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TECHNICAL MEMORANDUM OF TREASURY POSITION

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

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1. <u>Tax on Investment Income</u>

The House bill proposes a 7-1/2 percent tax on net investment income of private foundations. Treasury recommends that in lieu of this revenue-raising levy, a supervision tax be imposed to offset the cost of administering the audit program for foundations. It is estimated that 2 percent of net investment income would be sufficient for this purpose.

2. <u>Computation of Investment Income</u>

The bill now allows the full amount of a capital loss to be deducted from gross investment income. This is inconsistent with the method of computing taxable income of other taxpayers. Treasury recommends that the deduction for capital losses be limited to the amount of capital gains, with a five-year carryforward, thus providing the same treatment given to corporations.

The bill now allows a deduction for ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income. This provision should be clarified to make certain that it includes an allowance for depreciation (including accelerated depreciation) and depletion (including percentage depletion). Foundations should be allowed to claim such deductions to the extent they are related to gross investment income in computing the tax on net investment income in the same manner as other taxpayers.

The bill provides that, in computing net capital gain or loss, the basis of property held by a foundation on December 31, 1969, shall not be less than the fair market value of such property on such date. This treatment should be limited to the determination of gain. Losses should be determined in relation to adjusted basis. This is similar to the treatment now provided for property held on March 1, 1913.

3. Substantial Contributor

Several provisions of the bill depend upon whether a person is a substantial contributor to the private foundation. A substantial contributor is any person who (by himself or with his spouse) contributed more than $5,000 to the foundation in any one calendar year, or any person who (by himself or with his spouse) contributed or bequeathed the largest amount to the foundation in any one calendar year. The latter rule should be clarified to indicate that if two or more persons contribute the same amount, all such persons should be treated as the largest contributor if no other person contributes a greater amount. Since the spouse of a substantial contributor to the foundation is included in the group of disqualified persons, it is not necessary to apply the $5,000 minimum or the largest contributor rule to a husband and wife as a unit. Thus, the parenthetical "(by himself or with his spouse)" should be eliminated in both provisions.

4. Abatement of Taxes

In the case of a private foundation which voluntarily gives up its status as such or which has engaged in willful and flagrant violations of the law, the bill provides for a tax equal to the amount of tax benefit previously received by the foundation and its substantial contributors from the tax-exempt status of the foundation, limited to the value of the net assets of the foundation at a specified time. The bill gives the Secretary or his delegate authority to abate the unpaid portion of the tax if the private foundation distributes all of its net assets to a public charitable organization. In addition, if a private foundation which has not engaged in willful and flagrant violations of the law voluntarily terminates its status as a private foundation, the tax may be abated, provided the foundation has operated as a public charity for a continuous 60-month period prior to the date of such voluntary termination.

It does not seem logical that a private foundation which has not engaged in willful and flagrant violations should be subjected first to imposition of tax and later abatement of tax if it transfers its assets or converts to a public charity. On the contrary, Treasury believes that such a private foundation should be encouraged to transfer its assets to or convert to a public charity. Accordingly, Treasury recommends that the bill be amended to permit such a private foundation to terminate its status as such, following notice to the Commissioner, if it either transfers its assets to a public charity or operates as a public charity for a continuous 60-month period. In the latter case, the foundation would lose its private foundation status only at the end of the 60-month period, but no tax on termination of status would ever be imposed.

With respect to a private foundation which has engaged in willful and flagrant violations, the tax on termination of status currently applies under the bill, unless the Secretary abates the tax upon a showing that the foundation is distributing all of its net assets to a public charity. Provision should also be made for abatement of this tax if the State Attorney General takes appropriate corrective action to insure that such foundation's assets are preserved for charitable purposes.

5. Definition of Private Foundation

The bill excludes various categories of charitable organizations from the term "private foundation" where those organizations are subject to the discipline of continuing reliance on public support. One of the excluded categories is an organization which receives more than one-third of its support in the form of either gifts or receipts from the performance of its exempt function and meets certain other conditions.

Thus a definition of support should also be added to proposed section 509, since the definition of a private foundation may hinge upon the fraction of support received from various sources. Treasury recommends adoption of the definition currently in section 1.170-2(b)(5)(ii) of the Income Tax Regulations (which defines "support" in connection with the delineation of organizations qualifying for the 30 percent contribution rule of present law), modified to include in support any amounts received from the exercise or performance by an organization of its exempt purpose or function. Such amounts are already included in the numerator of the fraction described in proposed section 509(a)(2)(A) of the bill, and the bill should be clarified to include such amounts in the denominator as well.

6. Income Distribution Requirement

A nonoperating private foundation is required under the bill to distribute currently each year the larger of its net income or a minimum investment return based on a percentage (at present 5 percent) of the aggregate fair market value of the investment assets of the foundation. The minimum investment return is determined on a gross basis without deduction for investment expenses. A deduction should, however, be allowed for the tax on foundation income imposed by section 506 of the bill (or for the 2 percent supervision tax recommended by the Treasury).

For purposes of the income distribution requirement, the bill now allows a deduction for ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income. This provision should be clarified to make certain that such deduction includes an allowance for depreciation (including accelerated depreciation) and depletion (including percentage depletion).

Qualifying distributions (subparagraph (g) of proposed section 4942) include any amounts, including administration expenses, expended directly to accomplish the foundation's exempt purposes; they also include contributions to another organization in furtherance of such purposes. Limitations on payments to other organizations are provided in order to assure that the money will be currently expended and will not remain under the control of the persons in control of the private foundation. Thus, contributions to a private foundation which is not an operating foundation, to a foreign organization which would be a private foundation if it were a domestic organization, and to an organization controlled by one or more disqualified persons with respect to the foundation are not qualifying distributions.

The Treasury believes that these exclusions are more restrictive than is necessary to accomplish the desired purpose. Thus, Treasury recommends that contributions to a foreign organization which would be a private operating foundation if it were a domestic organization should be counted. Further, a distribution from one private nonoperating foundation to another such organization, or to any section 501(c)(3) organization which is controlled by one or more persons who are disqualified persons with respect to the foundation making the distribution, should be considered qualified if the recipient organization applies such cash or property directly to charitable activities within one year of receipt. Thus, contributions to such organizations should be counted if the recipient organization makes a distribution of such amount in addition to amounts required to be distributed under the income payout requirement (other than to another private nonoperating foundation or controlled organization) within such one-year period. This rule would not apply unless the contributing foundation obtains evidence demonstrating that the recipient organization has made the required distribution.

An operating foundation is defined in proposed section 4942(j)(3) as a foundation which (a) expends substantially all its income for activities in pursuance of its exempt function, and (b) either devotes substantially more than half its assets to its exempt function or receives support from at least five private foundations under certain conditions. It appears that the definition of an operating foundation now in the bill may in some cases (for example, when an organization has been funded only once and receives little support from other exempt organizations or the general public) provide an unwarranted exception from the minimum distribution requirements. In view of the suggested broadening of the definition of qualifying distributions to allow distributions from one foundation to another under the circumstances stated, the support part of the definition of an operating foundation should be deleted to prevent the possible unwarranted exception. Thus an operating foundation should be an organization which both (a) expends substantially all of its income, and (b) devotes substantially more than half its assets to its exempt functions.

The bill provides for a five-year carryover of distributions made in excess of the minimum distribution requirement. It was not intended that distributions for a taxable year beginning prior to January 1, 1970, would be counted for this purpose and the bill should make this clear.

7. Political Activities and Other Taxable Expenditures

The bill changes present law to prohibit carrying on propaganda or otherwise attempting to influence legislation, even though such activities do not amount to a substantial part of the activities of the foundation. No other changes in this provision of present law are made by the bill. However, for the first time the Code would contain a definition of activities covered by this prohibition. This has created some uncertainty because this definition is not all-inclusive. Treasury recommends that section 4945(c), as added by the bill, be amended to specify the types of activities which are to be prohibited irrespective of substantiality, which would be the same activities as result in denial of exemption under existing law if they are "substantial." As amended, this provision would read as follows:

> "For purposes of subsection (b)(1), the term 'taxable expenditures' means any amount paid or incurred by a private foundation for --

"(1) any attempt to influence legislation by attempting to cause members of the general public, or any segment thereof, to propose, support, or oppose legislation, and

"(2) any attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation (except technical assistance provided in response to a written request by such member, government official, or employee),

other than through making available the results of nonpartisan analysis, study, or research. Paragraph (2) of this subsection shall not apply to any amount paid or incurred in connection with an appearance before, or communication to, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation."

The bill requires that private foundations making gifts to other private foundations or to nonexempt organizations exercise some control over the expenditure of the funds. This provision was not, we believe, intended to make the private foundation an insurer of the activities of the recipient of the grant, provided the foundation uses reasonable efforts and establishes adequate procedures. The bill should be clarified to reflect this intent.

8. Foreign Organizations

The bill does not deal specifically with foreign exempt organizations which have U.S. income. Treasury recommends that the bill provide for a 2 percent supervision tax on U.S. source income of foreign organizations which would be private foundations were they domestic organizations. Further, a foreign organization should be denied exemption from U.S. income tax if it acts in a manner which would subject it or a disqualified person to tax under section 507 or chapter 42 if it were a domestic organization.

9. Return Requirements

The bill requires the Internal Revenue Service to make public, among other information, the names and addresses of all substantial contributors to exempt organizations. Treasury is concerned that this particular publicity will discourage contributions to churches, educational institutions, and publicly supported charities, and Treasury recommends that the provision be limited to contributions to organizations which are private foundations.

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Treasury recommends that a return be required by an exempt organization which liquidates or which substantially contracts or terminates its activities. Very small organizations should be relieved from filing this special return.

10. <u>Hospital Care</u>

Under present law, hospitals may qualify as exempt organizations under section 501(c)(3) if it is determined that they are operated for charitable purposes. This has caused uncertainty, and the bill provides for the inclusion of hospital care as an activity which in itself qualifies under section 501(c)(3). Thus, section 101(j)(7) of the bill provides for adding the following wording to section 501(c)(3): "or for the providing of hospital care."

Specific inclusion of hospital care in the bill, particularly in the form quoted above, could create an inference that other charitable activities not specifically included may no longer be treated as within the scope of section 501(c)(3). It is essential to good administration that there be flexibility in this provision. The proper scope of exempt functions under section 501(c) of the Code, and the most effective manner of describing them in the statute, are presently under study at Treasury and may be the subject of further legislative recommendations in this area at a later time. The Internal Revenue Service is expected to issue a ruling shortly clarifying the treatment of hospitals as section 501(c)(3) organizations. In view of these circumstances, and in light of the terms of the ruling when issued, the specific inclusion of "the providing of hospital care" in section 501(c)(3) of the Code by the bill should be reconsidered. At the very least, the Committee report should make it clear that the inclusion of hospital care is not intended to indicate that other activities which are charitable, educational, etc., in nature are not to be included under these general provisions of section 501(c)(3).

11. Effective Date

Under the bill, section 4942 does not apply to any organization which is prohibited by its governing instrument from making distributions of income unless the instrument can be changed. A similar rule should be provided for organizations which are not permitted to distribute any of their corpus; such a rule would excuse such organizations from the requirement of distributing 5 percent of the aggregate fair market value of their assets until it would be possible to amend their governing instrument.

Sec. 121--Other Exempt Organizations

Unrelated Business Income

Section 512(b)(3) of the Code currently excludes from the definition of unrelated business income rent from real estate and from personal property leased with such real property. The exception was intended to exclude "passive" investment income from the tax, but as interpreted broadly by the courts, all rents from personal property are excluded if the personalty has any connection with the lease of real estate. This has led to a situation in which an exempt organization may own substantial business assets, which together may constitute an operating business and which are leased to an independent management company. Most of the profits from the business can then be received by the exempt organization in the form of rent, affording a competitive advantage to the exempt organization contrary to the purpose of the unrelated business income provisions.

Two amendments to the bill are recommended to insure that income attributable to the active conduct of an unrelated business pays its fair share of tax. First, in order to make clear that only "passive" rental income is excluded from the unrelated business income, section 512(b)(3) should specify that rent from personal property is excluded only when the lease of personal property is incidental to the lease of the realty. The bill should also incorporate the test for "passive" rentals utilized in section 856(d)(1) (dealing with real estate investment trusts). Application of this rule would serve to tax real property rentals in any case where they are measured by reference to the net income from the property, but would exclude rentals based upon a percentage of gross receipts or sales.

Income Received by Exempt Organizations from Controlled Corporations

The House bill includes in the definition of unrelated business income all interest, annuities, rents and royalties received by exempt organizations from controlled corporations. As drafted, the bill would also tax receipts from controlled exempt corporations. Treasury recommends that this provision apply to income from exempt organizations only in proportion to their unrelated business income.

Investment Income--Fraternal Societies, Employee Associations

The House bill treats the investment income of fraternal beneficiary societies or voluntary employees' beneficiary associations as unrelated business income unless it is set aside for a charitable purpose or for the provision of life, sick, accident or other benefits. Treasury recommends that it be made clear that income is set aside for providing these benefits to the extent it is used for the reasonable cost of administration of the benefit program as well as the payment of the benefits themselves.

In addition, the income so taxed should be defined to exclude gain on the sale of assets used directly by the organizations in the performance of their exempt functions to the extent the proceeds of sale are reinvested in assets used for such purposes within a period of three years. Thus, gain realized by a fraternal benefit society on sale of its clubhouse facilities and reinvested in replacement facilities within the specified period should not be treated as unrelated business income.

Sec. 201--Charitable Contributions

1. Contributions of Appreciated Property

Under present law, the deduction of charitable contributions by individual taxpayers is subject to two separate limitations. A general limitation of 20 percent of adjusted gross income applies to all contributions. In addition, gifts to certain publicly supported organizations are permitted up to 30 percent of adjusted gross income. The bill increases the 30 percent limitation to 50 percent of a new contribution base (adjusted gross income plus allowable tax preferences).

The bill introduces new rules with respect to gifts of appreciated property. Gifts of appreciated property to certain organizations would either be limited to the taxpayer's basis in the property or would result in a tax on the unrealized appreciation if the taxpayer elected to claim the charitable deduction based on the fair market value of the property. This treatment would apply to gifts of appreciated property to private foundations, other than private operating foundations. Gifts to a private foundation would be excepted from the new rules where the foundation, within one year after its taxable year in which the contribution is received, applies such contributions to a charitable purpose in a prescribed manner. The bill then provides for a separate 30 percent limitation on gifts of appreciated property which are not subject to the new appreciated property rules (such as a gift to a publicly supported charity of a present interest in appreciated securities constituting a capital asset in the hands of the donor-taxpayer).

Thus, some gifts of appreciated property to a private foundation would be subject to this new appreciated property rule and some would not. Furthermore, since the class of organizations subject to the new rule for appreciated property is narrower than those excluded from the old 30 percent (and proposed 50 percent) limit, gifts of appreciated property under the bill are subject to three percentage rules: the 20 percent limit, the new 50 percent limit, and a new 30 percent limit.

The bill applies the new appreciated property rule, limiting the deduction to basis or requiring the appreciation to be included in income, to gifts of three classes of appreciated property--ordinary income property, tangible personal property, or a future interest.

These rules result in a confusing interrelation of three separate limitations applying in slightly different fashions to three classes of organizations. Treasury recommends that these rules be greatly simplified as follows:

(a) The 50 percent limitation should be expanded to cover any contributions made to organizations not subject to the application of the new appreciated property rule, which means adding to this group of organizations private operating foundations and other foundations if the contribution is passed through as a qualifying distribution within the succeeding year. Since contributions to such organizations directly benefit public charity, there is no reason for excluding them from the new 50 percent limit. This would mean that the remaining effective scope of the 20 percent rule, i.e., those donee organizations which would not come within the 50 percent rule as expanded, would be co-extensive with the new rule for taxing gain on appreciated property as that rule relates to the donee organization, i.e., a private foundation which is not an operating foundation or which does not channel the property to a publicly supported charity within one year. Hence, the Code should be restructured so that the 20 percent rule is a rule of limited rather than general application, and the 50 percent rule is the general rule. This change will result in considerable simplification, since the scope of the 30 percent limitation on appreciated property will then be co-extensive with the 50 percent group of donees.

(b) The bill should be further revised to make the 30 percent limitation apply only to the aggregate amount of appreciation in all property contributed during the tax year, and not to the aggregate value of all property with any element of appreciation. To the extent a taxpayer has basis in the appreciated property, he should be eligible for the 50 percent limitation before applying the 30 percent rule to the appreciation element.

For example, suppose a taxpayer with a contribution base of $30,000 contributes to a public charity an appreciated security held for more than six months having a fair market value of $20,000, a basis of $5,000, and thus $15,000 of appreciation. The 50 percent limit would first be applied to limit the total charitable contribution deduction to $15,000. The 30 percent limit would then be applied to limit the amount of deductible appreciation element to $9,000. The deductible contribution thus would be $14,000, being the total of the $9,000 appreciation element and the $5,000 basis. The taxpayer could carry over to the following year the remaining $6,000 of the gift, which would be deemed to constitute appreciation and thus would be required to be added to contributions of appreciated property, if any, made in the following year for purposes of applying the 30 percent limitation in such year.

As previously stated, the House bill applies the appreciated property rule (which limits the charitable contribution deduction to the amount of the taxpayer's cost or other basis in the property or, if he takes a charitable deduction based on the fair market value of the property, requires him to include the unrealized appreciation in income) to gifts of property which would give rise to ordinary income if sold by the taxpayer; and applies the rule also to gifts of tangible personal property, gifts of future interests in property, and certain gifts to a private foundation. Treasury recommends that the deduction not be so limited in the case of gifts of tangible personal property unless this section otherwise applies because, for example, the property is ordinary income property in the hands of the donor. Thus, a gift to a publicly supported charity of a present interest in a work of art held for more than six months by a person other than the creator of such work of art, in whose hands the work of art is a capital asset, should not be subject to the rule.

2. <u>Charitable Income Trusts with Noncharitable Remainder</u>

The bill amends section 170(b)(1) to deny a deduction for a contribution of charitable income interest to a trust which has a noncharitable beneficiary unless both the "grantor trust" provisions of section 671-678 apply and the charitable interest is in the form of either a guaranteed annuity or unitrust. The bill also provides a "recapture rule" to apply when the donor ceases to be the owner of such interest for purposes of section 671. Similar provisions with respect to this type of gift are added by section 201(h) of the bill to the estate and gift taxes deduction rules.

These provisions are unduly stringent in denying a deduction for a gift of a long-term income interest to charity. Where the term is sufficiently long, the donor has in effect given away such a substantial portion of the value of the property that it is appropriate to treat the transaction as an outright gift of an undivided interest in the property. Treasury considers that the proper dividing line is 20 years, the period of time when the present value of the income interest under the valuation tables in the regulations is approximately 50 percent.

Accordingly, Treasury recommends that these rules be liberalized and simplified by allowing a current deduction for the value of contributions of a guaranteed income interest to charity whenever the gift is for a period of more than 20 years whether or not the grantor trust rules apply. In this way, the complex "recapture" provisions could be eliminated and the rule could be made more equitable, with results as follows:

(a) Where the charitable income interest is in the form of a guaranteed annuity or unitrust for a period in excess of 20 years, a charitable deduction would be allowed in the year the trust is created for the present value of the contribution whether or not the income which goes to charity is includible in the taxpayer's income (because of the application of the "grantor trust" provisions of section 671 through 678).

(b) Where the taxpayer is subject to the "grantor trust" provisions, but the contribution is not in the form of a guaranteed annuity or unitrust for a period in excess of 20 years, the taxpayer would be permitted a charitable deduction in the year the income is taxable to him under section 671 and distributed to the charity. He would not be allowed a deduction in the year the contribution to the trust was made.

The estate tax provisions of the bill deny an estate tax deduction for an income interest given to charity. In the case of an estate, however, the double benefit (the basis for denying the income tax deduction) does not exist; there is no income tax deduction in addition to the exclusion of the income from income tax. Accordingly, the bill should be amended to allow the estate tax deduction for a gift of an income interest to charity. Other changes should be made to the estate and gift tax provisions to conform them to the changes recommended in income tax treatment.

3. Deduction by Estate or Trust

The bill amends section 642(c) to provide that an estate or trust is to receive a deduction only for amounts actually paid for a charitable purpose. The estate or trust would no longer be allowed a deduction for amounts permanently set aside or to be used for a charitable purpose. The bill applies to amounts paid, permanently set aside, or to be used for a charitable purpose after the date of the enactment of the bill.

Treasury recommends that this provision apply only with respect to taxable years beginning after December 31, 1969. Further, in a case where an irrevocable trust instrument has been executed on or prior to August 1, 1969, Treasury recommends that the requirements of this section should not apply unless and until it is possible to amend the instrument. Similarly, the provision should not apply with respect to an estate or trust pursuant to a will in existence on August 1, 1969, which is not subject to change under state law at any time prior to the testator's death because of the testator's incompetency or other disability. In any such case, however, the charitable contribution deduction for the amounts permanently set aside or to be used for a charitable purpose should be limited to its present value, and no amount would be deductible when such amounts were actually paid for charitable purposes at a later time.

Further, Treasury believes that different considerations apply to an estate than to a trust with respect to amounts set aside for charitable purposes. Estate administration is normally of relatively short duration with safeguards not normally present during trust administration. Estates present many factors which may make it either impracticable or in some instances contrary to probate law to make distributions currently. Accordingly, Treasury recommends that section 201(f) of the bill be changed so that the proposed limiting of a charitable deduction to amounts actually paid will apply only to trusts and the provisions of section 642(c) allowing deductions for amounts permanently set aside will continue to apply to estates.

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4. Disallowance of Estate Tax Deductions in Certain Cases

The bill amends section 2055(e) to provide that a charitable contribution deduction for estate tax purposes is not to be allowed for a charitable gift of a remainder interest in trust where there is a noncharitable income beneficiary unless the trust is either a charitable remainder annuity trust or a charitable remainder unitrust. This provision is to apply with respect to persons dying after the date of the enactment of the bill.

It is proposed that the effective date of the new estate tax provisions governing charitable deductions be deferred so that the new rules will apply only to persons dying after December 31, 1970. This will provide time for amendment of wills to comply with the new requirements. In cases where irrevocable trust instruments have been executed prior to August 1, 1969, it is proposed that the new requirements not be applied where the governing instrument cannot be reformed by amendment, judicial proceedings, or otherwise. This exception would apply, for example, in the case of an irrevocable intervivos trust under which the grantor reserves the income for his life, and upon his death the income is payable to his surviving spouse, with the vested remainder passing to designated charities. Under the exception, the deduction would be allowed for the value of the remainder interest even though it is impossible to amend the governing instrument to comply with these rules. A similar exception should be provided with respect to wills in existence on August 1, 1969, which are not subject to change under state law at any time prior to the testator's death because of the testator's incompetency or other disability.

5. Charitable Remainder Trusts

Section 201(e) of the bill amends section 170(h) of the Code to deny an income tax deduction for a charitable remainder interest in a trust unless such interest is in the form of a charitable remainder annuity trust or a charitable remainder unitrust. This provision is made effective with respect to transfers in trust made after April 22, 1969, although the provision was not contained in the Treasury Department's recommendations announced that date. The provision should be made effective with respect to transfers in trust made after August 1, 1969.

Section 201(i) of the bill adds a new section 664 to the Code providing definitions of a "charitable remainder annuity trust" and a "charitable remainder unitrust." Under the bill, a "charitable remainder annuity trust" must pay a sum certain not less often than annually, and a "charitable remainder unitrust" must pay a fixed percentage of the net fair market value of the trust assets, valued annually, not less often than annually. Such a trust would be exempt from tax and would be subject to the private foundation rules other than the income distribution requirement.

A charitable remainder trust should, in general, be subject to all of the substantive requirements governing private foundations. Accordingly, consistent with the income distribution requirement for private foundations, these provisions should be amended to provide that the specified amount may be paid out either to an organization described in section 170(c) or any other person, and may not be less than:

(a) in the case of a "charitable remainder annuity trust," an amount equal to 5 percent of the fair market value of the trust assets (valued at the date of contribution), and

(b) in the case of a "charitable remainder unitrust," an amount equal to 5 percent of the net fair market value of the trust assets, valued annually.

Sec. 211-213--Farm Losses

1. <u>Exemption from EDA Requirement</u>

Under the House bill, a taxpayer would not be required to add farm losses to an excess deductions account (EDA) if his nonfarm adjusted gross income does not exceed $50,000 for the taxable year. Treasury recommends that this figure be reduced from $50,000 to $25,000. Further, we recommend that in computing adjusted gross income for this purpose, taxpayers should be required to add back to adjusted gross income items of tax preference determined under the Limit on Tax Preferences proposal even though such amounts of tax preference are not subject to tax under LTP because they do not exceed the permissible limit.

The House bill excludes the first $25,000 of farm losses from EDA regardless of the taxpayer's nonfarm adjusted gross income. Treasury recommends that a taxpayer be required to add the full amount of farm losses (without an exclusion) whenever total farm losses exceed $15,000 and nonfarm adjusted gross income exceeds $25,000.

2. <u>Hobby Losses</u>

Section 213 of the House bill revises the "hobby loss" provisions of present section 270 to provide that losses from an activity will be disallowed if the activity is not carried on with a reasonable expectation of profit. An activity will be presumed to have been carried on without a reasonable expectation of profit if losses exceed $25,000 in any three out of five consecutive taxable years.

Treasury recommends that this provision be amended to make it clear that the reasonably anticipated profit must be an economic profit, not a "tax savings" profit, and that "profit" need not be determined on an annual basis.

It should also be made clear that those deductions which are allowable under the Code without regard to whether they are incurred in a trade or business or for the production of income, such as interest and certain state and local taxes, will continue to be deductible even where incurred in an activity not engaged in for profit. Similarly, it should be made clear that deductions incurred in an activity not engaged in for profit (other than those described in the preceding sentence) shall be allowable to a proper extent where income is realized from that activity. The amount allowed should be that proportion of the total of such deductions which the income realized bears to the total deductions attributable to the activity, including deductions described in the first sentence of this paragraph. Thus, if the taxpayer with a hobby farm has interest and taxes of $100,000, operating costs of $120,000, and depreciation of $80,000, and if the income from the farm is $30,000, the taxpayer should be entitled to deduct the full $100,000 amount of interest and taxes plus $12,000 of operating costs and $8,000 of depreciation.

Sec. 231--Moving Expenses

Under present law certain expenses of moving a taxpayer's family and belongings from one place of employment to another are deductible. In general, the deduction applies only if the taxpayer's new place of employment is at least 20 miles farther from his former residence than was his former place of employment. The bill increases the required distance before any deduction is allowed from 20 miles to 50 miles. Treasury recommends that the 20-mile test contained in existing law be retained.

Sec. 301, 302--Limit on Tax Preferences and Allocation of Deductions

The House bill treats the following items as preferences for the purpose of the Limit on Tax Preferences: (a) the excess of tax-exempt interest on state and local bonds over expenses related thereto which are not allowed as deductions;* (b) the amount (50 percent) of net long-term capital gains which is excluded from income; (c) the untaxed appreciation in value of property contributed to charity; (d) the excess of accelerated depreciation over straight-line depreciation of real property; and (e) the excess of any farm loss over the amount that would be deductible under normal accrual accounting rules. For purposes of the Allocation of Deductions rule, the items of tax preference are the same except that: (a) interest on state and local bonds is included only with respect to bonds issued after July 12, 1969 (subject to the same 10-year transition rule); and (b) the preferences for this purpose also include the excess of the deductions for intangible drilling expenses and percentage depletion over

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*Under a special transition rule, only 10 percent of such excess is taken into account in 1970, 20 percent in 1971, and, similarly, 10 percent more in each succeeding year so that the full amount is not taken into account until 1979 and thereafter.

the amount that would be deductible had these expenses been capitalized and recovered through straight-line depreciation and cost depletion.

1. Tax Preferences

Treasury recommends that the following modifications be made to the group of items treated as tax preferences:

(a) Appreciation in value of property contributed to charity should not be treated as a tax preference for the purpose of either the Limit on Tax Preference or the Allocation of Deductions.

(b) Interest on state and local bonds (without distinction as to when the bonds were issued) should be treated as a tax preference for the purpose of the Allocation of Deductions but not for the purpose of the Limit on Tax Preferences. The 10-year transitional rule should be eliminated.

(c) Intangible drilling expenses and percentage depletion in excess of cost should be treated as tax preferences for both the Limit on Tax Preferences and the Allocation of Deductions, except that a taxpayer 60 percent or more of whose gross income is from oil and gas properties should not treat the intangible drilling expense deduction as an item of tax preference for purposes of the Limit on Tax Preferences.

(d) In the case of percentage depletion, the amount of the preference should be computed by first allowing full recovery of the tax basis of the property (increased as described below); that is, percentage depletion would first become a preference only after full recovery of basis. This will avoid the necessity of calculating cost depletion for each taxable year. In those instances in which the intangible drilling cost deduction is treated as a preference under the proposal, the full amount of the deduction would be treated as a preference, but the amount would be added to basis for purposes of the Limit on Tax Preferences to be recovered in full before any amount of percentage depletion with respect to such property would be treated as a preference. In the case of a taxpayer 60 percent or more of whose gross income is from oil and gas operations, since the intangible drilling cost deduction would not be treated as a preference for LTP purposes, it would not be added to basis for purposes of the Limit on Tax Preferences, and thus percentage depletion taken by such a taxpayer in excess of actual basis (without inclusion of intangible drilling costs which have been expensed) would be the taxpayer's LTP preference.

(e) In addition to including the excess of accelerated depreciation over straight-line depreciation with respect to section 1250 property as a preference, the list of preferences should include such excess with respect to section 1245 property if such section 1245 property is leased on a net lease basis. Such excess should constitute a preference for purposes of both the Limit on Tax Preferences and the Allocation of Deductions.

(f) The amount of the deduction for interest, taxes, and ground rents with respect to real property during the period of construction of substantial improvements (other than housing construction) should be treated as a tax preference for both the Limit on Tax Preferences and the Allocation of Deductions.

(g) The excess of the deduction for amortization of rehabilitation expenditures for low-cost housing (provided in section 521 of the House bill) over the amount that would be deductible as straight-line depreciation should be treated as a tax preference for purposes of both the Limit on Tax Preferences and the Allocation of Deductions.

In connection with the Allocation of Deductions, allocable expenses which are disallowed because the taxpayer had items of tax preference which relate solely to the year in which a deduction is allowed (e.g., the excess of accelerated depreciation over straight-line depreciation) should be allowed to reduce the amount of ordinary income when the asset is later sold.

Also, as a complement to the rule that the intangible drilling cost deduction would not be treated as an LTP preference item for taxpayers 60 percent or more of whose income is from the operation of oil and gas properties, a provision should be added requiring such a taxpayer to recapture as ordinary income any gain on the sale of an oil or gas property (or a portion thereof), including a transfer to a controlled corporation, to the extent of intangible drilling costs previously deducted with respect to such property.

2. Intangible Drilling Expenses and Percentage Depletion

For purposes of determining the amount of tax preferences from percentage depletion and intangible drilling expenses, taxpayers would be divided into two broad categories: those whose income from oil and gas properties is less than 60 percent of gross income; and those whose income from oil and gas properties is 60 percent or more of gross income.

Taxpayers with less than 60 percent of their gross income from oil and gas properties would treat as preferences both percentage depletion and the intangible drilling cost deduction for both the Limit on Tax Preferences and for Allocation of Deductions. The amount of their preferences would be the full amount of the intangible drilling cost deduction taken during the year (not reduced by any amount which would have been allowable for the year as cost depletion or straight-line depreciation) plus, with regard to each oil and gas property, percentage depletion to the extent it exceeds the basis of the property and the amount of intangible drilling costs which were incurred with respect to such property and were expensed. Thus, percentage depletion would not begin to be treated as a preference until the cumulative amount thereof exceeded the basis of the property plus the intangibles expensed with respect to that property.

Taxpayers whose gross income is 60 percent or more from oil and gas properties would include both intangible drilling expenses and percentage depletion as preferences to the extent set forth above only for purposes of the Allocation of Deductions. The Limit of Tax Preferences for this group would be determined without inclusion of intangible drilling expenses deducted during the taxable year. Percentage depletion deducted during the year would be considered a preference to the extent it exceeded the adjusted basis of the mineral property to which it related as of the end of the taxable year (determined without regard to any depletion deduction for the current year). In addition, such group of taxpayers would be required to recapture as ordinary income any gain on the sale, exchange, transfer or other disposition (including transfers to a controlled corporation under section 351 of the Code) of an oil and gas property, to the extent of intangible drilling costs previously deducted with regard to such property. The recapture rule would extend only to this group of individual taxpayers who are not required to include intangible drilling costs as a preference for purposes of the Limit of Tax Preferences.

These special rules regarding percentage of income from oil and gas properties would not affect the treatment of persons whose preferences consist of percentage depletion for other minerals. Taxpayers with percentage depletion from a mineral property other than oil and gas properties would treat percentage depletion in excess of the basis of the property as a preference for both the Limit on Tax Preferences and the Allocation of Deductions, and would have no other preference with respect to the mineral activities concerning such property, irrespective of the percentage of their total income represented by income from such properties.

3. Net Leases of Personal Property

The excess of accelerated depreciation with respect to a particular item of section 1245 property over straight-line depreciation would be treated as a tax preference if that property is the subject of a net lease. For this purpose, a lease would be treated as a net lease only if: (i) the deductions allowable to the lessor for operating expenses with respect to the property are less than 15 percent of the rental income from the property; or (ii) the lessor is either guaranteed a specified net return or is guaranteed in whole or in part against loss. The excess described in the first sentence is to be computed separately for each item of section 1245 property.

The inclusion of this preference in the Limit on Tax Preferences should not be taken as creating any inference that a transaction is to be treated as a lease if it would otherwise be treated as a sale, loan, or other business transaction.

4. Interest, Taxes, and Ground Rents

The amount allowable as a deduction for interest, taxes, and ground rents with respect to real property during the period of construction of substantial improvements or additions to, or other reconstruction of, existing substantial improvements (other than housing construction) would be treated as a tax preference to the extent such amount exceeded any gross income from the property for that year. Such rule would apply only to real property used in the trade or business of the taxpayer, or held by the taxpayer for the production of income. Each separate acquisition of real property would be treated separately, irrespective of the eventual combined use with other parcels of real property. The rule would apply only if the improvements were "substantial," which would be defined as improvements having a value at least equal to the value of the land without improvements. The period of construction would be deemed to end when the improvement is placed in service for purposes of taking depreciation thereon. The amounts would not be treated as a preference if the construction consisted of residential rental housing as defined in proposed section 167(j)(2) as added by section 521 of the House bill. Nor would the amounts constitute a preference in any case in which the property was held primarily for sale to customers in the ordinary course of business or was inventory in the hands of the taxpayer.

5. Amortization of Rehabilitation Expenditures for Low-Cost Housing

The excess of the deduction allowable under section 167(k) of the Code (added by section 521(a) of the House bill) for amortization of rehabilitation expenditures for low-cost housing over straight-line depreciation would be treated as a preference. Straight-line depreciation for this purpose would be computed on the basis of the actual useful life of the property (or the addi[illegible] or improvement to the property) acquired or constructed with the rehabilitation expenditures. For this purpose, the excess would be computed separately for each item of property.

6. Adjustment of Recapture for Disallowed Allocable Expenses

Allocable expenses which are disallowed because the taxpayer has an item of tax preference which results in a deferral, rather than an exclusion of income, should be applied as an offset against any ordinary income on later sale of the asset giving rise to the preference. The tax preferences which result in a deferral rather than an exclusion of income are:

(a) accelerated depreciation on section 1250 property;

(b) accelerated depreciation on section 1245 property which is the subject of a net lease;

(c) farm losses;

(d) interest, taxes, and ground rents during period of construction;

(e) amortization of rehabilitation expenditures for low-cost housing; and

(f) the deduction for disallowed tax preferences allowable under section 218 of the Code (added by section 301(a)(2) of the House bill) to the extent attributable to the foregoing items of tax preference.

A separate account would be established for the allocable expenses disallowed by reason of each of the taxpayer's assets (or in the case of a farm loss, the group of assets) giving rise to a tax preference listed above. Thus, if a taxpayer were claiming accelerated depreciation on two section 1250 assets, two accounts would be established. The disallowed expenses added to such account would not retain their character as interest, taxes, medical expenses, or the like but would simply be carried as a dollar amount available to offset ordinary income if any, on a later sale of the asset which gave rise to the disallowance.

7. Publication of Statistics of Excludable Income

Section 6108 of the Internal Revenue Code should be amended to provide that the statistics the Secretary is required to publish annually shall include tax-exempt income in addition to taxable income, deductions, and credits.

Sec. 311--Income Averaging

Relationship to Accumulation Trust Rules

The House bill provides that if a taxpayer elects the benefits of income averaging, he will not also be entitled to the benefits of certain provisions of section 668 of the Code which limit the tax imposed by the throw-back rules on a beneficiary of an accumulation trust. The limitations of section 668 have the effect of spreading distributions of accumulated income over the taxable years during which the income was earned by the trust, which is a form of averaging.

If both income averaging and the limitations of section 668 were available, the taxpayer would obtain an unintended benefit in the event of a large accumulation distribution where the taxpayer qualified for averaging by reason of receiving such accumulation distribution. On the other hand, however, it is unfair and unnecessary to require a taxpayer who would qualify for the benefits of income averaging even in the absence of an accumulation distribution to choose between the benefits of income averaging with respect to all his income and the limitation on tax on accumulation distributions of section 668. Treasury recommends that the limitations of section 668 apply with respect to all accumulation distributions but that accumulation distributions be excluded from averagable income.

Sec. 321--Restricted Property

1. Transferable Interests in Restricted Property

Under the House bill an individual receiving restricted property in connection with his performance of services is subject to tax when his interest in that property becomes transferable even though it is still forfeitable. The intent of this provision was to impose tax when an individual received property which he could transfer to a bona fide purchaser for value whose rights would not be subject to the forfeiture provision. In such a case, the bill imposes a tax on the theory that such individual has unrestricted use of the property even though he might be required to respond in damages to the original transferor in the event of breach by him of the forfeiture condition.

This rule merely says that the property is not truly forfeitable if it is within the recipient's power to realize its full value, avoiding forfeiture, by transferring the property by sale. The House bill, however, would result in income to the employee merely because the property is transferable by gift or upon death though it remains subject to forfeiture. It would appear that the employee should not be treated as realizing income merely because a donative transfer could be made. The employee has not realized the value of the property and the circumstances depriving it of determinable value continue to exist.

Treasury recommends that the provision in the House bill be simplified by providing that an interest in property is not forfeitable unless the original transferor could compel a subsequent transferee to return the identical property upon the happening of events causing forfeiture. Where the property is forfeitable, the original recipient will be treated as realizing income on a transfer of the property for value if this occurs prior to the time the property ceases to be forfeitable. The original recipient would realize income equal to the amount received in the sale (assuming the sale is an arm's length transaction).

Under this rule, tax would not be imposed merely because the original recipient can transfer his forfeitable interest to another person in a donative transaction if such other person will also be subject to the forfeitability condition. Such a donative transfer will not, however, change the tax consequences to the original recipient at the time his transferee's rights become nonforfeitable; he will realize income at that time just as if there had been no donative transfer.

2. Transfers Under Qualified Annuity Plans

Under proposed new Code section 85(d)(2), transfers by an employer to an employees' trust which satisfy the qualification requirements of section 401(a) are not subject to the restricted property rules of section 85. Similar treatment should be provided with respect to premiums paid by an employer under nontrusteed annuity plans for an employee which meets these requirements.

3. Transition Rules

Under proposed new Code section 85(f), the restricted property rules of section 85 do not apply to property transferred before July 1, 1969, or to certain property transferred on or after that date if certain conditions are satisfied. This section should be amended to provide that where corporate securities to which section 85 does not apply because of these effective date provisions are exchanged for other securities in a tax-free transaction and the new securities are subject to restrictions identical to those applicable to the old securities, section 85 will not apply to the new securities.

4. Nonexempt Trusts and Nonqualified Annuities

Section 321(b) of the bill amends sections 402(b) and 403(c) of the Internal Revenue Code to provide essentially the same tax treatment for pension, profit-sharing, stock bonus, and annuity plans which do not satisfy the qualification requirements of section 401(a) as would be provided under the bill for restricted stock plans. This section should be amended to make it clear that the amount subject to tax when the employee's interest becomes nonforfeitable is the value of his interest in the trust at that time or the value of the annuity contract at that time. The value of amounts subsequently contributed to the trust, or premiums subsequently paid, by the employer on behalf of the employee should be includible in the income of the employee in the subsequent years in which contributed or paid to the trust or insurer.

In addition, section 403(c) should be amended to make it clear that the restricted property rules of section 85 do not apply to any amount excluded from gross income under section 403(b) dealing with annuities purchased for an employee by a section 501(c)(3) organization.

Sec. 341--Accumulation Trusts

1. Transitional Problem

Under present law, if a trust makes an "accumulation distribution"--that is, a distribution in excess of distributable net income for the current year--there is a five-year "throwback." This results in a recomputation of the beneficiary's income tax for each of such years to determine the increase in tax which would have resulted had the trust income been distributed to him currently rather than accumulated. This amount is then added to his tax liability in the year of distribution. Under existing law, however, the only accumulated income which is subjected to this additional tax is that which was accumulated in the five years preceding the year of the distribution. All earlier accumulations are distributed tax free. Moreover, there are several exceptions under the existing throwback rule so that even part of the accumulation during the preceding five years may be distributed free of additional tax.

The House bill removes the five-year limitation on the throwback rule as well as all of the exceptions. All accumulation distributions by trusts would be thrown back and the amount of tax at the time of distribution would be calculated as though they had been distributed to the beneficiary in the year earned by the trust. The bill provides, however, that this unlimited throwback rule will not operate to tax accumulations made in a taxable year of the trust ending before April 23, 1964. This limitation would prevent a throwback to years prior to the five years which are subject to the rule under existing law.

As indicated, however, the exceptions to the throwback rule contained in existing law are removed by the bill. Thus, even though a distribution would have qualified under one of these exceptions in present law, the distribution of such income accumulated by a trust prior to the effective date of this provision would be subject to additional tax when distributed.

Treasury recommends that present law be continued for all income accumulated in taxable years of trusts beginning on or before April 22, 1969, and that the unlimited throwback provided by the bill be made applicable only to accumulations made in taxable years beginning after that date. Any amounts accumulated in taxable years of a trust beginning before April 22, 1969, should, when paid out in an accumulation distribution in a taxable year beginning after that date, be subject to the law in existence on the date when the income was accumulated. Consistent with present law and the House bill, an accumulation distribution should be deemed to have been made from the most recently accumulated income of the trust. Thus, distributions made during taxable years beginning after April 22, 1969, would be subject to the new unlimited throwback rules to the extent the trust had undistributed net income accumulated during a taxable year beginning after such date.

For example, if a trust using the calendar year as its taxable year had undistributed net income of $500 accumulated in each of the years 1968 through 1972 and on December 31, 1973, made a distribution of $2,500 in excess of the trust's 1973 distributable net income, $1,500 would be taxed pursuant to the new unlimited throwback rules and $1,000 would be subjected to additional tax only if it did not fall within one of the exceptions to the definition of an accumulation distribution presently contained in section 665(b) of the Code. Thus, for example, if any portion of the $1,000 accumulated in 1968 and 1969 were distributed to meet the "emergency needs" of the beneficiary, or had been accumulated prior to the beneficiary's 21st birthday, such sum would be distributed tax free. There should, however, be no $2,000 de minimis exception for distributions made in taxable years beginning after April 22, 1969.

The five-year limitation of present law should continue to apply to income accumulated during taxable years beginning before April 23, 1969. Accordingly, if income accumulated in 1968 were distributed in 1975, it would be subject to no additional tax.

2. <u>"Short-Cut" Method of Limiting Tax</u>

The House bill provides that one method of limiting the beneficiary's tax attributable to an accumulation distribution is to compute the average increase in the beneficiary's tax caused by adding the average annual income of the trust for the period over which the amount distributed was earned to the beneficiary's income for the current year and each of the two preceding years. This averaging device would be more accurate if it utilized the three preceding years and excluded the current year.

The current year's income will necessarily include the trust income for that year even though it is not part of the accumulation distribution and therefore should not enter into the computation. Treasury recommends that this so-called "short-cut" limitation be altered to eliminate a recomputation of the beneficiary's tax for the current year and include in its place a recomputation of the tax for the third year preceding the year in which the accumulation distribution occurs.

Treasury also recommends that the short-cut method should not be available to the taxpayer if prior accumulation distributions made to him by two or more other trusts overlap the accumulation distribution in question. This is necessary to prevent the creation of multiple trusts with staggered accumulation distributions to take advantage of the short-cut rule. Thus, the short-cut method would not be available to limit the tax attributable to an accumulation distribution made to a beneficiary if during any preceding taxable year in which such accumulation distribution was deemed to have been distributed to such beneficiary under section 666(a) of the Code, prior accumulation distributions made by two or more other trusts were deemed, under section 666(a), to have been distributed to such beneficiary.

Sec. 401--Multiple Corporations

1. Transition Period

The House bill provides for an eight-year transition period beginning on January 1, 1969, during which the amount of each additional $25,000 surtax exemption, $100,000 accumulated earnings credit, and $25,000 limitation on the small business deduction of life insurance companies, otherwise allowable to the controlled group, would be phased-out. At the end of this period, the group would be limited to only one of each of these tax benefits.

Treasury does not oppose the eight-year phase-out period. However, the transition period originally recommended by Treasury on April 22, 1969, would also be equitable and would reduce the administrative complexity of the longer eight-year period. Under the earlier proposal, the maximum number of $25,000 surtax exemptions and other benefits listed above of a controlled group for taxable years including a December 31 after 1968 and before 1974 would be reduced over a five-year transition period in accordance with the following schedule:

Taxable years including --	Maximum number
December 31, 1969	100
December 31, 1970	50
December 31, 1971	25
December 31, 1972	10
December 31, 1973	5

2. Special Transition Rules

Treasury recommends that the two special transition rules, not included in its April 22, 1969, proposal, be eliminated from the bill. The first rule, in general, provides for a gradual increase of the dividends received deduction for certain transition period dividends from 85 to 100 percent over an eight-year transition period. The second rule applies only to a controlled group filing a consolidated return and, in general, provides for the deductibility of a gradually increasing portion of certain pre-consolidation net operating losses arising in the transition period. These rules involve extraordinary complexity and are not necessary in addition to the extended transition period to provide equity.

3. Mutual Insurance Companies

The House bill limits a controlled group of mutual insurance companies subject to taxation under section 821 of the Code to only one of each of the stated dollar amounts in subsections (a)(1) and (c) of section 821 (relating to the imposition of the income tax upon mutual insurance companies) and subsection (c) of section 823 (relating to the special deduction for a small company having a gross amount of less than $1,100,000). Treasury recommends that this provision be deleted as unnecessary.

After study of this provision, Treasury has found that there is no known controlled group of mutual insurance companies in existence, and because of the 80-percent stock ownership requirement of section 1563(a), it is very doubtful that such a group would come into existence in the future. Since it is extremely remote that the provision could ever apply, it can safely be deleted from the bill.

Sec. 411, 412--Debt-Financed Corporate Acquisitions and Related Problems

1. Disallowance of Interest Deduction

The House bill contains a provision denying corporations a deduction for interest paid on an obligation issued as consideration for the acquisition of stock or assets of another corporation under certain conditions. These conditions are designed to determine if the obligation has characteristics normally associated with equity rather than debt.

One of the conditions which must exist if the disallowance of interest on corporate acquisition indebtedness is to apply is that the obligation be "subordinated to the claims of trade creditors of the issuing corporation generally." Some recent acquisitions would not be covered because the indebtedness, though subordinated to pre-existing indebtedness, including, for example, substantial outstanding unsecured bank credit, is not subordinated to all "trade creditors generally." Treasury recommends that the scope of the definition of corporate acquisition indebtedness be broadened to include an obligation which by its terms (other than solely by operation of law) is subordinated in right of payment to the payment of any substantial amount of indebtedness of the corporation. For this purpose, indebtedness will not be deemed subordinated merely because the corporation has secured indebtedness; there must be a legal subordination of the debt.

Another condition which must exist for the interest on corporate acquisition indebtedness to be disallowed is that the issuing corporation have either (i) a debt-to-equity ratio in excess of two to one, or (ii) projected earnings which do not exceed three times its annual interest expense. Treasury recommends that in applying the debt-equity or projected earnings test in the case of a taxpayer engaged in the business of making loans, the amount of the taxpayer's indebtedness be reduced by amounts owed to the taxpayer and that the annual interest expense of the taxpayer be reduced by the taxpayer's annual interest income. Treasury believes that this was the intention of the House bill and that the failure to provide special rules for the application of these tests to such taxpayers was inadvertent.

The House bill provides for the disallowance of interest paid during the taxable year with respect to corporate acquisition indebtedness only to the extent that such interest exceeds $5 million, reduced, however, by the amount of interest paid during the taxable year on obligations which have the general character of "acquisition indebtedness" as defined in the bill. Obligations would have that character if they were issued for the acquisition of stock or at least two-thirds of the assets of another corporation, but do not fall within all of three specific tests as to subordination, convertibility, and debt-equity ratio. Although the Committee report states that the annual interest cost incurred or paid on such obligations issued before the effective date of this provision of the House bill would reduce the $5 million exemption, the bill itself is unclear on this point. Further, the Committee report places no limit on the number of past years which must be considered. Treasury recommends that the statutory language make it clear that the $5 million amount is so reduced, but only with respect to such obligations issued after January 1, 1964.

As pointed out above, one of the characteristics of "corporate acquisition indebtedness" as defined in the bill is that it is issued for the acquisition of stock or assets of another corporation. The bill specifies that in an asset acquisition, obligations do not fall in this category unless "at least two-thirds of the total value of all the assets" are acquired. Since the focus of asset acquisition transactions is on the operating assets, the two-thirds test might be avoided in those instances where the acquired corporation has more than one-third of its total assets in cash and non-operating properties. Accordingly, Treasury recommends that the two-thirds test be applied only to operating assets (excluding cash).

2. <u>Installment Method</u>

Under present law, a taxpayer may elect the installment method of reporting gain on a sale of real property, or a casual sale of personal property where the price is in excess of $1,000, if the payments received by the seller in the year of sale (not counting evidences of indebtedness of the purchaser) do not exceed 30 percent of the sales price. The

House bill would deny installment reporting where the obligations consist of bonds, debentures, notes, or other evidences of indebtedness with interest coupons attached, in registered form, or in a form designed to be readily traded on an established securities market. The House bill also provides that installment reporting is available only where payment of the principal, and interest (if any), of the obligation is required to be made periodically and in such amounts during the calendar year as shall be prescribed under regulations.

The latter provision requiring periodic payments throughout the term of the obligation is a significant departure from existing law and could disrupt the pattern of legitimate commercial transactions where payment is deferred because of lack of ability to make immediate payment. This is precisely the situation that the installment sales provisions were designed to ameliorate. The installment method is consistent with the cash method in not requiring the taxpayer to report income until the income has been assured by receipt of payment by the seller and thus until he has received cash to pay his tax.

Treasury recommends that this periodic payment provision be deleted except that installment reporting should not be available where the obligation is payable on demand. In all events, the periodic payment provision should not be made effective until January 1, 1970, so as to give taxpayers an opportunity to adjust to the new rule. The installment reporting rule had widespread application to many common sales transactions in small as well as large amounts, and many taxpayers may not be aware of this change at the present time. There was no advance warning of this change, and an adjustment period seems warranted.

Sec. 431, 432--Foreign Tax Credit

1. Foreign Tax Credit Reduction in Case of Foreign Losses

The House bill provides for the carryover of previously deducted foreign losses in computing the foreign tax credit limitation in the case of taxpayers who have chosen the per-country limitation (section 904(a)(1) of the Code) for the year in which the loss was incurred. Treasury recommends that this section also apply to taxpayers who have elected the over-all limitation (section 904(a)(2) of the Code) and who have sustained an over-all loss on their foreign operations in a prior year.

Treasury has concluded that the operation of the provision can be improved, and be made more equitable, by some technical changes which we believe consistent with the purpose of the House bill. These technical changes would make the provision inapplicable where loss carryover provisions in the foreign law achieve the same result as recapture; would provide a recapture rule where the taxpayer elects to deduct foreign income taxes; and would make it clear that capital losses, as well as other losses, are intended to be covered.

The changes would also limit the number of years to which losses must be carried (but at the same time eliminate the annual 50 percent limit on recapture). With respect to the provision providing for an addition to gross income in certain cases where property in the loss country is disposed of, the amount of the addition should be limited to the amount of gain on disposition and it should be made clear that the foreign tax credit limitation is to be computed without regard to such addition.

2. Foreign Mineral Income

The bill provides for the separate computation of the foreign tax credit limitation with respect to foreign mineral income in cases in which it is presumed that the amount of foreign tax in excess of the U.S. tax on the same income constitutes a hidden royalty payment. An examination of the tax and royalty structure in the international minerals industry does not justify such a presumption. Treasury believes that the defect to be remedied in present law is the ability of taxpayers to offset U.S. tax on other foreign income by the use of excess foreign tax credits generated as a result of the fact that the United States grants a percentage depletion allowance and the foreign country does not grant such an allowance or otherwise imposes a tax at a higher rate than the effective U.S. rate. Treasury believes that the "spill-over" of excess credits attributable to the percentage depletion allowance should not be permitted.

Accordingly, Treasury recommends that in lieu of the approach in section 432 of the bill, the amount of foreign taxes otherwise creditable under section 901 of the Code be reduced on a country-by-country basis by the amount by which the U.S. tax on the foreign mineral income, defined along the lines set forth in the House bill, is exceeded by either: (1) the foreign tax on the foreign mineral income; or (2) the simulated U.S. tax on such income calculated as though percentage depletion were not allowed for U.S. tax purposes (but as if cost depletion were allowed), whichever figure is lower.

The provision permitting a taxpayer to change from the over-all to the per-country limitation, set forth in the House bill, should be retained.

Any additional problems which may exist in this area, including the disguised royalty problem, require further long-range study and will be dealt with in the Treasury's planned restudy of the entire tax treatment of foreign income.

3. Continental Shelf Areas

Treasury recommends that the definition of the term "United States" in section 7701(a)(9) be amended by expressly including the continental shelf areas of the United States with respect to the exploration for, or exploitation of, mineral resources, consistent with principles of international law. This means, for example, that income earned with respect to mineral exploration and development on the continental shelf (whether or not there is a physical connection with the shelf) is income earned within the United States for tax purposes. Conforming amendments should also be adopted to delete reference to the Outer Continental Shelf where that term appears elsewhere in the Internal Revenue Code in conjunction with the term "United States." See for example, sections 48(a)(2)(B)(vi) and 617(a) of the Code.

The amended definition should also specify that continental shelf areas are not taken into account in determining whether a foreign country is contiguous to the United States for purposes of the Internal Revenue Code. This would make it clear that certain provisions dealing with contiguous countries are only applicable with respect to countries having a common land border with the United States.

Treasury similarly recommends that the term "foreign country" be defined in section 7701 of the Code to include the continental shelf areas of foreign countries with respect to exploration for, or exploitation of, mineral resources, to the extent tax jurisdiction is exercised by such countries over such areas under principles of international law. This change is desirable because international law does not recognize that coastal states have "sovereignty" over their continental shelves, but rather have limited "sovereign rights." Section 904(a) and 911 of the Code are examples of provisions which would be affected by this change.

Continental shelf areas should also be taken into account for tax treaty purposes in such cases where the other country indicates its concurrence.

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Sec. 441-443--Financial Institutions

1. Bad Debt Reserves

Under present administrative rulings, commercial banks are allowed to establish a reserve equivalent to 2.4 percent of noninsured loans, even though their recent actual experience would appear to entitle them to a reserve of less than 0.2 percent of such loans. The bill would require these institutions for the future (after the transition period) to compute additions to reserves on the basis of actual loss experience.

Mutual savings banks and savings and loan institutions, on the other hand, are allowed by provisions in the Internal Revenue Code to compute additions to their bad debt reserves using the greater of: (a) their actual experience; (b) 60 percent of taxable income; or (c) 3 percent of qualifying real property loans. In addition, savings and loan institutions, but not mutual savings banks, are required to meet comprehensive investment standards.

The House bill would repeal the 3 percent method of computing reserves. In addition, the allowance based on 60 percent of taxable income would be reduced to 30 percent over a 10-year period. Since favorable bad debt treatment is allowed mutual thrift institutions only because they provide a major source of residential mortgages, the bill would tie the bad debt reserve to a sliding scale which permits the full 30 percent of taxable income deduction only if a savings and loan institution has 82 percent of its assets invested in residential real estate loans and certain other qualifying items and only if a mutual savings bank has 72 percent of its assets in those categories. The 30 percent would be reduced a proportionate amount as qualified investment falls below the 82 percent or 72 percent mark, and the 30 percent method would be altogether denied if investment in residential and other qualifying property drops below 60 percent of total assets. Existing categories of qualifying property would be liberalized under the bill to include loans made for the improvement of commercial real property located within an urban renewal area or a model cities area, loans secured by an interest in educational, health or welfare institutions, loans secured by mobile homes not used on a transient basis and student loans.

Treasury recommends that in lieu of the provisions of present law and the House bill, all financial institutions (commercial banks, small business investment companies, business development corporations, savings and loan associations, cooperative banks and mutual savings banks) be required to compute their bad debt reserves using an actual experience method. Thus, mutual savings banks and savings and loan associations should be allowed the same bad debt deduction provided for other financial institutions under the House bill, including the use of a six-year moving average of actual bad debt experience and the use of industry bad debt experience in the case of new financial institutions. Moreover, under a transition rule, financial institutions would be allowed to maintain the balance in their existing reserve through an annual deduction equal to actual bad debt losses in excess of recoveries until an addition to the reserve is permitted under the actual experience method.

Section 441 of the House bill, which provides for the computation of bad debt reserves on the basis of actual experience, does not set forth any definition of the term "loan" or "loans outstanding." Section 441 should be clarified so that government insured or guaranteed loans, which were intended to be included in the loan base under the House bill, would definitely be included as "loans outstanding" under proposed amended section 585(b)(1)(B)(ii).

2. Special Housing Deduction

In order to provide an incentive for investment in residential real property mortgages (permanent financing) and certain other preferred loans, Treasury also recommends a separate special deduction related to investment by financial institutions in such mortgages and loans. The special housing deduction would be equal to a specified percentage of the gross income realized from residential real property mortgage loans and certain other qualifying loans. Treasury suggests that the special deduction be 5 percent of gross income from such loans. Gross income for this purpose would include discount, points, and any other amounts which in substance are interest income.

Qualifying loans would include not only residential real property loans but also certain other loans which further national policy objectives. Residential real property loans for this purpose should include long-term loans, including typical home improvement loans, but not construction financing, and would include the same categories proposed in the House bill--single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis by residents, mobile homes not used on a transient basis, and property used primarily for church purposes. Other categories of qualifying loans should include loans guaranteed by the Small Business Administration and the additional categories proposed in the House bill of student loans, loans made for the improvement of real property located within an urban renewal area or a model cities area, and loans secured by an interest in educational, health or welfare institutions.

To prevent the incentive from enabling financial institutions to avoid paying a reasonable tax on their income, a limit would be placed on the use of the deduction so that it could not reduce taxable income to less than 60 percent of their economic income. Economic income for this purpose only would be computed by adding tax-exempt interest to taxable income, and by determining such income without allowing the 85 percent dividends received deduction. Thus, if the financial institution's gross income consisted of $100,000 of interest income from residential real estate mortgages, and if its operating expenses (including interest paid to depositors) amounted to $80,000, its taxable income and its economic income would both be $20,000. The special deduction would be $5,000 (5 percent of $100,000 interest income), and it would pay tax on only $15,000. If the institution had instead received $5,000 of tax-exempt interest and only $95,000 of interest from residential real estate mortgages, economic income would remain at $20,000, but taxable income before allowance of the special housing deduction would only be $15,000. The special housing deduction ($4,750 before applying the limitation) would be limited to $3,000 since it could not reduce taxable income below $12,000 (60 percent of $20,000).

3. Transition Rule

The foregoing proposal is intended to provide for a substantial increase in the effective rate of tax to be paid by mutual thrift institutions as compared to present law. To prevent undue hardship on mutual thrift institutions and to minimize the possible adverse effect on the housing market, a transition rule should be provided to phase-in gradually the increased tax burden on these institutions.

Treasury recommends a five-year transition period during which mutual thrift institutions would be allowed a deduction equal to the greater of: (a) the special 5 percent deduction (subject to the 60 percent of income limitation); or (b) an amount equal to the following percentages of taxable income:

Taxable Year Beginning In	Applicable Percentage
1969	60
1970	56
1971	52
1972	48
1973	44
1974	40

The deduction would be allowable in full only if such institutions had at least 82 percent of their assets invested in residential real property loans and other qualifying loans and assets as defined in the House bill (72 percent for mutual savings banks). The amount of deduction otherwise allowable in any such year would be reduced 2 percent (4 percent for mutual savings banks) for each percentage point by which their percentage of assets invested in qualifying assets was less than 82 percent of total assets (72 percent for mutual savings banks). No deduction would be allowed if the percentage of qualifying assets were below 60 percent of total assets. These investment standards would remain in the law only until the end of the transition period (the end of the taxpayer's taxable year ending in 1974). Further, at that time the deduction based on a percentage of taxable income (40 percent for taxable years ending in 1974 as set forth above) would terminate, and the taxpayer would use only the special 5 percent deduction (subject to the 60 percent of income limitation).

Sec. 444--Foreign Deposits in United States Banks

The House bill extends from December 31, 1972, to December 31, 1975, the expiration date of the rule of existing law exempting from Federal income tax certain interest paid to nonresident aliens and foreign corporations on deposits in U.S. banks. This rule applies where the interest constitutes income not effectively connected with a trade or business of the foreign person in the United States. The extension of the expiration date would also apply to the existing exemption from Federal estate tax for such deposits held by nonresident aliens.

Under current law, interest paid by U.S. branches of foreign banks to nonresident aliens or foreign corporations ordinarily is not subject to U.S. income tax whether or not the interest is effectively connected with the depositor's U.S. trade or business. While the Foreign Investors Tax Act of 1966 recognized that U.S. business-connected deposits in U.S. branches of foreign banks should be subject to U.S. tax to the same extent as if the deposits were made in a U.S. bank, that Act provided that such deposits in U.S. branches of foreign banks would not become taxable until January 1, 1973. Treasury believes that there is no further reason to postpone this parallel treatment. Therefore, we recommend that interest paid by U.S. branches of foreign banks become subject to the same treatment as interest paid by U.S. banks effective with respect to taxable years beginning after December 31, 1969. We also recommend that parallel treatment be similarly provided for estate tax purposes for deposits by nonresident aliens in U.S. branches of foreign banks.

Sec. 451--Regulated Utilities

1. Normalization

The House bill requires a regulated utility under certain circumstances to use the normalization method of accounting in order to qualify to use accelerated methods of depreciation for tax purposes. The Ways and Means Committee report makes it clear that a utility is required to use the normalization method of accounting both in computing cost of service for ratemaking purposes and for the purposes of reflecting operating results on its regulated books of account. However, the bill as drafted creates a possible implication that a utility may satisfy the requirement of this section merely by using the normalization method of accounting for purposes of reflecting operating results on its regulated books of account. Any such implication should be eliminated.

The normalization method of accounting is defined in proposed new section 167(1)(5)(B) of the Code. This section provides that a taxpayer uses the normalization method of accounting only if he computes his tax expense for purposes of establishing his cost of service and of reflecting operating results in his regulated books of account by using a method of depreciation other than the method he used for purposes of computing his allowance for depreciation for tax purposes; he must also make adjustments to a reserve for deferred taxes to reflect the tax deferral resulting from the use of such different methods of depreciation. This provision of the bill should be clarified to indicate that such a taxpayer must compute both his tax expense (including any deferred tax expense) and his depreciation expense, for the purposes of establishing his cost of service and for reflecting operating results in his regulated books of account, based upon the same method of depreciation. This will prevent a taxpayer from computing his tax expense by a method only nominally different from the method used for tax purposes so that in effect he flows through most of the saving. To qualify for accelerated depreciation, the normalizing taxpayer must normalize to the full extent of the difference between the tax which would be payable under the method of depreciation for book purposes and that which is paid under the method used for tax purposes.

The normalization reserve required by the House bill is described as a "reserve for deferred taxes." In some jurisdictions the same purpose is accomplished by making adjustments to a depreciation reserve. The bill should not restrict the latter method of reflecting the tax deferral where it achieves the same result.

2. <u>Public Utility Property</u>

The bill defines public utility property to include property used predominantly in the trade or business of furnishing or sale of electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by the Communications Satellite Corporation), or transportation of gas, oil (including shale oil) or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency. Oil pipelines, unlike gas pipelines, are nonmonopolistic common carriers, subject to the regulation of the Interstate Commerce Commission. Like other common carriers such as railroads, motor carriers and air carriers, rates for oil pipelines are not fixed so as to provide a guaranteed return and the problem which has arisen with respect to the other regulated public utilities described in the bill does not pertain to carriers of oil and other petroleum products. Therefore, references in the definition of section 451 of the bill to "oil," "shale oil," and "petroleum products" should be deleted. On the other hand, the bill should make clear that property of regulated steam producers is within the definition of public utility property.

3. Effective Date

The bill provides that a taxpayer may not use an accelerated method of depreciation with respect to property acquired or constructed before December 31, 1969, unless he used an accelerated method in a tax return filed before July 22, 1969. The proper cutoff date is not July 22, 1969, since there was no public announcement of a change from the Administration's recommendation of April 22, 1969, until the press release dated July 25, 1969, and even then the announcement did not describe the provision as actually adopted in the bill. The date of July 22, 1969, should be changed to August 1, 1969, wherever it appears in section 451 of the bill. The August 1 date is the date the bill was introduced, the first date on which the terms of this provision became available to the public.

Under the bill, this provision is effective only with respect to taxable years ending after July 22, 1969; thus a taxpayer who has not yet filed his return for a taxable year ending before such date could apparently elect accelerated depreciation for such year even if he has not previously used such a method. This is not in accord with the intent of the bill and it should be changed to be effective for all taxable years for which a return has not been filed before July 22, 1969 (or August 1, 1969, as recommended above, hereinafter referred to as the "proper cutoff date").

It appears that certain utilities were collecting rates based upon flow-through, or had filed rate schedules with a regulatory agency based upon flow-through and were thus in effect committed to flow-through, and had reflected accelerated depreciation with flow-through in establishing cost of service and for reflecting operating results in their regulated books of account even though they had not yet filed a tax return using an accelerated method of depreciation. Utilities which have made such a change in computing their tax expense in their regulated books of account for the latest monthly accounting period ending on or before the proper cutoff date should be permitted to elect an accelerated method of depreciation with flow-through for such property and for future acquisitions.

Additionally, certain utilities had, prior to the proper cutoff date, filed with the Internal Revenue Service Form 3115, Application for Change in Accounting Method, which would have had the effect of permitting these companies to elect an accelerated method of depreciation for existing property. Although these companies had not reflected their decision to adopt accelerated depreciation for tax purposes in a return filed by that date, the Form 3115 evidences their decision to do so as much as the actual filing of a return. Treasury recommends that utilities which filed a Form 3115 prior to the proper cutoff date be permitted to elect an accelerated method of depreciation for property which is the subject of such Form 3115. In addition, since they had thereby evidenced their intention to elect accelerated depreciation for existing property, they should be allowed to

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elect accelerated depreciation for any year for which a return has not yet been filed (which would not be covered by the Form 3115). Further, if in addition to filing Form 3115, the taxpayer prior to the proper cutoff date used flow-through with respect to such property, he should be permitted to use flow-through with respect to future property.

Utilities which have not elected an accelerated method of depreciation in a tax return filed prior to the proper cutoff date, nor used accelerated depreciation in computing their tax expense in their regulated books of account for a monthly accounting period ending prior to the proper cutoff date, nor filed Form 3115 prior to the proper cutoff date would not be permitted to elect an accelerated method of depreciation for existing property.

Sec. 452--Effect on Earnings and Profits of Accelerated Depreciation

The House bill provides, as recommended by Treasury, that accelerated depreciation in excess of straight-line depreciation shall not be taken into account for purposes of computing the earnings and profits of a corporation. In this respect, the bill would treat the excess depreciation in the same way as the excess of percentage over cost depletion is treated in determining earnings and profits under existing law. The stated purpose of this provision is to prevent the payment of dividends which are not treated as ordinary income because accelerated depreciation in the case of some companies exhausts earnings and profits. Questions have been raised as to the application of this provision in the determination of the foreign tax credit under section 902 of the Code.

Section 902 allows a "deemed paid" foreign tax credit to a domestic corporation, owning 10 percent or more of the voting stock of a foreign corporation, with respect to foreign income taxes paid by such foreign corporation to the extent the taxes are allocable to a dividend paid by the foreign corporation to the domestic corporation. In general, the allocation of foreign taxes to the dividend is made on the basis of the ratio of the dividend to "accumulated profits," and any increase in "accumulated profits" will result in an allocation of less of the foreign taxes to the dividend. Since "accumulated profits" are determined in accordance with criteria applied under United States income tax law for determining earnings and profits (see Rev. Rul. 63-6, 1963-1 C.B. 126),* the increase in earnings and profits accomplished by the House bill (representing the excess of accelerated depreciation over straight-line depreciation) will increase "accumulated profits" and thereby decrease the foreign income taxes allocated to the dividend.

*While the taxpayer can elect to determine accumulated profits under one of two methods, both methods depend upon the U.S. concept of earnings and profits.

The net effect of this provision is to deny the benefits of accelerated depreciation to operations conducted through foreign subsidiaries by allowing a credit for the foreign taxes on the income as if only straight-line depreciation had been taken. The same result occurs under existing law with respect to percentage depletion. While not previously stated as an intended purpose of the provision, Treasury considers that this result is proper and that the provision should be retained in the form contained in the House bill.

Section 452 of the bill will effect a similar reduction in the foreign tax credit for foreign income taxes paid by a 50 percent or more owned foreign subsidiary of a 10 percent owned foreign subsidiary.

In addition, this provision would affect the U.S. taxation of subpart F income (section 951-964 of the Code) including minimum distributions under section 963 and the special foreign tax credit provisions, the increase in earnings of controlled foreign corporations invested in United States property (section 956 of the Code), gain on sale or exchange of stock in a foreign investment company (section 1246 of the Code) and gain on sale or exchange of stock of a controlled foreign corporation (section 1248 of the Code).

Sec. 461, 511-516--Capital Gains and Losses

1. Alternative Capital Gains Rate for Corporations (Sec. 461)

Under existing law, corporations which have an excess of net long-term capital gains over net short-term capital losses may exclude such excess from taxable income and pay an alternative tax of 25 percent of such excess. The bill increases the alternative capital gains tax rate to 30 percent for sales or other dispositions made after July 31, 1969.

Treasury recommends that the increase in the capital gain rate be made applicable only to the extent that in any year net long-term capital gains exceed net short-term capital losses plus $50,000.

2. Alternative Capital Gains Tax for Individuals (Sec. 511)

Under existing law, 50 percent of an individual's net long-term capital gain in excess of his net short-term capital loss is included in adjusted gross income. Existing law establishes a limit on the tax of a person other than a corporation by providing that the tax rate on the excess of long-term capital gains over short-term capital losses may not exceed 25 percent.

The effect of this limitation on the rate of tax is to increase above 50 percent the amount of long-term capital gains that are not subject to tax. In other words, the same tax burden would result if, instead of taxing the included 50 percent of these gains at a maximum rate of 50 percent, the portion of the total gains subject to tax were reduced below 50 percent and that portion were subject to the regular graduated rates of tax. The following example will illustrate the interchangeability of these approaches:

Assume that a single individual has $500,000 of long-term capital gains and no other income for the taxable year. Disregarding personal exemptions and itemized deductions, his tax is $125,000, i.e., 50 percent of the $250,000 of long-term capital gains which are included in his adjusted gross income. The same tax would result, however, if instead of taxing $250,000 at a 50 percent rate, $199,300 (39.86 percent) of his gains were subject to tax at the regular graduated rates of tax now in effect.

Thus, under the particular facts of the preceding example, the effect of the alternative capital gains tax is the same as permitting him to exclude $300,700 ($500,000 - $199,300), or slightly more than 60 percent of the $500,000 long-term capital gains. Under the tax rate schedule provided in existing law, this percentage can be as high as 64.3 percent, and under the tax rate schedule in the House bill, it can be as high as 61.5 percent.

Viewed as an exclusion of income from the tax base, the alternative tax is an item of tax preference which should be subject to the Limit on Tax Preferences. However, while it is known that under the proposed tax rate schedule the additional exclusion produced by the alternative tax will never exceed 11.5 percent of the total capital gain (61.5 percent maximum exclusion minus 50 percent exclusion available in all cases), the exact amount cannot be determined until the taxpayer computes his tax and his effective rate is known. For this reason, this tax preference cannot readily be integrated into the Limit on Tax Preferences, which is determined at an earlier stage in the tax computation.

The intent of the Limit on Tax Preference proposal is to make certain that a taxpayer will not be able to use the preferences beyond 50 percent of his income calculated without allowance of such preferences--an amount that might be referred to as his economic income. Thus, if a taxpayer has other preferences equal to or in excess of his taxable income, he will not pay tax on 50 percent of his economic income if he is allowed the benefit of the alternative tax under which he includes in adjusted gross income, in effect, less than one-half of his capital gains. On the other hand, if a taxpayer's taxable income exceeds his tax preferences, he would be paying tax on more than 50 percent of his economic income other than capital gains, and therefore he could be allowed in this circumstance the benefit of the alternative tax computation to a proper degree without violating the principle of the LTP proposal.

Treasury recommends that for taxable years beginning after December 31, 1969, in lieu of repealing the alternative tax, a limit be placed upon the amount of long-term capital gains to which it can be applied. The excess of the long-term capital gains over the limit should, after applying the 50 percent exclusion, be taxed at the ordinary rates (but at a rate not less than 50 percent applied to the 50 percent included portion). Thus, the amount by which the excess of the net long-term capital gain over the net short-term capital loss exceeds the limit would be taxed, after applying the 50 percent exclusion, at the graduated rates by including the full 50 percent includible portion in the taxpayer's adjusted gross income without the benefit of the alternative tax computation (except that the lowest graduated rates so applied would be not less than 50 percent).

The limit on the availability of the alternative tax would be four times taxable income adjusted in the following manner:

(a) Increased by the itemized deductions disallowed under the Allocation of Deductions,

(b) Reduced by the sum of:

(i) Allowable tax preferences (as defined for purposes of the Limit on Tax Preferences) in excess of $10,000 (the 50 percent capital gain exclusion would not be considered a tax preference for this purpose), and

(ii) Included capital gains (*i.e.*, 50 percent of the excess of the net long-term capital gains over the short-term capital losses).

If a taxpayer's allowable tax preferences (other than the 50 percent capital gain exclusion) do not exceed $10,000, the limit on the amount subject to the alternative tax would be deemed to be not less than $140,000 if married and $85,000 if single (under the Treasury's proposed rate schedule). A taxpayer would be permitted to carry over to the next succeeding five years the unused portion of his limit on the alternative tax for any taxable year.

For the first five taxable years ending after December 31, 1969, the unused limit on the alternative tax computation, if any, would be computed on the basis of the taxpayer's taxable income for the preceding five years, even though this rule did not apply to all such years. However, the Limit on Tax Preferences would be taken into account to reduce taxable income for years beginning before December 31, 1969, as if it applied to such years. In effect, a simulated computation would be made with respect to years beginning before December 31, 1969, to determine the carryover as if these provisions had been in effect.

The application of this limit on the availability of the alternative tax may be illustrated (for taxpayers filing joint returns) by the following examples:

*Example 1:

Dividends		$110,000
Long-term capital gain		250,000
Adjusted gross income ($110,000 + 1/2 of $250,000)		235,000
Taxable income		235,000
Limit on amount subject to the alternative rate		
Limit on alternative rate taxable income	$235,000	
Included capital gains	125,000	
	4 x $110,000	440,000
Tax computation		
Alternative tax on capital gain (25% x $250,000)		62,500
Tax on taxable income other than capital gain ($110,000 - married, filing joint return)		47,380
Total tax		$109,880

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

*__Example 2__:

Dividends		$ 35,000
Long-term capital gains		250,000
Adjusted gross income ($35,000 + 1/2 of $250,000)		160,000
Taxable income		160,000
__Limit on amount subject to the alternative rate__		
Limit on alternative rate (4 x $35,000)		140,000
Capital gain subject to alternative tax		140,000
Amount of capital gain included in adjusted gross income to which alternative tax will apply [one-half of $140,000]		70,000
Amount of capital gain included in adjusted gross income--to which alternative tax will not apply [one-half of ($250,000 - $140,000)]		55,000
Amount of taxable income to which alternative tax will not apply [$160,000 - $70,000]		90,000
__Tax computation__		
Alternative tax on capital gain (25% x $140,000)		35,000
Tax (married, filing joint return) ordinary income ($35,000)	$ 9,380	
**Capital gain of $55,000 (tax on $119,000 minus tax on $64,000)	29,740	39,120
Total tax		$ 74,120

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

**Capital gain in excess of limit is taxed at progressive rates, the lowest of which is 25%. Since one-half of gain is included in income, the lowest rate for the computation must be 50%. Hence the computation must assume an ordinary income element of $64,000, which is the point at which a married taxpayer reaches the 50% bracket.

*Example 3:

Dividends	$ 65,000
Long-term capital gain	300,000
Adjusted gross income ($65,000 + 1/2 of $300,000)	215,000
Taxable income	215,000
Limit on amount subject to the alternative rate	
Limit on alternative rate (4 x $65,000)	260,000
Capital gain subject to alternative tax	260,000
Amount of capital gain included in adjusted gross income to which alternative tax will apply [one-half of $260,000]	130,000
Amount of capital gain included in adjusted gross income--to which alternative tax will not apply [one-half of ($300,000 - $260,000)]	20,000
Amount of taxable income to which alternative tax will not apply [$215,000 - $130,000]	85,000
Tax computation	
Alternative tax on capital gain (25% x $260,000)	65,000
**Tax (married, filing joint return) on $85,000 (dividend income of $65,000 plus capital gain of $20,000)	33,540
Total tax	$ 98,540

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

**Since the $20,000 of capital gain is taxed at the marginal rate of 50% or above, it is not necessary, as in example 2, to assume a hypothetical ordinary income in order to compute the tax on the portion of capital gain which is taxed at progressive rates of 50% and higher.

3. Holding Period of Capital Assets (Sec. 514)

Under existing law, capital gains on assets held for more than six months are considered long-term gains. The House bill lengthens the holding period to 12 months. Treasury recommends that the six months holding period be retained. In addition, we recommend that the provisions of the bill changing the holding period for timber under existing law be eliminated.

4. Casualty Losses Under Section 1231 (Sec. 516)

Under present law, uninsured losses from casualty or theft of property used in a trade or business, or property held for the production of income, are deductible from ordinary income. The bill provides that all casualty gains and losses, whether or not insured, are to be consolidated, and if losses exceed gains, the excess gives rise to an ordinary loss. If the gains exceed the losses, the excess is consolidated with other section 1231 gains and losses. However, the bill, apparently through a drafting error excludes from this treatment capital assets which are neither used in a trade or business nor held for the production of income (*i.e.*, personal capital assets).

Treasury recommends that casualty gains and losses on personal capital assets be included in the consolidation of casualty gains and losses. Treasury believes this was the intention of the House bill and that the exclusion of such gains and losses was inadvertent.

5. Transfer of Franchises (Sec. 516)

Under present law, the tax treatment of the transfer of franchises has been uncertain. Some such transfers have been treated as sales, resulting in capital gains, and some have been treated as leases so that payments to the transferor are treated as ordinary income. The bill denies capital gain treatment to the transfer of a franchise if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise.

Treasury recommends that the criteria for determining whether capital gain treatment will be denied the disposition of the franchise be broadened to include the method of payment. Thus, the term "significant power, right, or continuing interest" would include a right to continuing payments unless such payments are to be made only for a specified period which is substantially less than the useful life of the property and which in any event is less than 20 years.

Sec. 521--Real Estate

1. Recapture of Depreciation

The House bill provides that with respect to sales of depreciable real estate at a gain after July 24, 1969, accelerated depreciation taken after July 24, 1969, in excess of straight line depreciation will be recaptured as ordinary income to the extent of such gain. Thus, the percentage reduction under existing law in the amount recaptured, based on the period the asset has been held, would be eliminated.

Although more favorable depreciation is provided under the House bill for new residential housing than for other buildings, no difference is provided under the recapture rule. It appears that application of the same recapture rule tends to reduce materially the stimuli to new residential housing intended by the House bill.

Treasury recommends that there be a percentage reduction in the amount of excess depreciation recaptured with respect to sales of new residential housing in the hands of the original owner. The percentage reduction, however, should be stretched out over a substantially longer period than that provided in existing law. The full excess of accelerated over straight line depreciation should be recaptured with respect to sales within the first ten years, at which time the percentage reduction would begin at the rate of one percent per month. A sale after the fourth month of the nineteenth year of the taxpayer's holding period would thus result in no recapture.

Treasury recommends further that the recapture rule of existing law be retained without change for certain Federally-assisted projects under the so-called FHA 221(d)(3) and FHA 236 programs. These programs provide a limited return to investors of 6 percent, this low rate of return having been based on the existing favorable tax treatment. It is inappropriate to change this treatment unless and until Congress acts to increase the allowable return.

The revised recapture rules of section 1250 would apply under the House bill to all depreciation attributable to periods after July 25, 1969. It is suggested that the effective date be changed to apply to depreciation taken after December 31, 1969. This would provide a simpler transition rule comparable to the effective date provision used when section 1250 was first enacted.

2. Foreign Housing

The House bill reduces accelerated depreciation allowances for certain real estate investments. New real estate other than housing would be limited to an amount not in excess of the amount allowable under the 150 percent declining balance depreciation method. Housing was excepted from the limitation in order to foster our national housing goals. As drafted, however, the House bill would allow the benefits of 200 percent accelerated depreciation in respect to housing constructed both in the United States and in foreign countries. Treasury recommends that the 200 percent depreciation allowance be available only for housing constructed in the United States or its possessions. The same transition rule for existing commitments as is contained in proposed section 167(j)(3)(B) (which would be added by section 521(a) of the bill) would be provided.

Sec. 531--Cooperatives

Additional 30 Percent Requirement

Under present law, cooperative organizations are permitted to reduce their taxable income by the amount of "qualified" patronage dividends distributed to members. This requirement is satisfied if a "qualified" written notice of allocation is distributed and if 20 percent or more of the amount of a patronage dividend is paid in money or by qualified check.

The House bill imposes an additional requirement in order for a written notice of allocation to be treated as "qualified." The bill provides that an additional 30 percent (phased-in over a 10-year period) must be paid to patrons either: (1) with respect to the current allocation; or (2) in redemption of prior allocations by the cooperative for any taxable year.

The additional payout requirement will result in complexity and administrative difficulty. The House bill provides that the requirement may be met either: (1) by an additional cash payment on account of the patronage dividend for the current year; or (2) by redemption of any prior qualified written notice of allocation by the cooperative for any taxable year. The following problems illustrate the difficulty of this rule.

Since the cooperative is allowed a period of 8-1/2 months after the close of its taxable year within which to pay a patronage dividend, a payment could be made by a fiscal year cooperative after April 15 (the patron's calendar year filing date) of a given year which the cooperative might allocate to a written notice of allocation issued by the cooperative prior to the end of the previous calendar year. This would thereby qualify a previously issued notice which had not yet otherwise been qualified, and which would then be taxable to the patron for the prior calendar year even though his return had already been filed. This could not occur under existing law where the 20 percent cash payment requirement must be satisfied at the time the written notice is issued.

Similarly, the cooperative might satisfy the additional 30 percent payout requirement by redeeming prior written notices of some patrons and not others. The bill contains no requirement that redemptions be made on a pro rata basis. As a result, written notices of allocation could become qualified, and become income to patrons, although some patrons receive more cash in relation to their allocations in a given year than others.

For example, a cooperative on a calendar year basis might pay patronage dividends of $1,000 each to Patrons A and B on March 15, 1970 ($200 in cash and $800 in written notices of allocation). The cooperative at that time might also pay $600 in cash in redemption of prior years' written notices of allocation held by A, thus qualifying the written notices issued to both A and B, though A received $800 in in cash and B only $200. In fact, the cooperative might instead pay only $300 in redemption of prior years' notices held by A but apply this to B's current written notice of allocation so that B would be taxed currently but A would not (since the additional 30 percent payout requirement would not be deemed satisfied with respect to A).

Treasury has considered whether better rules could be developed with respect to the additional 30 percent payout requirement but has concluded that the 15-year payout requirement, when fully effective, will be sufficient in and of itself to assure adequate annual payments to patrons. Thus, the complexities of the additional 30 percent payout requirement are unnecessary and the requirement should be deleted.

Sec. 601--State and Local Obligations

1. Subsidy for Taxable Issues

Treasury recommends that the provisions in the House bill providing an election to state and local governmental units to issue taxable bonds and for payment by the Federal Government of a percentage of the interest yield on such taxable issues be deleted. The Administration is developing an alternative provision which will be submitted to the Congress in due course.

2. Arbitrage Obligations.

Some states and localities have used funds received from the issuance by them of tax-exempt bonds to purchase higher yield taxable securities. Since municipal governments are not subject to Federal income taxes, the interest received is not taxed in their hands; the issuer thus profits in an amount equal to the spread between the tax-exempt interest paid and the higher interest received on the higher yield taxable securities. The House bill deals with this problem by providing that an "arbitrage obligation" shall not be entitled to tax-exempt status. The definition of an arbitrage obligation is left to regulations.

Treasury supports the objective of the bill to deny tax-exempt status to state and local bonds issued in a true arbitrage transaction. However, Treasury recommends that the bill be amended to provide a rule which may be easily understood and applied and which furnishes a clearer standard to be followed in the regulations. Treasury proposes that an obligation be considered an "arbitrage obligation" if, under regulations prescribed by the Secretary or his delegate the circumstances (including but not limited to the terms of the obligation, the specified purpose of the issue, the nature of the security provided for the obligation, and all other relevant facts) demonstrate that the result of the issuance is the realization of an arbitrage profit from reinvestment of the proceeds in higher yield securities other than governmental obligations to which section 103(a) of the Code applies.

The provision, however, should contain explicit authority for the regulations to treat temporary investment of the proceeds of an issue in higher yield securities as not constituting an arbitrage transaction where substantially all of the proceeds of the issue are used within a specified period for other purposes, such as construction of new government facilities. Similarly, authority should be given to provide that obligations issued to refund obligations then outstanding which are not themselves arbitrage obligations will not be arbitrage obligations if the refunding is completed within a stated period.

Further, explicit authority should be given to exclude from the definition of an arbitrage obligation any obligation the proceeds of which are used to provide permanent financing (mortgage funds) for family housing, sports facilities, or other exempt activities specified in section 103(c) of the Code. No limit is placed in the Code on the issuance of tax-exempt bonds to construct governmental facilities which may in fact produce a profit from operation. The same considerations justifying the blanket exemptions from industrial revenue bond treatment apply with respect to funds used to provide mortgage financing for the construction of such facilities. The exception should only be available if the yield received on such mortgage obligations does not substantially exceed the interest yield on the obligations of the state or local government. Further, a limitation should be included making the exception inapplicable with respect to such obligations of the state or local government for any period for which they are held by the mortgagor (see, for example, section 103(c)(7) of the Code).

Sec. 704--Amortization of Pollution Control Facilities

1. <u>Definition of a Certified Pollution Control Facility</u>

The House bill provides for five-year amortization of the cost of a "new identifiable treatment facility" construction of which is completed after December 31, 1968, or which is acquired after that date. There is no differentiation between pollution control facilities which are added to existing plants and those which are incorporated into new plants constructed after that date. In general, the cost of modifying an existing installation for pollution control is greatly in excess of the cost of incorporating such facilities into new construction. The impact of pollution control laws will thus be more severe on existing plants where the need for such devices is the greatest. A special incentive for installation of pollution control facilities in new plants constructed in the future subject to pollution control laws seems unnecessary.

Treasury recommends that the benefits of this provision be limited to pollution control facilities added after December 31, 1968, to plants which were in actual operation on that date. In addition, the definition should be further limited so as to exclude any facility which serves any function other than pollution control.

The intent of this provision of the bill, as shown by the Committee report, is to assist those industries which add pollution control devices to correct or reduce pollution now being released directly in the course of manufacturing operations. It has been suggested that the bill could be construed to extend this rapid amortization privilege to primary fuel processors, such as an oil refinery, which add facilities to remove pollutants from fuels sold to customers. The bill should be clarified to limit the provision solely to installations which prevent or minimize the direct release of pollutants into the air or water in the course of manufacturing operations and to exclude any facilities which tend to remove from fuel certain elements which upon burning would cause pollutants to be released.

2. Amortization Basis

The five-year write-off provided by the House bill, when applied to property having a long useful life, is a considerably greater tax benefit than the 7 percent investment credit. For instance, for property with a 50-year life, the five-year amortization is approximately equal to a 20 percent investment credit. This provides too great a tax benefit and makes the benefit vary too greatly dependent on the normal life of the equipment.

Treasury recommends that the five-year amortization be limited to:

(i) the adjusted basis of property with a normal useful life of 15 years or less; and

(ii) in the case of property with a longer life, the proportionate part of the adjusted basis which is represented by the first 15 years of the normal useful life of such property.

In this latter circumstance, the taxpayer would commence depreciation of the remainder of the basis in the sixth year over a period of time equal to the remaining normal useful life. The taxpayer would use any method of depreciation otherwise allowable under section 167 of the Code, as though the remaining basis represented the cost of a separate item of new property acquired on the first day of the sixth year.

Sec. 801-805--Adjustment of Tax Burden

Treasury recommends several changes in the provisions of the bill relating to the adjustment of the taxes paid by individuals. Treasury also recommends certain changes concerning computation of tax by the Internal Revenue Service for persons electing this treatment, withholding provisions, and other related matters. Finally, Treasury recommends a tax reduction for corporations. No changes are recommended with respect to the 50 percent maximum rate on earned income (Sec. 802) or the new rate schedules for married persons (Sec. 804).

1. Low-Income Allowance

The bill adopts the Treasury proposal for a low-income allowance designed to eliminate from the tax rolls persons with income at or below the poverty levels, effective for 1970 and subsequent years. Under the Treasury proposal the allowance was to be reduced by 50 cents for each dollar of adjusted gross income over the maximum tax-free income. The bill eliminates this "phase-out" after 1970, thus in effect converting the low-income allowance (in combination with the existing minimum standard deduction) into a minimum standard deduction of $1,100 for each taxpayer for 1971 and later years.

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Treasury recommends that the "phase-out" be retained but liberalized so as to provide that the reduction in the low-income allowance be 25 cents for each dollar of income above the maximum tax-free income. This would be effective for 1970 and subsequent years.

2. Standard Deduction

The bill increases the present 10-percent standard deduction and $1,000 ceiling to 15 percent with a $2,000 ceiling in three stages: 13 percent and a $1,400 ceiling in 1970; 14 percent and a $1,700 ceiling in 1971; and 15 percent and a $2,000 ceiling for 1972 and subsequent years.

Treasury recommends that in lieu of these increases, the percentage and dollar limitations of the standard deduction be increased to 12 percent and $1,400 effective for 1971 and subsequent years. There would be no increase for 1970.

3. Single Persons

The bill extends the "head-of-household" tax rates to all single persons 35 years and older and to widows and widowers, regardless of age. In addition, the bill extends for an unlimited period the joint return privilege now granted for two years to a surviving spouse maintaining a home for a dependent child.

Treasury recommends that the extension of the joint return privilege for surviving spouses beyond two years be eliminated. In lieu of the extension of head-of-household rates to all widows and widowers and single persons age 35 and over, Treasury recommends that for 1971 and subsequent years the single person s rate schedule be reduced so that a single person (whether under or over age 35) will pay a tax that is no more than 20 percent greater than the tax paid by a married couple with the same taxable income. In addition, the head-of-household rates would be adjusted (for persons who qualify for that status under present law) so that they fall, as they do now, approximately halfway between the new single persons rate schedule and the married persons rate schedule. To accomplish the foregoing, the following rate schedules representing the rates when fully effective in 1972 and later years would apply (somewhat higher rates would apply for 1971 reflecting roughly the same tax differential from the married persons tax burdens applicable for 1971):

Taxable Income Bracket	Regular Rate Schedule	Head-of-Household Rate Schedule	Intermediate Rate Schedule
$ 0 - 500	13%	13%	13%
500 - 1,000	14	13	14
1,000 - 1,500	15	15	15
1,500 - 2,000	16	15	16
2,000 - 3,000	18	17	18
3,000 - 4,000	18	17	18
4,000 - 6,000	21	19	20
6,000 - 8,000	23	20	22
8,000 - 10,000	27	22	24
10,000 - 12,000	30	23	26
12,000 - 14,000	34	25	28
14,000 - 16,000	37	27	30
16,000 - 18,000	40	29	32
18,000 - 20,000	42	31	34
20,000 - 22,000	44	32	35
22,000 - 24,000	47	34	37
24,000 - 26,000	47	36	37
26,000 - 28,000	49	38	42
28,000 - 32,000	49	40	42
32,000 - 36,000	50	43	47
36,000 - 38,000	50	45	47
38,000 - 40,000	52	47	52
40,000 - 44,000	52	48	52
44,000 - 50,000	54	51	54
50,000 - 52,000	58	53	58
52,000 - 60,000	58	53	58
60,000 - 64,000	60	55	60
64,000 - 76,000	60	55	60
76,000 - 80,000	60	55	60
80,000 - 88,000	61	57	61
88,000 - 100,000	61	57	61
100,000 - 120,000	62	60	62
120,000 - 150,000	63	62	63
150,000 - 160,000	64	62	64
160,000 - 200,000	64	63	64
200,000 - 240,000	65	64	65
240,000 - 300,000	65	64	65
300,000 - 400,000	65	65	65
Over - 400,000	65	65	65

Married persons would use the regular rate schedule by determining the tax on one-half the income in the joint return and then doubling the amount of tax so determined, as under existing law. Single persons would use the intermediate rate schedule. It is not appropriate to eliminate the regular rate schedule and construct a new rate schedule for joint returns because married persons filing separately are not to be eligible for the intermediate rate schedule. Married persons filing separately will be required to use the regular rate schedule. This treatment is necessary to prevent married persons from arranging their affairs so as to have amounts of income on which, if they could separately use the intermediate rate schedules, the combined tax would be less than the amount payable on a joint return.

4. Repeal of the State Gasoline Tax Deduction

Present law permits an income tax deduction for state and local taxes levied on the sale of gasoline or other motor fuels. Treasury recommends repeal of this provision, effective for 1971 and subsequent years. Gasoline tax payments paid or accrued in carrying on a trade or business or for the production of income would continue to be deductible.

5. Liberalization of Filing Requirements

Present law requires an individual to file a return if his gross income is $600 or more. An individual over 65 is required to file if his income is $1,200 or more. The House bill made no change in these requirements although the Low-Income Allowance adopted in the House bill substantially raises the levels under which individuals will not be subject to income tax. Treasury recommends that the filing requirements be raised to the new nontaxable levels created by the Low-Income Allowance as follows: $1,700 for single individuals; $2,300 if married or over 65 ($600 if married and either spouse files a separate return); $2,900 if married with one spouse over 65; and $3,500 if married and both spouses are over 65. This proposal should eliminate filing of returns by approximately 5 million individuals.

6. Tax Computed by Internal Revenue Service

The bill authorizes the Secretary or his delegate to extend by regulation the election granted by section 6014(a) to taxpayers to have their tax computed by the Internal Revenue Service. Treasury recommends that section 6014 be amended to permit the Secretary or his delegate under regulations to extend this election regardless of: (1) the amount or source of his adjusted gross income; (2) his marital filing status; (3) the nature of credits claimed; or (4) his electing the standard deduction. This greater degree of flexibility will permit the Internal Revenue Service to extend substantially its program of assistance to taxpayers.

7. Withholding Provisions

Treasury recommends the inclusion of provisions authorizing the Secretary to promulgate regulations giving employers more flexibility in devising withholding systems to fit their particular needs. Thus, the Code should provide for regulations which permit "annualizing" of wages for this purpose and which authorize the Secretary or his delegate to approve other methods which would produce substantially the same amount of withholding as is required by sections 3402(a) or 3402(c) of the Code. The "annualizing" provision would permit the employer to: (a) multiply the amount of wages paid to an employee in the current payroll period by the number of such periods in the year, (b) determine the amount of withholding upon such annualized wages as if such wages constituted the actual wages for the entire year, and (c) determine the withholding for the current payroll period by dividing the amount in (b) by the number of payroll periods in the year.

Treasury also recommends that the existing problem of overwithholding with respect to nontaxable students who work only during the summer months (and any other nontaxable persons who work for only part of the year) be resolved in the bill. Such persons should be relieved of any withholding on certification by them to their employer that they: (a) estimate that they will have no Federal income tax liability for the current year; and (b) in fact had no Federal income tax liability for the preceding year. This could relieve as many as 10 million persons from unnecessary withholding. A substantial administrative saving to the Internal Revenue Service would result from the elimination of the necessity for issuing refunds in these cases.

Also, the Treasury recommends the inclusion in the bill of provisions which would authorize the promulgation of regulations prescribing conditions for voluntary income tax withholding with respect to amounts paid for services which are not "wages" as defined in section 3401 of the Code. The authority to withhold would apply in those cases in which both the person paying and the individual receiving such remuneration agree voluntarily to such withholding. This would simplify income tax payment for retired persons (or their survivors) receiving annuities, farm and domestic workers, recipients of payments under supplemental unemployment benefit (SUB) plans, and other persons receiving payments for services not now subject to withholding where they choose to agree voluntarily to withholding.

In cases in which a voluntary withholding agreement is executed, the remuneration covered by the agreement would be deemed to be "wages" for purposes of the Code provisions which relate to withholding on wages. Accordingly, the person paying the remuneration would be liable for timely payment to the United States of the amounts withheld. Further, the amounts withheld would be credited to the recipient of the remuneration as a payment against his Federal income tax liability. The provisions of the Code requiring information documents regarding wages paid and amounts withheld, and providing for penalties for nonpayment of withheld amounts, would be applicable.

The amount to be withheld would normally be computed on the basis of the regular withholding rates or tables. However, as in the case of mandatory withholding, the recipient could request the withholding of additional amounts. Voluntary withholding agreements could be entered into whether the remuneration paid related to present, past, or future services.

8. Withholding Rate Schedules and Optional Tax Tables

Treasury recommends that the bill incorporate the annual withholding rate schedule into the Code. This will eliminate any question as to the proper amount of withholding which could be derived from various combinations of rates and wage brackets. These schedules will provide a clear basis for all other withholding rate schedules and wage bracket withholding tables.

Treasury also recommends that the optional tax tables be incorporated into the Code by the bill. This will also serve to set forth specifically the amount of tax imposed under any method of tax computation adopted by the taxpayer.

9. Reduction of Tax on Corporations

Under present law, the corporate tax rate is 48 percent on taxable income in excess of $25,000 (without regard to the income tax surcharge). The rate consists of a 22-percent normal tax rate imposed by section 11(b) of the Code (applying to all corporate income) and a 26-percent surtax rate imposed by section 11(c) (applying to corporate income in excess of $25,000). Thus, corporations are taxed at a 22-percent rate on their first $25,000 of taxable income and at a 48-percent rate on the taxable income above that amount.

Treasury recommends that section 11(b) of the Code be amended to provide that the normal tax rate in the case of a taxable year beginning after December 31, 1970, would be 21 percent and that section 11(c) of the Code be amended to provide that the surtax rate in the case of a taxable year beginning after December 31, 1971, would be 25 percent. The combined corporate tax rate for 1971 would thus be 47 percent, and for 1972 and subsequent years it would be 46 percent.

Section 963(b) of the Code (relating to receipt of minimum distributions by domestic corporations) should also be amended to provide for new minimum distribution tables to reflect the change in corporate tax rates for taxable years beginning after 1970. For taxable years beginning in 1971, the following table would apply:

If the effective foreign tax rate is (percentage)--	The required minimum distribution of earnings and profits is (percentage)--
Under 9	82
9 or over but less than 17	78
17 or over but less than 25	75
25 or over but less than 31	68
31 or over but less than 35	62
35 or over but less than 38	50
38 or over but less than 40	36
40 or over but less than 41	24
41 or over but less than 42	13
42 or over	0

For taxable years beginning after 1971, the following table would apply:

If the effective foreign tax rate is (percentage)--	The required minimum distribution of earnings and profits is (percentage)--
Under 9	81
9 or over but less than 17	77
17 or over but less than 24	74
24 or over but less than 30	67
30 or over but less than 34	61
34 or over but less than 37	49
37 or over but less than 39	35
39 or over but less than 40	23
40 or over but less than 41	12
41 or over	0

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