible];

(7) Net unrealized losses on [illegible] property would be allowed as an offset [illegible] against ordinary income for the 3 taxa[illegible] the [illegible]edent's final income tax return (with [illegible]mitations); and

(8) Gains on transferred assets giving rise to ordinary income would be eligible for averaging under the present income averaging rules.

This proposal would apply to transfers by gift or by death after December 31, 1969.

Tax-Free Transfers Between Husband and Wife

Under present law, by virtue of the so-called marital deduction, a husband is permitted to transfer one-half of his property to his wife free of any estate tax or gift tax. In addition, in order for a transfer of property at death from one spouse to another to be tax-free, the property must be transferred directly from the decedent to the surviving spouse, and the surviving spouse must be given outright ownership (or its equivalent) over the property. Specifically, a transfer of property from a husband to his wife with income payable to her for life and upon her death all remaining property to their children does not qualify for the marital deduction and is, thus, taxed in full in the husband's estate.

The Treasury report proposes, if the unified transfer tax discussed below is adopted, that an exemption from the unified transfer tax be given for the full amount of any property—

(1) That passes outright to a spouse (either during the life of the transferor spouse or at his or her death); or

(2) That passes subject to any kind of legal arrangement assuring the transferee spouse, for life, or for any other period of time that commences currently, of enjoyment (or use) of the property or the income from it.

Further, in the case where a transferee spouse is given, or left at death, an income interest in trust, subject to a power exercisable by the trustee to invade corpus for the benefit or use of others, the transfer in trust would qualify as a tax-free transfer. However, any payments from corpus to persons other than the transferee spouse would be treated as transfers made by the transferee spouse at the time such payments are made. If the transferee spouse has no control over the invasion power, then the tax would be collectible only out of the property distributed from corpus.

Also, it is proposed that an option be available to the transferor to have any portion of property transferred to a spouse subject to the transfer tax. Property taxed under this option would not be taxed again upon transfer by the surviving spouse if it can be traced. This option would be exercisable by the transferor except that in the case of a transfer at death, if the decedent had made no election, then it could be exercised by the surviving spouse. Certain other complex rules are provided for transfers of partial and concurrent interests. These more technical recommendations are discussed in the Treasury report.

This proposal would be effective for all transfers occurring after the date of enactment. However, it would not be effective until 2 years after the date of enactment in the case of any transfer pursuant to a provision of a will which was executed before a date to be specified, where the amount passing to the surviving spouse is described in terms of the maximum allowable marital deduction under the Internal Revenue Code.

Estate Transfers to Minor Children

Under the present estate tax law, a transfer at death from the last surviving parent to a minor child is taxed the same as a transfer to any other person. Because special relief is frequently justified in these cases, the Treasury report recommends that a transfer at death to any child of the decedent under 21 years of age be nontaxable to the extent that the transfer does not exceed $3,000 multiplied by the number of years remaining until the child reaches 21. The child must not have another parent (including parents by adoption) living at the time of death.

Unification of the Estate and Gift Taxes

Under present tax law, the estate and gift taxes are provided as two separate taxes. Each tax is treated as a separate system and, in general, each system has its own set of rules. The estate tax is imposed upon property transferred at death and utilizes a progressive rate structure, so that the larger the estate, the higher the rate of tax. An exemption of $60,000 is granted to each estate and only amounts in excess of that exemption are taxed. Property which is transferred during a lifetime is generally not subject to the estate tax, but is instead, subject to a gift tax. The gift tax is imposed upon transfers of property which are made during a person's lifetime. The gift tax provides for a total $30,000 exemption which is applicable to all gifts made during the taxpayer's lifetime. In addition, a $3,000 per donee exclusion is provided each year with respect to gifts of present interests made to each individual person. Similar to the estate tax, the gift tax is also a progressive tax with the rate increasing with the cumulative lifetime total of property transferred. The estate tax is paid out of property which belongs to the estate while the gift tax is paid by the donor and does not reduce the amount of the gift. Because the two taxes are treated as separate systems, the estate tax begins with a new scale of rates irrespective of the amount of gifts which have been given by the decedent during his lifetime.

The Treasury report recommends full unification of the estate and gift taxes into a single transfer tax. The proposal would provide that—

(1) Lifetime gifts and transfers at death would be added together to determine the total amount subject to the unified transfer tax and a single exemption of $60,000 and a single rate schedule (approximately 20 percent lower than present estate tax rates) would be made applicable to that total. The present $3,000 per donee per year exclusion would be continued;

(2) The tax would be imposed upon the fair market value of the property transferred, including, in the case of both lifetime and death transfers, the amount of tax paid on the transfer. Fair market value would be determined as of the date of the gift. Generally, in the case of property passing upon death, the value would be determined as of the date of death or 1 year later (the alternative valuation date), as under present law;

(3) The unified tax imposed upon death would be reduced by any State death taxes paid with respect to property upon which the Federal tax is payable, as is done under present law. The maximum limitations of the present law would continue to apply;

(4) Under present law, if a decedent acquired property from a prior decedent whose death occurred within 10 years before the death of the decedent, the decedent's estate is allowed a credit against its estate tax. However, because the Treasury report proposes that unlimited transfers be allowed tax-free between spouses, the present credit for tax on prior transfers would be eliminated after a 10-year transition period; and

(5) As under present law, any individual who during a calendar year made a gift in excess of the annual per-donee exclusion ($3,000) would file a transfer tax return for that year. In the case of a decedent, a return would have to be filed if his estate—plus the value of taxable gifts, and the tax paid on them—totaled more than the amount of the overall exemption of $60,000.

Under the proposal, the unified transfer tax would become effective on January 1, 1970. A transition rule is provided so that the new rates would be fully implemented in 10 years. Each individual would be entitled to a $60,000 lifetime exclusion which could be applied against any transfers made after December 31, 1969. For purposes of determining the rate bracket applicable to transfers after December 31, 1969, all included transfers after December 31, 1968, would be counted as transfers for purposes of the new unified tax. However, transfers made on or before December 31, 1969, would be taxed under the present system.

The present estate tax rates and the new proposed unified transfer tax rates are contained in the following table:

Taxable transfer	Present estate tax rate (percent)	Unified transfer tax rate (percent)	Tax at top of bracket	
			Present	Proposed
0 to $5,000	3	3	$150	$150
$5,000 to $10,000	7	7	500	500
$10,000 to $20,000	11	11	1, 600	1, 600
$20,000 to $30,000	14	11	3, 000	2, 700
$30,000 to $40,000	18	14	4, 800	4, 100
$40,000 to $50,000	22	16	7, 000	5, 700
$50,000 to $60,000	25	16	9, 500	7, 300
$60,000 to $80,000	28	18	15, 100	10, 900
$80,000 to $100,000	28	20	20, 700	14, 900
$100,000 to $150,000	30	22	35, 700	25, 900
$150,000 to $250,000	30	24	65, 700	49, 900
$250,000 to $350,000	32	25	97, 700	74, 900
$350,000 to $500,000	32	27	145, 700	115, 400
$500,000 to $750,000	35	29	233, 200	187, 900
$750,000 to $1,000,000	37	31	325, 700	265, 400
$1,000,000 to $1,250,000	39	33	423, 200	347, 900
$1,250,000 to $1,500,000	42	35	528, 200	435, 400
$1,500,000 to $2,000,000	45	37	753, 200	620, 400
$2,000,000 to $2,500,000	49	41	998, 200	825, 400
$2,500,000 to $3,000,000	53	44	1, 263, 200	1, 045, 400
$3,000,000 to $3,500,000	56	47	1, 543, 200	1, 280, 400
$3,500,000 to $4,000,000	59	49	1, 838, 200	1, 525, 400
$4,000,000 to $5,000,000	63	53	2, 468, 200	2, 055, 400
$5,000,000 to $6,000,000	67	56	3, 138, 200	2, 615, 400
$6,000,000 to $7,000,000	70	59	3, 838, 200	3, 205, 400
$7,000,000 to $8,000,000	73	61	4, 568, 200	3, 815, 400
$8,000,000 to $10,000,000	76	63	6, 088, 200	5, 075, 400
$10,000,000 and up	77	65		

The present gift tax, which would be absorbed in the new proposed unified transfer tax, is presently imposed at the following rates:

Taxable transfer	*Percent*
0 to $5,000	2¼
$5,000 to $10,000	5¼
$10,000 to $20,000	8¼
$20,000 to $30,000	10½
$30,000 to $40,000	13½
$40,000 to $50,000	16½
$50,000 to $60,000	18¾
$60,000 to $100,000	21
$100,000 to $250,000	22½
$250,000 to $500,000	24
$500,000 to $750,000	26¼
$750,000 to $1,000,000	27¾
$1,000,000 to $1,250,000	29¼
$1,250,000 to $1,500,000	31½
$1,500,000 to $2,000,000	33¾
$2,000,000 to $2,500,000	36¾
$2,500,000 to $3,000,000	39¾
$3,000,000 to $3,500,000	42
$3,500,000 to $4,000,000	44¼
$4,000,000 to $5,000,000	47¼
$5,000,000 to $6,000,000	50¼
$6,000,000 to $7,000,000	52½
$7,000,000 to $8,000,000	54¾
$8,000,000 to $10,000,000	57
$10,000,000 and up	57¾

Generation Skipping

Under present law, individuals may make gifts of property outright to grandchildren, great-grandchildren or persons of similar ages, and thus bypass, in the ordinary sequence of inheritance, one or more generations. Similarly, an individual may transfer property in this manner at death. Although a gift tax or an estate tax is imposed at the time of the initial transfer, no gift tax or estate tax, or a substitute tax, is imposed because a generation is skipped by such transfers. Similarly, individuals may give property, or leave property at death, in trust for the benefit of specified heirs or other individuals. The income from the trust (and even the principal) may be for the benefit of individuals of one generation with the remaining corpus of the trust being held for the benefit of individuals of another generation. Present tax law does not provide for a second transfer tax on the corpus of the trust if a generation is skipped by this type of arrangement.

The Treasury report proposes that a substitute tax be imposed if property is transferred, by gift or at death, so that it will be received by any person who is more than one degree in family relationship below the transferor, such as a grandchild, without the payment of a transfer tax by an intervening generation. If property is transferred to a person unrelated to the transferor, the transferee would be considered more than one degree below the transferor if he is more than 25 years younger than the transferor. The substitute tax would apply whether the transfer is in the form of an outright gift or through a trust.

Generally, the substitute tax would be imposed on the transferor (in the case of a gift) or on his estate (where the property passes at death). The substitute tax would be computed by multiplying the value of the transferred property by 60 percent of the transferor's marginal tax rate. This tax would be paid in addition to the regular tax.

The Treasury report further proposes that an election could be made by the individual who is being skipped to treat the gift or transfer at death as if he had received the property and then made a retransfer to the individual actually receiving the property. No substitute tax would be imposed on the original transferor; however, the individual being skipped would have to pay a transfer tax at his present bracket rates. For all unified tax purposes, the individual would be treated as if he actually received the property and then had it retransferred.

The same substitute taxes would be imposed for additional generations that are skipped. Complex rules are provided for trusts. These trust rules are not discussed here because they are more technical in nature; however, the rules treat transfers in trust in accordance with the general theory for outright transfers discussed above.

This proposal would apply to transfers on or after January 1, 1970. However, the substitute tax would not be applicable to distributions from irrevocable inter-vivos trusts created before January 1, 1969, or to trusts created by will of decedents dying before January 1, 1970.

Rate Reduction

The Treasury report concludes that the taxation at an income tax rate of unrealized gains in the value of assets transferred as a gift, or at death, and the unification of the estate and gift taxes into one transfer tax would produce substantial revenue yields under the present rate structure. The report proposes that, because of these revenue increases, there should be an offsetting decrease in revenues by a scheduled reduction of the transfer tax rates over a period of 10 years. After 10 years, the top transfer tax rate is proposed to be 65 percent compared with the present top estate tax rate of 77 percent. The remainder of the rate schedules would be reduced commensurately by about 20 percent, with a few minor exceptions.

Liberalization of Payment Rules

Estates which consist largely of interests in closely-held businesses or in farms frequently encounter difficulties whenever decedents' heirs wish to maintain ownership of the businesses or farms. This occurs because the heirs are forced to raise money to discharge the estate's tax liability by selling the business or farm.

The Treasury report proposes the following:

(1) Under present tax law, an estate containing a farm, partnership interest, or stock in a closely held corporation may elect to pay the estate taxes attributable to such an interest in up to 10 annual installments. However, this relief is not available unless the value of the interest exceeds either 35 percent of the value of the gross estate or 50 percent of the taxable estate of the decedent. It is proposed that these installment payments would be permitted if the value (as determined for Federal estate tax purposes) of these interests exceeds 25 percent of the taxable estate of the decedent. In addition, certain more technical changes would be made in the definition of a closely-held corporation;

(2) Under present tax law, district directors may require, as a condition to the granting of an extension of time to pay taxes, that the taxpayer furnish a bond for up to double the amount with respect to which an extension is granted. It is proposed that, in

addition to permitting the use of bonds, security arrangements could be made when extensions of time for the payments of these taxes are requested. The types of security arrangements which would be permitted would be specified in the Internal Revenue Code; however, the precise arrangement which would be required in each individual case would be left to the discretion of the district director; and

(3) Under present tax law, partial redemptions of stock in a corporation are usually taxed as ordinary income. However, capital gains treatment is given to certain redemptions of corporate stock which do not exceed the amount of death taxes, or funeral and administration expenses. To qualify for this favorable treatment, the stock redemption must be accomplished by a corporation whose stock comprises more than 35 percent of the value of the decedent's gross estate, or more than 50 percent of the decedent's taxable estate. The Treasury report proposes that capital gains treatment be given if the corporate stock comprises more than 25 percent of the taxable estate of the decedent and that redemptions of stock in these situations be permitted to extend over a period of 10 years. However, the use of notes, or similar receivables and rights, to avoid these time limitations would not be allowed and redemptions will be permitted only to the extent necessary to pay taxes on closely held businesses.

Revenue Effect of Estate and Gift Tax Proposals

The estate and gift tax proposals of the Treasury report have revenue effects that would change considerably over a long period.

The report estimates that, generally, removing the limit on transfers to spouses would cause a revenue loss of about 13 percent of the present estate and gift taxes. This loss would eventually decline to about 10 percent.

Unification of estate and gift taxes initially would cost a revenue loss of about 1 percent of the present estate and gift revenues. After 10 years this unification would be converted into a 5-percent revenue gain over present estate and gift taxes.

The generation skipping substitute tax would initially increase the estate and gift taxes revenue by 2 percent. After 10 years this revenue increase would be 4 percent.

The taxation of unrealized capital gain upon transfer of property at death or by gift would initially cause a revenue gain equal to 6 percent of present estate and gift tax revenues. After 10 years this revenue gain would become 23 percent.

The estate and gift tax rate changes would reduce present revenues by 17 percent after 10 years.

The report further estimates that the other substantive changes recommended in the estate and gift tax systems would approximately cancel out. The overall combined changes would reduce taxes on estate and gift tax returns filed for 1970 decedents by 7 percent. For 1980 decedents, there would be an increase by about 5 percent of the taxes on estate and gift tax returns. The revenue loss in fiscal year 1971 would be less than \$100 million. In fiscal year 1972, there would be a \$260 million loss. In the 10th year after the enactment of the estate and gift tax proposals, there would be a revenue gain of about \$360 million.

Supplementary Material in the Treasury Report

The tax reform studies and proposals also contain material relating to the following subjects:

(1) The tax treatment of minerals;
(2) The tax treatment of timber;
(3) The tax treatment of real estate; and
(4) The tax treatment of financial institutions.

The accumulation of this supplementary material was completed after the recommendations of the Treasury technicians had been completed and prepared for transmission to the Congress. These supplementary materials are attached to the tax reform document as background for the development and assessment of future proposals in the areas with which they deal. However, no recommendations are advanced by the Treasury report with regard to the matters dealt with by the supplemental studies.

Tables

TABLE 1 (PT. 1).—*Summary revenue estimates for income tax provisions*

[In millions of dollars]

	Revenue change, 1969 levels
INDIVIDUAL INCOME-TAX CHANGES	
Relief for persons in poverty: Liberalization of minimum standard deduction	−1, 130
Elimination of unacceptable tax abuses:	
Minimum individual income tax	+420
Allocation of deductions	+405
Correction of abuses by nonfarmers of farm tax rules	+145
Taxation of multiple trusts and accumulated income in trusts	+70
Limitation on tax burden: Maximum individual income tax	−205
Increased simplification and equity in treatment of deductions:	
Liberalization of limits of general standard deduction:	
Increase percentage of adjusted gross income limit to 14 percent	−215
Increase dollar limit to $1,800	−1, 190
Revision of charitable contributions deduction:	
Allowance of deduction outside the standard deduction	−440
Disallowance of deduction under the 3-percent threshold	+1, 470
Disallowance of unlimited deduction [1]	+25
Increase deduction ceiling to 50 percent	−20
Repeal of gasoline tax deduction	+310
Consistency of capital gain and loss rules [2]	+100
Liberalization of moving expense rules	−85
Revised tax treatment of elderly	−80
Total individual income tax changes	−420
CORPORATE TAX CHANGES	
Correction of tax abuses and defects:	
Multiple surtax exemptions [2]	+235
Mineral production payments [2]	+200
Tax-free reserves of mutual savings banks	+40
Total corporate tax changes	+475
Allowance for improved administration through reduction in number of itemizers and changes in charitable deduction	+100
Net revenue change for income tax provisions	+155

[1] Although the provision would not be eliminated until 10 years after enactment of the reform program, the revenue gain from its elimination is shown at 1969 levels.
[2] This is the expected revenue when the transition is fully accomplished.

TABLE 1 (PT. 2).—*Summary revenue estimates for transfer tax provisions*

	Percent of tax that would be due under present law at year of death—	
	1970	1980
Unlimited marital deduction	−13	−10
Unification	−1	5
Substitute tax (for generation skipping)	2	4
(Other substantive estate provisions approximately cancel out.)		
Estate and gift tax rate changes	0	−17
Total estate and gift tax	−13	−18
Capital gains on transfer by death or gift	6	23
Total transfer tax changes	−7	+5

NOTE.—Details may not add to totals because of rounding.

Revenue Collections

	Fiscal year 1971	Fiscal year 1972	Fiscal year 1976	Fiscal year 1980
Expected yield, present law (billions)	$4.3	$4.6	$6.0	$8.7
Percentage change, in fiscal year revenues	−1.6	−5.7	+1.0	+4.2
Revenue change (millions)	−$70	−$260	+$60	+$370

NOTE.—Details may not add to totals because of rounding.

TABLE 2.—*Overall effects of the individual income tax reform proposal (1969 levels)*

[Dollar amounts in millions]

AGI (in thousands of dollars)	Present law tax	Tax change	Percentage tax change	Present law AGI [1]	Tax change as percent of AGI
0 to 3	$1,159	−$415	−35.8	$18,952	−2.2
3 to 5	3,177	−495	−15.6	36,766	−1.3
5 to 7	5,439	−393	−7.2	57,388	−.7
7 to 10	13,925	−432	−3.1	139,762	−.3
10 to 15	18,916	−478	−2.5	157,751	−.3
15 to 20	7,550	+79	+1.0	53,418	+.1
20 to 50	12,795	+503	+3.9	67,323	+.7
50 to 100	6,326	+385	+6.1	21,404	+1.8
100 to 500	4,666	+403	+8.6	12,141	+3.3
500 to 1,000	645	+113	+17.5	1,510	+7.5
1,000 and over	891	+200	+22.4	2,091	+9.6
Total	75,490	[2] −530	−.7	568,506	−.1

[1] Taxable returns.

[2] The overall revenue loss of $530,000,000 differs from the $420,000,000 loss on table 1 by the $40,000,000 difference between the 1969 and longrun effect of the capital loss limitation provision and the $70,000,000 gain from current taxation of individuals of income accumulated in certain trusts.

TABLE 3.—*Tax status change in taxable and nontaxable returns under the reform program (1969 levels)*

[Number of returns in thousands]

AGI (in thousands of dollars)	Nontaxable under present law	Taxable made nontaxable by reform program	Nontaxable made taxable by reform program	Nontaxable under reform program
0 to 3	11, 632	2, 535	40	14, 127
3 to 5	1, 062	835	40	1, 857
5 to 7	279	105	30	354
7 to 10	94	10	30	74
10 to 15	32	5	5	32
15 to 20	7		2	5
20 to 50	4		2	2
50 to 100	. 7		. 3	. 4
100 plus	. 5		. 3	. 2
Total	13, 111	3, 490	150	16, 451

NOTE.—Details may not add to totals because of rounding.

TABLE 4.—*Number and percent of tax returns affected by individual income tax provisions of the reform program (1969 levels)*

[Number of returns in thousands]

AGI (in thousands of dollars)	Number of returns (taxable and nontaxable)	Number of returns			Percent of returns		
		With no change	With tax increase	With tax decrease	With no change	With tax increase	With tax decrease
0 to 3	21, 640	11, 590	285	9, 765	54	1	40
3 to 5	10, 285	1, 025	995	8, 265	10	10	80
5 to 7	9, 916	346	2, 645	6, 925	3	27	75
7 to 10	16, 875	110	6, 860	9, 905	1	41	58
10 to 15	13, 340	55	5, 935	7, 350	(1)	44	55
15 to 20	3, 151	21	1, 945	1, 185	1	62	37
20 to 50	2, 363	15	1, 913	435	1	81	18
50 to 100	329	1	301	27	(1)	91	8
100 to 500	75	(1)	66	9	(1)	88	12
500 to 1,000	2	(1)	1. 4	. 6	(1)	70	30
1,000 and over	1	(1)	. 7	. 3	(1)	70	30
Total	77, 977	13, 162	20, 945	43, 870	17	27	56

1 Less than 50 returns or .5 percent.

NOTE.—Details may not add to totals because of rounding.

TABLE 5.—*Gainers (tax decrease) and losers (tax increase) from individual income tax provisions of the reform program by filing status and deduction status under present law (1969 levels)*

[Number of returns in thousands]

AGI (thousands of dollars)	Present standard and itemized returns					
	All returns		Joint returns		Other returns	
	Gain	Lose	Gain	Lose	Gain	Lose
0 to 3	9,765	285	935	80	8,830	205
3 to 5	8,265	995	2,780	485	5,485	510
5 to 7	6,925	2,645	3,480	1,615	3,445	1,030
7 to 10	9,905	6,860	7,935	6,125	1,970	735
10 to 15	7,350	5,935	6,700	5,535	650	400
15 to 20	1,185	1,945	1,095	1,840	90	105
20 to 50	435	1,913	395	1,780	60	133
50 to 100	27	301	22	276	5	25
100 and over	10	68	7	61	3	7
Total	43,870	20,945	23,355	17,795	20,515	3,150
	Present itemized returns					
	All returns		Joint returns		Other returns	
	Gain	Lose	Gain	Lose	Gain	Lose
0 to 3	685	225	175	65	510	160
3 to 5	1,505	960	780	470	725	490
5 to 7	1,995	2,615	1,230	1,600	765	1,015
7 to 10	2,995	6,770	2,625	6,110	370	660
10 to 15	3,590	5,825	3,390	5,475	200	350
15 to 20	725	1,915	675	1,820	50	95
20 to 50	250	1,890	235	1,760	15	130
50 to 100	19	300	15	275	4	25
100 and over	9	68	6	61	3	7
Total	11,775	20,565	9,135	17,635	2,640	2,930
	Present standard returns					
	All returns		Joint returns		Other returns	
	Gain	Lose	Gain	Lose	Gain	Lose
0 to 3	9,080	60	760	15	8,320	45
3 to 5	6,760	35	2,000	15	4,760	20
5 to 7	4,930	30	2,250	15	2,680	15
7 to 10	6,910	90	5,310	15	1,600	75
10 to 15	3,760	110	3,310	60	450	50
15 to 20	460	30	420	20	40	10
20 to 50	185	23	160	20	25	3
50 to 100	8	1	7	1	1	(1)
100 and over	1	(1)	1	(1)	(1)	(1)
Total	32,095	380	14,220	160	17,875	218

[1] Less than 500 returns.

NOTE.—Details may not add to totals because of rounding.

TABLE 6.—*Number of itemizers shifting to standard deduction under reform program (1969 levels)*

[Number of returns in thousands]

AGI class (in thousands of dollars)	Total number of returns (taxable and nontaxable)	Present law: Nonitemizers		Present law: Itemizers		Shifting to standard deduction		Reform program: Nonitemizers		Reform program: Itemizers	
		Number	Percent of total	Number	Percent of total	Number	Percent of present law itemizers	Number	Percent of total	Number	Percent of total
0 to 3	21,640	19,740	91	1,900	9	1,550	82	21,290	98	350	2
3 to 5	10,285	7,547	73	2,738	27	1,950	71	9,497	92	788	8
5 to 7	9,916	5,212	53	4,704	47	2,645	56	7,857	79	2,059	21
7 to 10	16,875	7,037	42	9,838	58	4,680	48	11,717	69	5,158	31
10 to 15	13,340	3,877	29	9,463	71	5,420	57	9,297	70	4,043	30
15 to 20	3,151	492	16	2,659	84	1,215	46	1,707	54	1,444	46
20 to 50	2,363	213	9	2,150	91	555	26	768	32	1,595	68
50 to 100	329	9	3	320	97	35	11	44	13	285	87
100 and over	78	1	1	77	99	3	4	4	5	74	95
Total	77,977	44,128	57	33,849	43	18,053	53	62,181	80	15,796	20

NOTE.—Details may not add to totals because of rounding.

TABLE 7.—*Factors reducing taxes for taxpayers with high adjusted gross income of $100,000 or over, 1967 level*

[Dollar amounts in millions]

	All over $100,000	$100,000 to $500,000	$500,000 to $1,000,000	$1,000,000 and over
Amended adjusted gross income [1]	$16,720	$12,205	$1,875	$2,640
Less personal deductions (taxes, interest, charitable contributions, etc.) but not including the unlimited charitable contribution	2,350	1,800	260	290
Amended taxable income	[2] 14,370	[3] 10,405	[4] 1,615	[5] 2,350
Less ½ of capital gains on assets actually sold	3,775	2,260	575	940
Less exempt interest on State and local bonds	440	330	70	40
Less deduction for unlimited charitable contribution	105	15	15	75
Less farm "tax losses"	70	55	10	5
Less excess percentage depletion [6]	60	25	25	10
Taxable income	9,870	7,700	905	1,265
Tax [7]	4,715	3,563	490	662
Tax as percent of taxable income	47.8	46.3	54.1	52.3
Tax as percent of amended taxable income	32.8	34.2	30.3	28.2
Tax as percent of total income	28.2	29.2	26.1	25.1

[1] After deductions for proper business expenses.

[2] Includes $45,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells and $5,000,000 of tax exclusions for the aged.

[3] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells and $5,000,000 of tax exclusions for the aged.

[4] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells. Tax exclusions for the aged are negligible in the aggregate for this group.

[5] Includes $15,000,000 of deductions for intangible petroleum drilling expenses in excess of the depreciated value of oil wells. Tax exclusions for the aged are negligible in the aggregate for this group.

[6] Although the figures shown in the table are total depletion, they approximate the amount of excess percentage depletion since the bulk of claimed depletion is in excess of the recovery of basis.

[7] This tax figure reflects the lower alternative rate applicable to realized capital gains, the retirement income credit, and other credits.

TABLE 8.—*Characteristics of the estimated 1,100 tax returns in 1964 with adjusted gross income over $200,000 and effective tax rates [1] of 22 percent or less [2]*

	Amount (millions)
Amended adjusted gross income [3]	$658
(Including dividends of	134)
(Including wages and salaries of	50)
Less ½ of capital gains excluded from AGI	182
Excess percentage depletion [4]	59
Net farm losses over gains	15
Contributions [5]	73
Other personal deductions	111
Total adjustments	440
Less unused adjustments	8
Taxable income	210
Tax before credits	102
Credits	4
Tax after credits	98
Effective rate on amended AGI (percent)	15
Effective rate on amended taxable income [6] (percent)	21

[1] The effective rate used for selection was the tax over amended adjusted gross income.
[2] Based on a 1 in 15 sample.
[3] Amended adjusted gross income is adjusted gross income plus the excluded part of net long term capital gains, the exclusion due to percentage depletion and for the group as a whole the excess of farm losses over farm gains.
[4] Although the figure shown in the table is total depletion claimed, it approximates the amount of excess percentage depletion since the bulk of claimed depletion is in excess of the recovery of basis.
[5] The sampling process involves a fairly large sampling error on items that are a small portion of the universe. It is clear that this contribution deduction is low because the sample included only 3 unlimited contribution cases while the expected number in a 1 in 15 sample should have been 6.
[6] Amended taxable income equals amended AGI less deductions other than the unlimited charitable contribution deduction.

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